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INSIGHT

Are Technology Stocks Too Expensive?

By C WorldWide Asset Management Fondsmaeglerselskab A/S.

Technology and internet shares ("Connected Lives") have been on a tear and have been the sector leading equity markets higher. For instance, in 2017, US technology shares rose almost double compared to S&P 500, which rose 22% in USD. Does this mean that technology stocks have risen too fast and are overpriced, thus arguing for a lower portfolio allocation? In the following, we will argue why technology shares still deserve a sizable weight in a global portfolio. Technology stocks are not created equal, and we highlight what in our opinion characterizes a winning technology and internet company.

Technology stocks are not created equal

There are big differences between technology companies, and the sector is not a homogeneous group. This is, in part, due to the winner-takes-all phenomena driven by the network-based business models which creates a self-reinforcing virtuous cycle for the market leader. This is the reason why the market leader typically ends up with a high market share, and we get an oligopolistic or even monopolistic market structure.

Another factor is the degree of differentiation. Some areas within technology are fairly commoditized. This is typically the case within the hardware sector, where scale and strong balance sheets are needed to stay ahead of competition. Here, margins are typically low. Conversely, the software companies typically have a more differentiated product which can be sold with higher margins. Finally, we have the internet companies and cloud companies, which we thematically frame as "Connected Lives". Here some companies succeed in becoming platform companies, where Google, Amazon, Facebook, and Alibaba are prime examples. A platform company enjoys the benefit of a highly leverageable business model with more open-ended business opportunities and an extremely low marginal cost of providing the product or service.

When we search for exposure to technology and stocks within "Connected Lives", we prefer the platform companies, as they more or less control their own destiny with very high barriers-to-entry and thus long-term highly profitable business models. Typically, the product or services these companies offer makes our everyday life easier. That is why they are so attractive and therefore less prone to the ups-and-downs of the business cycle. we choose to invest in the more capital intensive typical or more cyclical part of the technology sector, we focus on the clear market leader that has a balance sheet and scale to be a cost and technology leader.

Valuation goes hand-in-hand with strength of business model

When valuing a technology or a "Connected Lives" company, it is necessary to assess each company case by case as the business models are so diverse. Actually, a company valued at a P/E of 20 can be expensive, just as a company trading at a P/E of 100 can be considered cheap. The platform companies often trade at a higher earnings multiple as the duration of the business model or the so-called "competitive advantage period" can be very long.

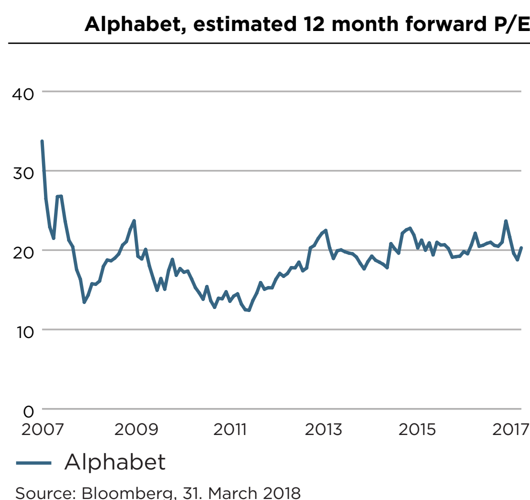
Many commentators focus on select companies that have a high current P/E-multiple and claim that the technology sector is overpriced or is in a bubble territory. Generally, we don't agree with this point of view as the outlook for many companies are supported by structural tailwinds as more and more of our consumption, be it product purchases or entertainment, moves

online. But again, the true conclusion is found at the individual stock level.

Consider three of the prominent so-called FANG stocks; Facebook, Amazon, and Alphabet (Google). Below we depict the current and historical P/E-valuation of Alphabet and Facebook. As can be seen, a few years ago, Facebook was trading at an earnings multiple of 40-50 times. However, as growth has been very strong (around 40% annually), the P/E-multiple has fallen as earnings have grown more than the share price has increased. Furthermore, Facebook is a platform company that benefits heavily from the network effect – the more users it has, the more attractive it becomes for other people to join – which is why Facebook is close to being a social network monopoly. Alphabet's P/E-multiple has for several years been trading around 20 times, which is close to a market multiple, despite the company's historical growth trajectory of around 20%. Alphabet together with Facebook are the primary beneficiaries of the tectonic shift from offline to online advertising.

Figure 1

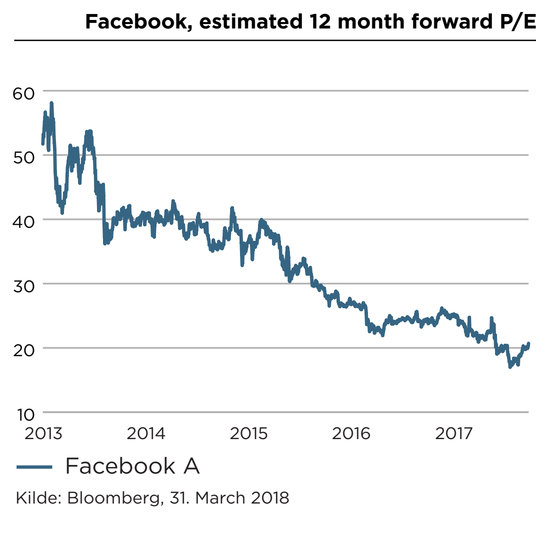
Alphabet, estimated 12 month forward P/E



Source: Bloomberg, 31. March 2018

Figure 2

Facebook, estimated 12 month forward P/E



Kilde: Bloomberg, 31. March 2018

On the other hand, Amazon is trading at a P/E above 300 times, which by normal standards is considered extremely expensive. Still, we don't think Amazon is an overly expensive stock as the multiple can partly be attributed to Amazon investing its vast amount of cash flow to benefit from the long-term opportunities. In addition to being a retailer, Amazon is a marketing platform, a delivery and logistics network, a payment service, a credit lender, an auction house, a major book publisher, a producer of television and films, a fashion designer, a hardware manufacturer, and a leading provider of cloud server space and computing power with a market share of +30%. Today, Amazon is most likely the company with the largest addressable market globally, which is why the company is investing so heavily, thereby depressing current earnings. One way Amazon creates barriers-to-entry is by investing in its distribution network while they tie-in customers with the popular Prime membership, which offers customers a high value proposition when staying-on the Amazon platform. Read more about Amazon in our White Paper: Amazonification.

The bigger companies tend to get bigger

So, to decide whether a company is expensive or cheap, you need to undertake a company specific assessment and to make your own judgement about its prospects. As shown, technology and "Connected Lives" are not a homogeneous group of stocks. We have a long-term preference for the platform companies as they have a scalable business model, high margins, and typically strong market opportunities. That said, these companies typically have a beta above 1, and the more commodity-like the business model, the higher the beta. This means, if equity risk premiums rise, when investors become risk averse, these stocks will typically suffer more than average.

Currently, a critical issue is the risk of increased regulation in the aftermath of the Cambridge Analytica scandal. More focus around treatment of personal data is inevitable as has been demonstrated by the newly enacted legislation around personal data in Europe. Regulation can curb companies' opportunities and put a cap on the long-term growth potential. However, new regulation will probably hurt smaller companies hardest, as the biggest have the financial strength to withstand these challenges.

We live in a world with increased political interference in the corporate sector, constant innovation of new technology and business models, combined with the growth of a new, stronger and more affluent middleclass consumer in emerging markets. Change is therefore constant which creates both threats and opportunities. As an active investor, we strive to find the long-term winners. This requires insight and patience. We navigate our portfolios by carefully selecting, monitoring, and refining our stock selection based on an analysis of global themes and trends. Technology and "Connected Lives" are supported by structural growth trends and are themes that can be rewarding for the long-term investor. You can follow our investments on cworldwide.com.

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