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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH as at September 2015.

Apple's EU tax bill

Apple attracted headlines not solely for the launch of its new iPhone 7 this month, but also for an eye-popping €13bn tax bill from the European Commission. The EC ruled that the 'sweetheart deal' struck between the Irish Government and the US tech giant was illegal. Apple and the Irish Government have both defended their actions and promised to appeal.

Certainly, there is little doubt that this was an attractive deal for Apple. The Company paid an effective corporation tax rate of 0.005% in 2014 on its European profits. The question is whether the furore could damage Apple's bottom line and/or its brand.

We believe that the issue may finally help push US Congress to agree on the terms of its Repatriation tax deal. When agreed, this would allow US companies to bring back profits into the US at a reduced corporation tax rate. If it is reasonable, money currently residing overseas could flow back into the US, and potentially fuel higher dividends, share buybacks and support merger and acquisition activity. Nevertheless, Apple will have to acclimatise itself to paying a tax rate of 15-20% rather than zero, but it could get a tax credit against its EU bill.

We do not believe there will be brand damage. Apple is simply following a script that has been widely used by other companies. Intellectual property is moved into an offshore subsidiary that pays lower taxes. These lower taxes apply unless the money is brought back onshore. Companies have been doing this for some time: Apple may be a high profile target, but its brand is unlikely to see much of a dent. Its share price has so far been unmoved by the furore.

A technology M&A boom

Technology is currently a hot spot for merger and acquisition activity, but not always for the reasons people might think. Yes, there are big companies buying new and innovative companies to support their growth, but there is also considerable consolidation in certain, lower growth, parts of the market. This latter type of deal is epitomised by the semi-conductor industry.

Growth rates across the semi-conductor industry are relatively low: there is little operational leverage and little potential for organic revenue growth. At the same time, the cost of debt is extremely low. This has seen a wave of deals: Avago, for example, has bought a couple of smaller companies, such as Broadcom. It has borrowed to buy, securing interest rates of 6% and below, then aggressively cut costs after take-over and now plans to raise prices to pay back the debt. This has proved an effective model to grow earnings.

Inevitably there is still merger and acquisition activity among higher growth companies. In some cases higher growth stocks have been marked down significantly over the past few months, either because the growth rate has slowed, or the market has focused on profit as opposed to sales growth. In 2013, the revenue to market capitalisation was as high as 17x for some of these companies; at their low in February, it was less than five.

For companies looking for lines of growth, this presents an opportunity. This was the catalyst behind the Salesforce.com/ Microsoft bidding war for LinkedIn, or for Demandware and Adobe, and for many smaller companies. For the aquiree company, it can be a good way to stem some employee restlessness, at a time when they might not have seen their share options grow for some time.

We believe any repatriation of foreign earnings to the US could fuel further merger and acquisition activity in the technology sector. Equally, currency may also be a spur for some companies, as it was in the deal for UK-based Arm holdings.

and this part of our portfolio is performing well. This includes companies such as Apple, IBM or Qualcomm. Income from treasuries is still at rock-bottom levels and investors are hungry for income. This trend is just as marked in the technology sector as it is elsewhere.

The US election – a boom time for advertisers?

It will not have escaped investors' notice that there is an election imminent in the US. While we would not seek to call the result or comment on the candidates, it does have some implications for the stocks in which we invest. In particular, between the Election, the Olympics and the European Football Championships, there had been an expected surge in advertising, particularly in television and Facebook advertising.

Historically, election years have been a boom time for the advertising industry, but this time, they've been disappointed. This has a number of reasons: Donald Trump hasn't had to pay for a lot of media coverage, managing to create it on his own, while Hillary Clinton, perhaps recognising that television isn't her strongest media, also hasn't been running a lot of advertising. It certainly hasn't generated the boom people thought.

This has exaggerated the existing problems at many of the listed TV networks, which have already been contending with a shift from television to online video. Many networks are struggling to generate any growth at all and have seen their share prices come under increasing pressure this year.

Samsung woes

With an exploding battery on the Note, one of its flagship products, and an ensuing product recall, it has been a difficult few months for Samsung. Nevertheless, we have used this as an opportunity to top up a little for the trust. Almost all the mobile companies have been forced to do product recalls at one point and there are plenty of reasons to believe Samsung should recover well from this shock.

A number of carriers have been offering 'sweetener' deals to get people to switch carriers. This has helped generate demand for phones. The Samsung Galaxy, which is the main competitor to the iPhone 7 hasn't had any problems. At the same time, many people are happy with the Note and it is generally well-reviewed in spite of its problems. Samsung has decided to replace the whole phone rather than just the battery, which customers like.

Samsung understands the problem and knows how to fix it. It will be expensive, but this is reflected in the Samsung share price. Ultimately, it may even help its market share because the refurbished Notes will be available on the market at a discount. We believe Samsung will come out the other side.

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