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Investment Insights from Silicon Valley

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*Source: Allianz Global Investors GmbH.

Disrupted disrupters

The past few months have seen some difficult times for some of the globe's most 'disruptive' companies: lawmakers, competitors and regulators have bitten back, and in some cases threatened to derail their nascent business models.

No-one would expect the path of a disruptive company to run smoothly. After all, existing businesses will do all they can to protect themselves. As a disrupting company gets larger and they start creating problems for more competitors, those companies employ their strongest defence mechanisms. These might be anti-trust legislation, as we've seen with Google and Apple in the EU, or the taxation of Amazon and Facebook (all holdings in our trust).

In our experience, if companies are wise they will play ball. Amazon, for example, initially didn't pay any sales tax – it lowered prices and that was a significant incentive for customers to use it. It then saw rising irritation by individual US states, who were losing sales taxes. Amazon realised it would have to pay more to prevent punitive legislation. It was a complex issue but a solution was found by management team.

However, this isn't universally true. There are other companies that take the view that as long as they are benefiting the consumer, they are untouchable. This is a dangerous position. Regulators will start looking at whether their presence is actually good for the long-term interests of consumers - healthy markets require competition. If a company is building a foothold in a number of different markets and has ambitions to be a large company, then it is a good idea to work with regulators and customers, and figure out a way to guide the business over time.

Most 'disruptive' companies find a way to deal with this. Some have learnt the hard way. Microsoft's initial dealings produced some branding issues. However, ultimately it resolved these issues and built a more durable company as a result.

De-equitisation and IPOs

Partly as a result of teething problems among the 'unicorns' (those companies with a private valuation of over £1bn), and partly as a result of over-valuation relative to the public market, relatively few high profile IPOs (Initial Public Offerings) have come to market in 2017. Those that have come to market have struggled, which in turn has made investors more sensitive about valuations and less inclined to support IPOs. The problem has become circular.

There has also been a long-term trend of 'de-equitisation' – shrinking public equity markets, with fewer companies becoming public and M&A (Mergers and Acquisition) activity reducing the overall stock of equity. At the same time, there is plenty of capital flowing around private markets and many companies have preferred not to subject themselves to the scrutiny of public markets. Many have the capital they need to grow, are generating a lot of cash and therefore don't need the extra resources a public listing would provide.

This is particularly true when companies realise it may necessitate a change in strategic direction. Some companies aim to follow the same policy that they've followed when they are private with growth as the most important metric. It hasn't always worked. This gives some of the 'unicorns' a bit of a pause, prompting them to look harder at how forgiving the public markets are going to be.

Having said that, it is not a permanent state and it is only a matter of time before the best models start becoming public. Private markets will eventually become more discriminating and investors will increasingly value the checks and balances they provide.

A new iPhone (or three)

To great fanfare, Apple has unveiled its iPhone X – a celebration of 10 years since the launch of the first iPhone. The X model isn't available until November. In the meantime, iPhone fans have to be content with the new 8 and 8+ models, and demand to date has been weak. It is difficult to judge whether this is a significant problem for Apple yet and at the moment, we're reserving judgment on whether the replacement cycle will be as strong as before. Is the price of the phone too high for the features on offer? Is demand genuinely weak, or are users still waiting for the X model?

The question is always whether there is enough in the new phone to prompt people to upgrade. It certainly addresses some of the perennial gripes with the existing iPhones – the glass is harder, the battery life is longer and there are new applications, with facial recognition the biggest headline change as this provides improved security. The question is will this be the catalyst consumers need to upgrade?

Emerging markets versus development markets?

It used to be that developed market stocks attracted a higher valuation because, in general, business models and governance were superior. As such, they were thought to offer more investor protection and greater durability. However, with technology companies today, that isn't necessarily the case. There is a real question mark, for example, over whether China's Alibaba may have a more effective model to Amazon. Amazon coordinates logistics, but doesn't do them itself. Alibaba, on the other hand, is self-sufficient enabling increased control and lower margins. Equally, governance is improving among many emerging market companies that aspire to an international presence and, in many cases, is of similar standards to US companies.

As it stands, many of the Chinese internet giants have higher growth rates for a lower valuation multiple. Companies such as Alibaba have caught up somewhat with US valuations, but there is still a discrepancy. That said, Alibaba doesn't have anything similar to Amazon's Echo yet and has only just started to move into Cloud technology. We own both, believing it will be interesting to see how the market develops.

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