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Outlook for the technology sector in 2015

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Lead Manager, Allianz Technology Trust. With over 40 years of experience of investing in technology companies, Walter Price has witnessed the evolution of the technology sector from the birth of the personal computer to the arrival of the internet and now the shift to cloud computing. Based in San Francisco, giving him close proximity to many of the world's most innovative companies, he heads up the Global Technology Team which manages US$4.4billion* in assets.

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*Source: Allianz Global Investors GmbH as at Nov 2014. This is no recommendation or solicitation to buy or sell any particular security.

Walter Price, Manager of Allianz Technology Trust, provides his outlook for the technology sector in 2015 and reviews the top technology trends of 2014.

Key themes for 2015:

1. The major IPOs of this year will be in the area of 'sharing apps' – Uber, Airbnb and Lyft are moving closer to IPO and look set to command significant valuations. These are exciting technologies, but our participation will be governed by the valuations at which these companies come to market.
2. We are optimistic on higher growth companies at the moment. In 2014, the more 'optimistic' valuations were quashed by the market. Those companies with chunky revenues, but without the earnings growth to match, saw their valuations slide. Markets have preferred those companies with lower valuations, but more clarity on earnings – Apple or Microsoft, for example. As a result, there has been a convergence in valuations, and higher growth companies look relatively more attractive at the start of 2015.
3. Security we believe will continue to be a major theme in 2015: It is just getting started and companies are still only in the early stages of adjusting to the various threats presented by a new, more sophisticated, breed of hacker.
4. Although software as a service is well-established as a trend, it remains under-penetrated. Companies are just starting to realise the flexibility and cost-efficiency outsourcing can provide. In 2014, this trend went mainstream, in 2015, we believe it will break out.
5. Technology is likely to have a profound effect on the media and advertising market in 2015. The ability to measure effectively is replacing 'gut feel' advertising with clear science. TV advertising will come under greater stress, but for Internet advertising – which can be clearly measured and targeted – it could be a strong year.
6. The resurgence of Apple has been one of the biggest stories of 2014 and all eyes will be on it again in 2015. It had an extremely good product cycle – revenues topped $42bn in the quarter, its strongest growth in almost two years. It had strong share price growth in 2014, and we believe it will be very hard to replicate this success next year.

2014 – a year in review

The biggest event in 2014...

Technology companies grabbed more than their fair share of headlines in 2014, with a number of high profile IPOs and mega-deals, plus the emergence of important new trends such as security. However, the Alibaba IPO must take the prize for the most significant technology event of the year.

Its size alone made it noteworthy: The IPO raised $25bn on the New York Stock Exchange. However, there was more at work: It was a clear indication of the globalisation of technology, and demonstrated comprehensively that an emerging market-domiciled company could compete on equal terms with its international peers.

In many ways, Alibaba has proved itself a better and more mature company than many of its US-listed peers. Its business model may ultimately prove superior to rivals such as Amazon: Alibaba has delivered astonishing growth in profitability and it has significant balance sheet strength. Its model works well for both buyers and sellers, the pricing and product variety is better, and the company delivers greater economies of scale.

The company is also led by a competent and enlightened management team. Nowhere was this more visible than in the IPO process itself: The management team cared deeply that investors made money as well, which has not been the case with every high profile IPO this year. They weren't simply venture capitalists out to make a buck, but the management team assessed those investors who would be genuine long-term holders of company stock. For us, it demonstrated that Chinese entrepreneurs often have a little something special and certainly, that there is no monopoly on technology genius in the US.

The hottest deals...

Technology was a hotbed of merger and acquisition activity this year as corporate confidence improved. These deals fell into three main types: Firstly, there were defensive deals, where companies saw a threat to the long-term strength of their business and made acquisitions to defend their position: For example, Facebook responded to the success of WeChat, owned by TenCent in China, with the $20bn acquisition of mobile messaging service What's App. It is widely speculated that Facebook will use WhatsApp's messaging platform to develop a money transfer service, as it is unlikely that Facebook could develop this service on its own.

There were also deals whereby private equity groups would take over cash generative, but broken technology businesses. These are companies that are not growing, and without a clear path to future growth, but with reasonably strong cash flows that can be leveraged.

Finally there were marriages between old and new. A legacy technology company understands that it needs a presence in certain markets, but cannot take the business risk – or the hit in earnings - to build that presence itself. They look to buy it, seeking out innovative new technology groups, which may be hungry for funding. Perhaps the best example of this is SAP. SAP has surrounded its core ERP software with software-as-a-service products, which it can sell to its installed user base. In this way, it doesn't have to take the hit of starting again from scratch. SAP can, to some extent, protect its legacy business. Competitor Workday has an expense management system as part of its finance management product, and certainly some firms will choose to take the packaged solution. However, SAP has reasoned that plenty of its clients do not want to negotiate a full-scale change and there will be some for whom this add-on solution works better than starting over.

Legacy technology provider of the year...

At the start of 2014, many legacy technology providers were on the cusp of a business critical transformation. They either made the transition to the cloud effectively, or their business suffered a lingering death. Over the year, some are notably further along in that transition than others.

Microsoft has undoubtedly come furthest in its journey. At the other end of the scale are companies such as IBM, which have a uniquely difficult legacy and where share prices have struggled. In contrast, Microsoft can reasonably claim to have made its transition to the cloud. This year it has become the biggest seller of cloud services to business customers, outpacing even established cloud names such as Salesforce.com.

Admittedly, cloud services still represent a relatively small part of Microsoft's business, but this year has seen it release a free version of Office to Apple iPad users. Office in the Cloud means that users can now share documents from any device. This is good for customers.

Microsoft's transition to the cloud also has some welcome knock-on effects. Piracy has been a huge problem for Microsoft, particularly in emerging markets where software may be stolen and distributed on the streets. It is estimated that only around half of the Microsoft accounts have been paid for through the proper channels. The move to the cloud, and away from disk-based software, eliminates this problem in a stroke. This may be why the Chinese government is investigating Microsoft's competitive position.

Microsoft still needs to adjust to the end of its near-monopolistic position, but it has shown itself to be more flexible than some many had predicted. As such, it certainly stands out as the legacy provider who has made the most progress in 2014.

Exciting new technology of the year...

If the success of a company can be measured in the panic in which it induces in its competitors, Uber, Airbnb and other 'sharing economy' apps are surely the most exciting new technologies of the year. Taxi drivers across Europe have gone on strike in protest at Uber, which allows travellers to hail cabs by simply tapping on their iPhones. Airbnb may prove similarly disruptive for hotels.

These companies use the internet to create a whole new wave of competition for old industries. As such, many have become extremely valuable in a very short space of time. The latest round of fundraising valued Uber at $40bn, for example. The benefits for the consumer are clear, as these apps are hugely innovative.

Industry trend of the 2014...

Security was the all-pervasive trend of 2014 and remains one of the highest growth areas of technology. In 2014, the dark side of the Internet was exposed: There are dangers to everyone being connected. It makes it easier for criminals to reach targets and to exploit those targets once found.

The security breaches over the year have increased in severity and magnitude. Major retailers such as Home Depot and Target have proved vulnerable, but there have been more complex and innovative attacks: Mt. Gox, the largest repository of bitcoins in Japan saw millions of dollars-worth of bitcoins stolen to the extent that it destroyed the company. No-one could trace the perpetrators.

The cost to companies is significant and for CEOs who neglect the problem, it can be career-destroying. The CEO of Target mishandled the problem and it cost him his job. Many have rightly concluded that they need to implement a whole new level of security. We still consider that security could be a major threat to the development of the Internet. Companies have to re-think their security; they can't simply assume it's a benign world out there. This is a strong tailwind for companies such as FireEye or Palo Alto Networks.

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