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# Investment Insights
from **Silicon Valley**

www.rcmtechnologytrust.co.uk

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With over 40 years of experience of investing in technology companies, Walter Price has witnessed the technology sector improve user productivity through the revolution in semiconductor design, the birth of the personal computer and the arrival of the internet. 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 billion* in assets.

## Technology earnings

**When the higher valued technology stocks sold off in March and April, the key to their revival or otherwise was always likely to be earnings. As it was, many of the bellwether technology groups either hit or beat consensus expectations in the April earnings season.**

Amazon's results were an important indicator for many. It grew revenues to $19.74bn in the first quarter of this year, an increase of 23% over last year. It reassured the market that growth was still there for the online retailer and that the group had put its weaker fourth quarter behind it.

Facebook also reported a promising first quarter, generating profits of $642m, ahead of analyst expectations. The strength of mobile advertising was key in pushing revenues higher and it now makes up 59% of all advertising on the social networking site.

Even among the lower growth legacy technology groups, there were signs of improvement. Cisco, for example, said pressures on revenues were easing. Sales in the current quarter were likely to be between 1% and 3% behind last year, which is ahead of expectations and shows a marked slowing in the group's decline. It suggests Cisco could return to earnings growth sooner than many expect.

Against this backdrop, and with some stocks around 30-40% off their highs, we think valuations once again look more reasonable, in aggregate across the technology sector.

*Source: Allianz Global Investors Europe GmbH as at December 2013. This is no recommendation or solicitation to buy or sell any particular security.

### Where to avoid?

That said, the sell-off in technology stocks has most acutely impacted those companies without the substance to support current valuations. Those companies that have not hit earnings targets, or where there are doubts about their long-term business model, have been hit hard and are not yet showing signs of recovery.

Perhaps the most glaring example of this is Twitter, which is some 60% from its highs. It was one of the few technology groups to report disappointing earnings. Although it managed to double its quarterly revenue to $250m, it is still struggling to grow its active user base. Analysts had hoped for stronger than 25% growth to $255m. We did not participate in the Twitter IPO, believing that there were too many questions over its long-term strategy. We have yet to revise our view.

### Chinese internet

While many of the Western high growth technology names have seen their share prices revive from the lows of April, Chinese internet stocks have remained stubbornly low. Partly, we believe, this is down to the 'Alibaba' effect - the potential flotation of the Chinese eBay/Amazon hybrid is putting pressure on all global internet companies. The company seems determined to go ahead with its ambitious listing, and its high growth and good profitability mean that other groups look weak in comparison.

A number of Chinese technology companies are hoping to list in the US over the next few months, but the early signs are not promising. Twitter-equivalent Weibo managed to secure its listing in April, but only at a reduced valuation. It had hoped for more than the $285m it raised. Equally, companies that are already listed have seen their share prices suffer: Baidu, Youku Tudou and Sohu have all been hit.

Many Chinese companies are also suffering because efforts to compete outside their home market haven't been very successful: Baidu has tried in Japan with little success, for example.

However, despite this, we would argue that China is still the most exciting country outside the US for internet development. Companies such as Ten Cent prove that it is possible for Chinese companies to build distribution networks globally. It is simply a case of treading carefully, particularly in the current febrile IPO market.

## Palo Alto Networks

The recent rout in technology markets has provided some good opportunities to pick up favoured stocks that have been knocked back. Palo Alto Networks has been a notable company of interest, where we have used recent weakness to add to our holding.

The group provides provides security for corporate networks. A number of major security breaches, particularly for the large retail groups, have forced companies to scrutinise their own systems and ask whether they are robust enough to withstand tenacious criminals.

Palo Alto Networks is likely to experience some strong growth on the back of this generally benign backdrop for security groups. However, it is also committed to operating in a more streamlined and efficient way. It has ambitions to double its margins over the next two years. It has recently bought Israeli cyber security group Cyvera, which gives it expertise in so-called 'zero day' attacks, which expose previously unknown vulnerabilities.

At the moment, Palo Alto Networks is still the young upstart to larger rivals such as Cisco and Check Point. However, it has been taking meaningful market share from both these competitors and believes its technology is sufficiently differentiated to allow it to take more. Certainly it is adopting a new approach to firewall technology and the nature of the recent attacks suggests its approach may be the more effective.



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