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# Investment Insights from Silicon Valley

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## Walter Price

**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.

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

## The earnings season – the good...

This has been a volatile earnings season, polarising into the good - which have done extremely well – and the bad, which are now facing serious questions about their sustainability.

The flag-bearer for the 'good' companies has been Apple, which had a blow-out quarter. It is delivering vast earnings and generating tremendous cash. The management commentary also brought some positive surprises: Our view had been that the revenue strength was simply the existing users upgrading, but Apple said that new users had been just as important. We would like to see more evidence, but if that is the case Apple has a lot further to run.

Amazon also had a strong quarter. The company's sales were good, and the company saw profitability in the US in particular. Perhaps more importantly, investors started to feel better about the new investments made, having previously considered some of its new project choices a little frivolous. There seemed to be a renewed focus on the part of management on the returns to investors and capital allocation. The management team appears to have revised its previous view that it had unlimited funds and could spend as it saw fit. This is likely to make people a lot more enthusiastic about the shares.

The third group that did well was Netflix. There had been concern over one of its new flagship programmes – Marco Polo - which had received poor reviews. It turned out not to be a dud, with many users signing up for another season. Overseas sales, another source of concern, accelerated. Its profitability continued to improve and the shares saw a huge rebound.

## ... and the bad

The semiconductor industry was a notable weak spot. Micron Semiconductor had a good quarter, but its guidance was disappointing, suggesting that its output was slowing down. SanDisk said it didn't have enough capacity, prompting concern that the transition to new technology would not be smooth. This echoes the problems of other groups such as Samsung and Intel.

Microsoft also disappointed markets. Investors had been focused on its transition to the Cloud and how well that was going, but they started to worry about its core Windows and Enterprise businesses. Both disappointed this quarter and the group pushed down its overall guidance for 2015 as a result.

IBM was another disappointment. The company had weak sales and went as far as to suspend its guidance for the remainder of the year.

## Our conclusions

2015 is the year in which the cloud computing phenomenon will truly assert itself. To date, mid-sized companies have been relatively comfortable adopting cloud computing, but larger companies have been more reluctant. Certainly, some have done some development and testing work, but relatively few have committed to a wholesale switch to the Cloud.

These larger companies are now capitulating. The big pharmaceutical companies, for example, have now transferred around 5-10% of their workload onto the cloud and it is likely to accelerate from here. Even where companies are reluctant to move to a public cloud, such as in the banking sector, they

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are significantly reducing the number of data centres and operating a more cloud-like architecture.

This has significant implications for the legacy software and hardware companies. Previously they have managed to push upgrades by promising 10-15% productivity improvements. This message is no longer as compelling when companies could achieve a 50% productivity improvement by switching to a new architecture. We believe that the disparity in pricing between the two approaches will become increasingly hard for companies to ignore, making life harder for the legacy providers to retain customers. Notably, Amazon is on its 16th price cut for cloud services and a number of the banks are threatening to muscle in, creating greater competition.

Incidentally, this shift may ultimately generate significant improvements in corporate productivity, which in turn will act as a boost for the global economy. This might argue against a bearish interpretation of the US economic outlook.

## Death of the IPO?

Spotify recently hired Goldman Sachs to help it raise a new round of funding in the private market. It rejected talk of an imminent IPO, prompting analysts to comment that more companies may delay their IPOs while private money was so readily available. The IPO market has been buoyant, but we believe there are no reasons to fear for its health just yet.

Spotify certainly enjoys a higher valuation in the private market than it might attract in the public market, but this is unlikely to be its only rationale. It may be looking at the experience of Pandora, where shares have tumbled as the group cut its earnings forecast. Spotify's model requires it to have 50-100m subscribers before it makes money. This is higher than Pandora and still Pandora is struggling.

This is simply a reminder that the public markets are focused on earnings growth not revenue growth. If a company can't deliver that, it is better off staying in the private market. Spotify's management may have this in mind as it delays its IPO.

## The importance of share prices

A new focus on share price performance has been seen among technology companies. Previously, some technology companies seemed content to generate huge cash balances, leading investors to conclude that they didn't care very much about external shareholders. It is becoming increasingly clear that they do.

There is a good rationale for this: there is a huge global battle for good engineers. Engineers want to get their slice of the cake if they build a good product. Share options have been the best way to allow engineers to participate in the growth of the company on the back of the products they build. If the share price starts

tumbling, however, the engineer may defect across the street to Facebook to ply his trade there.

The situation for management is stark: If you can't support the share price, you can't recruit the right engineers. This is creating an increasing focus on shareholder returns, of which we should all be beneficiaries.

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