# Market Research #002

*This is the second in a monthly series of Independent research produced by the Murray Wealth Group Research Team. The purpose of this series is to provide insight into our portfolio construction and how our research shapes our investment decisions. We welcome any feedback or questions you may have on these monthly commentaries.*

## Why We Like The Technology Sector

Our Global Equity Growth Fund has a high concentration in the technology sector, with Alphabet (6%), Facebook (5%), Microsoft (4%) and Apple (3%) being core holdings. In addition to these four stocks, holdings in various other tech stocks, including Amazon and Netflix, make up an additional 10% of the portfolio, for a total weighting of 28%. Our focus for this piece is on highly-profitable Alphabet, Facebook, Microsoft and Apple; our analysis of Netflix and Amazon, which have not yet reached profitability, will be featured in a future mid-month piece.

As long-term growth managers, we like to own companies that can both increase their revenues at an above-average rate and translate those revenues into profits and excess cash after making the necessary investments to fuel their growth. Some investors and commentators are skeptical of these technology investments, arguing that valuation levels are too high and that excessive speculation means they should be avoided. We do not agree!

Let's examine some quick performance statistics for each of our focus companies.

| Revenue ($Billions) | Facebook | Microsoft | Google | Apple |
|---|---|---|---|---|
| 2013 | 7.9 | 77.8 | 55.5 | 170.9 |
| 2017 | 40.7 | 90.0 | 110.9 | 229.2 |
| 2020E | 86.6 | 127.0 | 181.7 | 279.8 |
| 2013-17 annual growth rate | 51% | 4% | 19% | 8% |
| 2017-20 annual growth rate | 29% | 12% | 18% | 7% |
| **Free Cash Flow ($Billions)** | | | | |
| 2013 | 2.9 | 24.6 | 11.3 | 44.6 |
| 2017 | 17.5 | 31.4 | 23.9 | 50.8 |
| 2020E | 26.9 | 42.3 | 39.8 | 69.8 |
| **Free Cash Flow/Revenue** | | | | |
| 2013 | 36% | 32% | 20% | 26% |
| 2017 | 43% | 35% | 22% | 22% |
| 2020E | 31% | 33% | 22% | 25% |
| **Financial Strength (2017)** | | | | |
| Cash (Debt) on Balance Sheet | 41.7 | 46.7 | 97.9 | 165.1 |
| Net Cash/FCF | 1.5x | 1.1x | 2.5x | 2.4x |

**Revenue:** Revenue for the group has grown at an impressive compound annual rate of 20% since 2013. Momentum is expected to remain strong, with growth in the 2017-2020 period expected to average 16% per annum (a bit lower than the prior period as revenue growth at Facebook is expected to slow from 51% to only 29%). We believe that these companies are well positioned competitively to continue growing at much higher rates than the economy for years to come. We would not be surprised to see growth in the 2020-2025 period similar to current rates.

**Free Cash Flow:** Free cash flow is how much cash is generated after capital investments and thus is available to pay dividends, make acquisitions and/or reduce debt. Evaluating the ratio of free cash flow to revenue provides a good high-level view of how profitable a company is after capital expenditures (how much cash equity holders accrue for every dollar of revenue). It is not unusual for high growth companies to experience negative free cash flow during years in which they are investing heavily in future growth. However, on average, these four companies generate free cash flow equivalent to about 30% of revenue, a very impressive level considering this cash is available after capital spending.

**Net Cash/Debt:** We include this metric to show that there is little to no financial risk in most of these companies. Both Alphabet and Facebook not only have no debt but have large stores of cash on their books. Microsoft and Apple are also still firmly in a net cash position, although they do have long-term debt, a function of the extremely low interest rates of the past decade and foreign cash/tax repatriation issues. If economic activity declines, all four can easily absorb any financial impact. More opportunistically, in market declines, they can use their cash to buy back shares or acquire new businesses at more attractive prices.

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Now let's compare these shares with some popular blue-chip equities to see how they compare from a value perspective. We have selected 3M Company and Johnson & Johnson, two large cap growth companies that trade at similar P/E multiples.

| **Revenue** | **Group Average ex AMZN/NFLX** | **MMM** | **JNJ** | **Notes** |
|---|---|---|---|---|
| 2013-17 annual growth rate | 20% | 1% | 2% | Tech Group growing at much higher |
| 2017-20 annual growth rate | 16% | 5% | 5% | rates 2017-2020 |
| **Free Cash Flow/Revenue** | | | | |
| 2013 | 29% | 13% | 19% | Tech Group demonstrated better |
| 2017 | 30% | 15% | 23% | ability at turning revenue into cash |
| 2020E | 28% | 16% | 25% | flow |
| **Financial Strength (2017)** | | | | |
| Net Debt/FCF | -1.9x | 2.3x | 1.6x | Tech companies have lots of cash, not so for 3M/JNJ |
| **Valuation** | | | | |
| FCF Yield | 5.85% | 3.30% | 3.10% | |
| P/E | 19.02 | 21.10 | 15.00 | |
| P/CF | 14.15 | 15.42 | 12.75 | |

Our tech peer group shows better financials results, both over the last five years and forecast through 2020. They will generate greater revenue growth, are more profitable on a free cash flow basis and have sounder financial footing. For 3M and Johnson & Johnson, 2.3 and 1.6 years of free cash flow, respectively, are required to reduce debt to zero, while the tech group has net cash balances today.

On the valuation front, the group screens attractively versus our two comparators in terms of their free cash flow yield (the ratio of free cash flow to market value). The tech peer group also compares favourably on traditional metrics like P/E and P/CF. Given the positive comparison, we believe it is reasonable to value our tech peer group at a premium to both 3M and Johnson & Johnson. Their demonstrated ability to grow revenues at rates of 15%-20%, combined with their ability to convert sales into free cash flow provides conviction to our overweight position in the sector.

So just how risky are these companies on a standalone basis? Not very! Facebook, Apple, Microsoft, and Google all have strong growth rates both on an historical and forward-looking basis, have been converting sales into free cash flow at a great rate and have strong balance sheets. We continue to find valuations very attractive and believe our investors will do well holding these stocks in our portfolio over the longer-term.