Market Research #005

This is the fifth in a 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.

Reviewing the Technology Thesis

In late March, we published a research piece on why we like the technology sector and remain overweight the sector in our Global Growth portfolio, specifically the quattro of companies; Facebook, Apple, Alphabet and Microsoft (please see our report: Why we like the Technology Sector). We highlighted the reasonable relative valuations, high revenue growth rates and strong free cash flow generation as the three pillars of our investment thesis. Qualitatively, all these companies are benefitting from a secular shift to internet-based revenue that should withstand any downturn in the economic cycle; Microsoft through its cloud computing division, Facebook/Alphabet through online/mobile advertising and Apple through increased services revenue (although sales of iPhones are still the main revenue driver).

However, investments are not without risks, and with additional scrutiny in the sector since we published our original piece, we decided to revisit our assumptions and determine which companies are more, or less, attractive. Below we update a table initially published in our first report with information as of September 11th in Figure 1.

Figure 1. Updated estimates September 2018 versus March 2018

in billions	2020E (April estimate)				2020E (September estimate)			
Company	Revenue ($)	FCF ($)	EPS	FCF Margin	Revenue ($)	FCF ($)	EPS	FCF Margin
Apple	279.8	69.8	14.26	24.9%	288.9	64.4	15.21	22.3%
Facebook	86.6	26.9	10.75	31.1%	82.7	22.8	9.51	27.6%
Google	181.7	39.8	56.46	21.9%	192.4	41.0	56.41	21.3%
Microsoft	127.0	42.3	5.12	33.3%	135.6	41.2	5.68	30.4%

**EPS = Earnings Per Share, FCF = Free cash flow, the amount of actual cash generated after capital expenditures and adjusted for non-cash expenses such as depreciation.*

Clearly, the big picture hasn't changed as these companies all continue to generate substantial revenue growth with strong free cash flow. However, the rate of growth in these metrics has shifted, substantially in some cases, which helps explain the relative performance of each company (Figure 2 illustrates the percentage difference in the metrics with the new estimates).

Figure 2: Change in share price and forward estimates

	Share Price		Change in		Change in		
Company	Mar-18	Sep-18	Share Price	Revenue	FCF	EPS	FCF Margins
Apple	168.34	223.85	33.0%	3%	-8%	7%	-11%
Facebook	157.68	165.94	5.2%	-5%	-15%	-12%	-11%
Google	1037.14	1177.36	13.5%	6%	3%	0%	-3%
Microsoft	91.27	111.24	21.9%	7%	-3%	11%	-9%

With new share prices and estimates, we present the current valuation levels versus March 2018 (Figure 3). For complete context, we included the new growth rates.

Figure 3: 2020E Valuation and Growth Rates

	2020 Valuation		Growth Rate (2017-20)		
Company	P/E	FCF Yield	Revenue	EPS	FCF
Apple	14.9	7.02%	6.9%	11.2%	15.7%
Facebook	17.5	5.07%	28.6%	15.4%	20.4%
Google	21.1	4.88%	17.9%	18.5%	20.5%
Microsoft	19.6	5.50%	12.2%	10.4%	15.7%

Company updates

While often lumped together, each of these companies has its own unique sets of opportunities and headwinds. However, each remain tremendously profitable and generates excess cash beyond what it needs to grow its operations.

Apple

In spring 2018, the street was concerned with iPhone sales after poor guidance from iPhone suppliers created fears surrounding demand for Apples products, specifically its higher priced iPhone X. Those fears were proven to be unfounded as the strength of Apple's last two quarters has sent the shares well into new high territory. The valuation has increased due to growing expectations for the company's services revenue (such as apps or advertising), which is more stable and recurring than device sales.

We trimmed our position into strength from 3% to 2.5% as ultimately, we believe there is a risk around its strong margins, given that technology hardware producers generally see margin pressure increase as the technology becomes commoditized.

Facebook

Facebook is facing increased regulatory scrutiny in Europe in the form of GDPR (General Data Protection Regulation) and media pressure to contain misinformation rampant throughout its Facebook property. As a result, user growth has slowed and the company is investing heavily in security/privacy measures at the expense of margins. We also believe user estimates for its Facebook property may be too high in the near term. While this transitory period has highlighted some of the weaknesses in its business model, ultimately, we see many positive factors benefitting the company longer term.

- Facebook remains the quickest and easiest way for small and medium-sized businesses to advertise with the highest IRR's in media.
- Facebook Watch, its streaming service, should increase retention as an option for consuming content.
- Its Instagram property is experiencing very strong growth and could improve with a rumoured expansion into direct retailing (likely in the form of a commission and payment processing fee paid by merchants).
- Facebook could launch its own dating service through Instagram and/or Facebook to take on Match/Tinder.

There is potential for monetization of its messaging platforms WhatsApp and Messenger. We have reduced our target weighting rom 5% to 4.5% to account for the near term transitory weakness in user growth; however, Facebook remains our third largest position in the fund.

Google

Google remains an enduring internet technology company that continues to see sturdy growth in its legacy Google properties (Google, Maps, YouTube) augmented by new platforms such as Google Cloud and its Waymo (self-driving car) division. Google Cloud remains a distant third after Amazon (AWS) and Microsoft (Azure, see below), but recent data points indicate a growing uptake among enterprise customers for Google's cloud services. The Cloud market could grow by 90% over the next three years, according to research from industry research firm Gartner, to reach US$110B. Alphabet currently holds just a 3% market share, and while it will likely never catch Amazon's 40 market share, its cloud revenue could turn into a true growth driver if it can take a growing piece of the pie. Its Waymo division has the leading position in its field and looks to test pilot projects in Arizona later this year. While in its infancy, if Alphabet can develop and become a significant player in this market, it could be worth hundreds of billions of dollars, according to Morgan Stanley.

Alphabet remains our largest holding in the fund at 6% target weighting.

Microsoft

Microsoft has undergone a tremendous transformation over the last five years under the helm of CEO Nadella. Microsoft has transitioned its client base to the cloud and is growing its enterprise cloud infrastructure web services (Azure) at very strong rates (~90% growth). Microsoft benefits from a high level of trust, particularly among large enterprise customer weary of providing Amazon (or Google) custody of its product, customer, regulatory or other sensitive data. Microsoft also operates data centers (the physical location containing the servers for cloud services) in twice the number of countries as Amazon and has built out almost 50% more capacity than Amazon (indicating confidence in future workloads). These additional workloads should come on stream at very, very high margins and help support Microsoft's newly expanded EPS multiple.

Microsoft remains our fifth largest holding in the fund at a 4% target weighting.