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Allianz Technology Trust PLC Update

Current market performance comment - bringing a focus on technology.

Walter Price
Portfolio Manager

Update from Silicon Valley—coronavirus and the tech market

I thought we would write our thoughts at this time on the Covid-19 virus and its effect on technology companies. This is a view from Silicon Valley. At this time, most businesses are shut down, and employees are working from home. The San Francisco Bay Area was the first in the US to go to a "shelter in place" rule, which means only essential businesses and facilities are able to stay open. Most tech companies, in fact most companies in the area, have gone to virtual workplaces, with heavy use of technology, including Zoom, Ring Central, Google, Cisco, and Microsoft conferencing or videoconferencing. The Bay Area is like a ghost town in most places – few people out, very little traffic, but there are long lines at the supermarkets.

As we think about the future, we need a model of the progression of the virus. The best model we have seen is from a Harvard Professor who postulates that the virus is doubling every 6 days and that the number of cases is about 50 times the reported ones in the US, where there has been little testing for anyone not showing symptoms. Using these numbers and the reported cases on the Johns Hopkins website, we calculated about 60,000 cases in the US last Friday. Taking that model, it would imply about 60 million cases in 10 weeks or in mid-May and perhaps 120m 6 days later. Under this scenario, that would probably be the time frame for a virus peak, and cases would start to plateau or decline from there. Of course, they could keep rising in the rest of the world, but that is a signpost. The virologist from Harvard predicted that 40-70% of the population would catch the virus in the next year, and I saw a doctor in Northern Italy quoted in the WSJ that 60% of the people in his town had it.

By utilising methods like the Bay Area has adopted, the curve of infection could be flattened, which means the peak would be lower and the spread would be more extended in time. Under this scenario, shutdowns and/or cautious behaviour would continue into the third quarter. However, once the cases peak, we think the market will stabilise and begin trending upward.

The earnings impact is pretty drastic on many tech companies. For example, we looked at the distribution of advertising revenues by industry at one of the leading online advertising platforms from the last breakout they gave in 2016, reduced the vulnerable industries like travel, most of retail, autos, etc. by 50%, and came up with an estimate that their revenues could decline by 20% from current estimates. This is enough to move earnings per share (EPS) from $15 a quarter to $5 a quarter. This is just a rough calculation on variable margins, but we are now guessing that the sequence might be $10, $5, $10, $15 (so $40 total) for EPS rather than the $61 presently estimated. The estimate for 2020 is probably better moved to 2021. In this market environment, when companies estimate lower earnings for the next quarter, their stocks fall sharply. The particular example we looked at is of a powerful company with lots of cash that we believe will show some weakness as EPS estimates are reduced, but that should be able to stabilise its stock with share repurchases. We think this shows the vulnerability of advertising models when businesses across the economy shut down – even those with high ROI can see a significant negative impact.

Of course, there are companies that will grow right through the crisis, as we expect many of our cloud companies with subscription models to do. However, in this environment, closing new business for growth will become more difficult for large transactions even with video conferencing usage. We assume many of these companies to show slower growth in 2021, but by then they will be growing their sales pipelines again. For example, Salesforce.com's stock bottomed in 2008 long before the growth rate in its revenues bottomed. Gaming companies and Netflix are seeing growth rates accelerate during this time, as are companies that enable remote, secure work like Citrix, Z Scaler, and the five communication companies mentioned above.

What we have done is rotate our portfolio out of some positions in the companies where we expect negative earnings surprises and into stocks in the favourable areas above. We have also raised some cash, but we understand that shareholders will not want us to go to very high levels there. Mostly we have refocused on the companies that we think will be benefitted by this traumatic event and will emerge stronger on the other side of the crisis.

There is no question in our minds that the present events will spur the use of technology and change how we work in the future. Virtual work is having a revival, and many employees are getting a crash course in making effective use of video conferencing. Companies are finding that is not so bad, and one CFO told us that he always suspected that they could reduce travel and still do well (Micron). The move toward "digital transformation", which was in the middle of adoption, will now happen faster and with more certainty. Ecommerce will become the majority of commerce, not the minority. So, we think most of our portfolio companies should have a decent 2020 and a great 2021.

A longer-term view

Financial markets have been particularly stressed over the past few weeks due to the fears around the global spread of the coronavirus. There is significant uncertainty over the severity and duration of the outbreak, the ability of governments to contain the outbreak, and about how the global economy will fare as factories, airports, stores, schools and entire cities shut down.

Central banks around the world are reducing interest rates in hopes of softening the economic impact, but investors are still concerned that further government fiscal policy moves will be needed to provide underlying support to the global economy. These fears will likely persist until green shoots begin to materialise in the form of slowing COVID-19 infection rates in the US and Europe. This could take several weeks since wide-scale city isolating is just beginning in several regions.

While it is too early to predict the ultimate economic impact of the coronavirus outbreak, we do believe some industries will be more severely impacted than others. With sharply lower interest rates, financials companies will be challenged to grow profits. Lower oil prices will have a negative impact across multiple industries in the energy sector, as well as some industrials companies that supply equipment to oil companies. Within technology, supply chain disruptions will have a meaningful impact on some hardware and semiconductor companies. However, as alluded to above, we expect companies associated with the digital transformation to hold up better than other segments in the economy. As companies adjust budgets due to supply and/or demand disruptions, there may be some delays in deal closings, but the need for companies to reduce costs should accelerate the move to cheaper and more productive solutions such as cloud, software as a service, artificial intelligence, cyber security, etc.

Additionally, we think the decline in interest rates makes equities particularly attractive as an asset class, and it should stimulate business and consumer spending over the long term. Companies providing the technology solutions mentioned above should see a meaningful benefit as these are dynamic and growing companies delivering products and services that solve real-world problems. Although further market volatility is possible in the near term, and earnings estimates will likely come down over the next few months, we believe the long term reward to risk ratio is now more attractive.

The recent market decline is certainly not pleasant, but we maintain our conviction in the long-term growth opportunity for these companies. The global digital transformation will continue to progress due to numerous cost and productivity benefits relative to traditional technologies.

For more Silicon Valley insights from Walter Price and the rest of the team, please visit www.allianztechnologytrust.com where you will find more information, including the interviews below:

Walter Price talks technology, coronavirus, and the upcoming US election with Mark Colgate of Asset TV (recorded 6th March 2020).

Proactive Investors interview Walter Price (recorded 6th March 2020).