Equity Research; Global tech rout; where next?

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INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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Nasdaq sell off, it has happened

- A sell off in US technology names is underway. The Nasdaq has retreated 4,000 points in 6 months and -27.61% from November 2021 highs. Tech names need stability and positive catalysts at Q2 urgently.

- US equities are normally driven by domestic factors with international issues a distant second. However, negative international factors in 2022 have reversed the sector role play. US energy stocks that spent years lagging tech indices have led US markets, whilst the tech peer group, that usually leads, have crashed. But investors are wrongly positioned for a role reversal. At end Q1 2022 the combined FAANG valuation was \$7trn vs the US energy sector at \$700bn – 1/10th of the top tier US techs (CNBC). There isn't a ramp for investors to exit techs.

- Valuation – few investors deny US techs were aggressively valued, some concede techs were 'bubbles', 'fair weather structures' created by low free floats/ investor, boardroom, company hype. At an intrinsic level, many techs could not stand up to conventional stock analysis because their valuations imply unrealistic forward growth rates. 'Mid-tier' US techs (>\$10bn market cap, i.e. Teladoc, Trade Desk, Snowflake, Zoom), at 2021 highs were 14x annual sales and collectively \$5trn, or 10% of total US market cap (Factset). This 'mid-tier' area has rightfully, been hardest hit with declines of >50% in c.77% of constituents.

- US President Joe Biden's priorities are inflation and jobs growth. Biden scores well on jobs, but poorly on inflation. Biden has talked up jobs but said little about US equities or US bonds allowing capital markets to decide. This is neutral for US techs. Biden will not berate the Federal Reserve or start trade wars, as Trump did, to no effect, or talk up equities.

- US techs have taken hits before- in November 2018 the FAANG group lost \$1trn in a sell off linked to slowing GDP and semiconductor shortages. Supply chain tightness is also evident in 2022, however the tangible difference is changing demand. The consumer is being hit by rising inflation and could cut/ delay discretionary IT/ software spending as a first response. More evidence on this is due at Q2.

Nasdaq Comp, the T-bond 'smoking gun' emerges

source: www.google.com

- The trigger is investors' re-appraisal of US inflation (April +8.3%) / Fed Funds outlook and a bond market re-pricing; the 10 YR yield +84% v S&P -17% v Nasdaq 100 -27%
- Higher inflation increases staff, marketing, admin, development expenses and reduces profits. Tech businesses, owing to their high multiples are sensitive to higher costs and reduced expectations.
- Can higher costs be passed on via tech pricing? IT pricing is normally a function of competition. One off price rises can hurt market share, it impacts customer acquisition/ increases churn and can result in lower volumes. IT hardware pricing naturally declines due to ageing. Tech is not like bus tickets or consumer goods that will rise over time.
- Was the 'tech boom' partly due to cheap money? *Sine qua non*. Yes. Techs could not resist the global bond sell off.
- End of the Fed's Greenspan 'put'. Given the context, the Fed cannot suddenly cut rates if equities decline. Without the Fed's perceived underwriting of losses, the downside risk has increased.

US Treasury 10 year bond v US S&P and Nasdaq 100

www.cnbc.com

Tesla / Twitter and Netflix – the tale of 3 tech companies

One of the US tech sector's foibles is it creates 'superman' personas along with 'personality cult' support structures, devotees whose belief system holds that 'superman' does no wrong. This creates large valuation premiums and lasting anomalies linked to both the persona and cult. But 2022 is all about 'hubris', who bears the risk of superman's whims? What happens when 'superman' makes a mistake? or is hostile to his cults' vested interests? What if any, are the coping mechanisms?

www.google.com

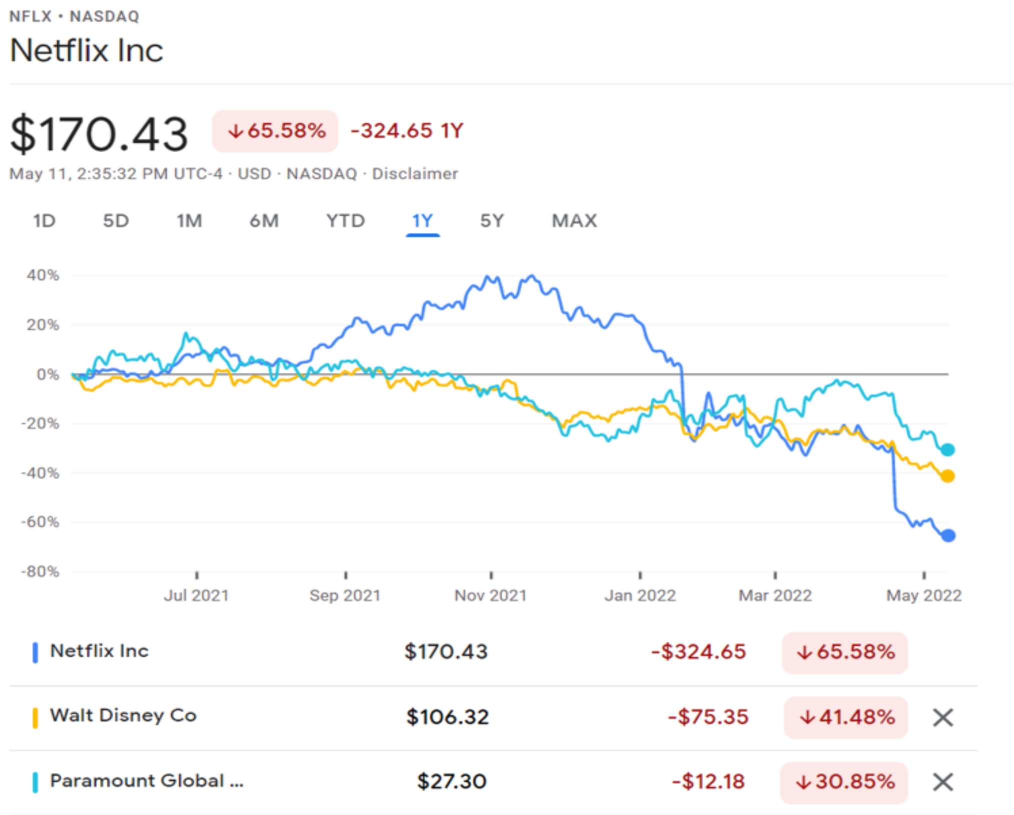
On 25th April 2022, Tesla Inc (TSLA) founder Elon Musk, the world wealthiest individual (c. $237bn) agreed to pay $54.20 per share / $44bn cash for Twitter – an offer rapidly accepted by Twitter's board. They had struggled to get Twitter profitable (FY21 revenues $5.1bn/ FY21 net loss $221m), (FY20 net loss $1.14bn) and had concluded 2023 goals were unobtainable. Attention shifted to how Musk would fund $44bn given his cash levels were a modest $3bn.

Elon Musk part funded the Twitter leveraged buy-out (LBO) using Telsa share sale proceeds- precipitating a 32.4% drop in Tesla shares. Did Tesla devotees deserve this? It was Musk's second overtly hostile act in 12 months. Over 2021 Musk sold 20.7m Tesla shares for $16.4bn (c. 5m shares were gifted) but due to a 22.8m Tesla share option award ($6.24 per share strike price) Musk ended 2021 with 2.1m Tesla shares more than he started. This is tapping shareholders at its finest. Their coping mechanism has been to 'sell' Tesla.

Why, given rising competitor EV challenges, has Musk opted for a new headache in a new industry? Twitter's structural problems will be worse with $16bn of new LBO debt v $6bn net cash now. Twitter is not generating the cashflow to support high debt. Musk's plan is back of the envelope stuff. He wants to increase the tweet word limit and move Twitter onto a subscription business, despite c. 17% of Twitter's 397m free users being willing to pay. A loss of subscribers would hit Twitter's $5.5bn- $6bn advertising revenues. The Twitter LBO has raised questions about Musk's weak M&A deal logic. Some suspect this is an expensive publicity stunt and Musk will abort Twitter soon.

Tesla's valuation at 105x P/E is still high against peers (Volkswagen AG 4.9x P/E) who are adding EV to their fleets and catching up. Tesla has cutting edge autonomous driving technology that has yet to be monetized. However investors need to price in that Musk's 17% stake will be mortgaged against Twitter, and his reputation has suffered. Will his cult following evaporate some more? The complexities have multiplied, so it is possible.

Streaming linked companies have de-rated considerably with market leader Netflix hardest hit. During Q1 the board lost c. 1% of the subscriber base. Whilst not catastrophic, the guidance is for further subscriber losses due to price hike linked cancellations. With $17bn in off balance sheet debt linked to program funding, the company is devising strategies to introduce advertising, cut spending, and tackle password sharing.



Netflix will meet tougher conditions with lower EPS growth. Investors assumed high streaming growth, but competitors (Apple TV, Prime Video) arrived, and the music stopped. Netflix de-rated from 50x P/E to 16x (-66%).

Conclusion;

Global tech is being re-priced, with persistent 'ratcheting down' and no signs yet of capitulation or stabilisation. This suggests investors remain weary of 'falling knives' and Q2 updates. Given the size of the tech sector, relative to alternatives, we are concerned about larger declines ahead. We do not expect improved economic nor geopolitical news soon. We suggest investors focus on 'value', low multiple stocks for now.

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