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Global Technology: market volatility update

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COVID-19 is clearly having a significant negative effect on the world economy and financial markets, including the technology sector. Away from the outbreak, the fundamental backdrop for the sector remains healthy, as many of the positive trends of recent years continue to drive the market. These include faster network speeds, capital spending on cloud data centres, and the continuing momentum of online commerce.

China remains centre stage

A host of global companies have issued warnings in recent weeks about the effect of COVID-19 on their operations, and the technology sector was no exception, as these included portfolio holdings Apple and Microsoft. Perhaps this should have been unsurprising to investors, given that the virus originated in China. The country has become crucial to the technology industry, as both a supply-chain partner and a source of revenue. (Apple derived about 15% of its sales from China in 2019's fourth quarter).

China has imposed measures such as travel restrictions in response, a problematic issue for technology firms. While activity seems to be resuming, Apple and Microsoft have shown that this process will take time. More positively, the number of coronavirus cases in China does seem to be levelling off.

Sector overview

While acknowledging the still imperfect information about the depth and duration of social distancing and its economic impact, followed by uncertainty about the slope of the recovery, we continue to go through the process of updating our models to reflect revised estimates and price targets.

Data Centre and PCs should hold up better than other areas – Enterprise data centre had been weak in 2019, so this area should not have to reduce estimates from peak levels. PC demand was thought to be weak but may likely improve as there should be a 'gearing up' phase where businesses and students need to buy additional PCs and monitors to work or study remotely from home. Meanwhile, Cloud should benefit from more daily activities moving online.

Enterprise networking spending is typically less volatile than other parts of Enterprise hardware IT. Governments may also consider pulling forward infrastructure projects like 5G and increasing size, similar to what China did in 2009 with 4G.

Wafer Fab Equipment (WFE) and memory are levered to computing and handsets and appear to be coming off trough levels in 2019. These companies should hold up better given some of the positive trends in computing and communication.

During the week ending 15 March, Broadcom missed its April guide and pulled the fiscal year 2020 guide due to H2, 2020 uncertainty, which was not surprising. The key uncertainty in the second half of 2020 is timing of the iPhone 5G launch to which management doesn't have good visibility and is taking a conservative stance. Broadcom's share price has been pressured as many investors see the company as a highly levered, M&A rollout with heavy exposure to Apple. While a lot of that was true historically and some of it remains true, that doesn't really capture the story. Today, Broadcom's business mix is more data centre / networking spending than handsets. Broadcom's recurring software revenue is 20% of sales, it has >70% gross margins, >50% operating margins, and around 45% free cash flow margin; it will return $10 billion in FY19 to shareholders, including $4 billion of dividends, and in FY20 is expected to grow its dividend (source: Bloomberg).

The company's leverage is not extreme, and management is committed to lowering its absolute level of debt. Broadcom looks more like a mature software company than a volatile semiconductor company and if management continues on the path of showing sales growth in software, growing free cash flow and dividends at double digit compounded annual growth rates, and reducing absolute debt level, we believe that the stock will follow.

Semiconductors were one of the technology markets laggards for the week ending 20 March, as earnings guidance was withdrawn at Lam Research during the week. On 16 March, multiple counties in California issued a 'shelter in place' order, which requires the company to temporarily stop on-site work at its Fremont and Livermore locations for three weeks. Additionally, Lam Research has supply chain activities in Malaysia, and on 16 March, the Malaysian government issued an order to close certain business activities. The implementation of these orders prevents the company from manufacturing products at its Fremont and Livermore (California) facilities and receiving required parts from key suppliers. These government directives may impact the company's ability to meet its March quarter financial guidance. The withdrawal of guidance negatively impacted other semi-cap names including AMAT and Teradyne, in our global technology portfolios.

Sector overview (continued)

In the near-term, mixed trends within computing remain strong, and 5G phones still should have a strong cycle, albeit later than previously expected, are among the reasons to believe that WFE spending should hold up relatively well. Against that, however, is an expectation that the economic impact caused by COVID-19 with a sharp downtick in economic activity in Q2, 2020 and Q3, 2020, will likely result in a pullback in both consumer and corporate spending, which will eventually impact the magnitude of WFE spending.

Long-term, we continue to like the WFE sector because it is a long-term sustainable business driven by growing semiconductor intensity in the economy with growing content and a broadening out of applications, such as Artificial Intelligence.

Logic/Foundry spending by Intel, Taiwan Semiconductor Manufacturing Company (TSMC) and the Chinese should also return on a strong secular footing, while NAND and DRAM spending should recover from trough levels to support growth in demand for electronics. In that context, we continue to see considerable upside to Lam Research over a long-term time horizon.

On 25 March, Micron reported earnings, gross margins and revenues at or above the high end of estimates. While the measured period ended prior to the global economy largely shutting down, management did see strength in data centres and PCs that have seen increased demand from the work / learn from home trend, which is helping to offset some of the weakness experienced in handsets, consumer electronics and autos. Micron has considerable leverage to computing, 5G and the positive inflection in NAND/DRAM pricing to help mitigate some of the negative economic impact of COVID-19. Micron should continue to benefit given its exposure to the secular trends of data centres, consumer gaming and e-commerce. Additionally, the memory sector's improving structural profitability should dampen the cyclical price volatility that has historically been associated with the sector. The team continues to monitor the supply / demand trends of the memory industry.

Outlook

While the COVID-19 situation remains fluid, we remain of the view that the coronavirus outbreak doesn't wipe out the long-term transformational technological trends of cloud computing, 5G, electric vehicles, streaming and cyber security for the next few years. We continue to monitor the situation and remain on alert for any significant disconnect between industry valuations and underlying fundamentals.

We remain committed to our time-tested and disciplined investment process, which relies on deep fundamental analysis to identify those companies that trade at attractive valuations and have the best growth prospects and the potential to deliver solid investment returns over time.