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A Montgomery White Paper

DECEMBER 2013

Tech Stocks: Seduction or Sound Value?

Outside the soaring newcomers, IRESS is also beyond fair value but it has a solid record and outlook.

By Roger Montgomery

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When newspapers refer to a “frenzy” in tech stocks and breathtakingly report on the latest tech wunderkind, you know it is time to block out even more market noise and strictly focus on company valuations. Being seduced by hype is a surefire way to burn money.

Remember the crazy valuations for tech stocks in the late 1990s and the insane spruiking that accompanied them? The latest boom is arguably a year – maybe two – from those heady days, and some new tech stars have substance and terrific long term prospects. But an expected rush of tech floats, soaring valuations, and over-zealous promoters are never good signs.

The emerging accounting software provider, Xero, is an example. One investment bank recently dubbed it the “Apple of Accounting” and suggested it could become a \$10 billion tech stock within five years, listed on the US Nasdaq Exchange. After its shares soared sixfold this year, Xero is capitalised at \$3.85 billion, or about 13 times the size of its well established, profitable rival, Reckon, and at least three times the size of MYOB, based on its acquisition price in 2011.

Xero has a big price tag for a loss-making company that has about a 4 per cent share of the small business market for accounting services in Australia. Undoubtedly, Xero has a lucrative position as accounting software moves from a desktop product paid for upfront to a monthly service via cloud computing. But its valuation is factoring in incredible growth in market share and revenue.

Freelancer is another highly valued tech stock. The internet float soared from a 50 cent issue price in November to as high as \$2.60, before easing to \$1.33, for a \$573 million valuation. It has a terrific position in the global micro-jobs sourcing market, a highly scalable business model, and forecast gross margins of 88 per cent. Even so, value investors would need a compelling reason to pay \$573 million for a company forecast to earn \$471,000 in FY13.

Xero, Freelancer and other fast-growth tech stocks might head higher for the balance of this year or next, such is the current fervour. But chasing loss-making companies with nose-bleeding valuations is speculation, not value investing. These valuations have no room for even the slightest disappointments in revenue or customer growth.

To put these prices in perspective, Xero’s valuation is more than twice that of IRESS, one of the highest quality ASX

listed mid-cap stocks and a terrific long term performer. IRESS, too, looks overvalued after strong price gains this year, but has a lot more substance than most tech stocks.

IRESS provides financial markets information and wealth management services to finance industries in Australia, New Zealand, South Africa, Asia and, increasingly, the United Kingdom. Chances are your full-service broker uses an IRESS terminal for sharemarket information.

The business excels on several fronts. Wealth management technology, once embedded in organisations, is highly “sticky” and has high switching costs to change vendors. These attributes, and the capital investment required to develop the technology, create barriers for new entrants.

Being seduced by hype is a surefire way to burn money

IRESS technology provides recurring, annuity-like income as financial professionals automatically re-subscribe for the information and wealth management services each year. Dependency on these services gives IRESS some degree of pricing power and earnings visibility.

Another attraction is scalability. IRESS has done a good job taking its intellectual property to other markets, without loading on debt or issuing highly discounted equity capital raisings that dilute existing shareholders.

The ability to grow globally is just as important. Almost 20 per cent of IRESS revenue comes from outside Australia and New Zealand, a proportion that should grow rapidly since the acquisition in September 2013 of Avelo, a leading financial technology provider in the UK.

These attributes invariably create a high quality company. IRESS is one of only 29 ASX-listed companies with the cherished A1 Montgomery quality rating. IRESS has been A-rated since 2004 and received the highest performance rating in seven of the past ten years.

Its return on equity (ROE) has hovered above 30 per cent for the past decade, debt is low, and operational cash flow has grown strongly. IRESS had no debt until the Avelo acquisition was funded, partly by the issue of \$170 million in new debt, which is conservative. Net debt will be \$111 million after surplus cash is also used to fund the Avelo deal. The IRESS balance sheet has scope for further acquisitions.



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Returns to 30 November 2013

Code		Change	Outperformance
MPF	The Montgomery [Private] Fund	39.17%	-
XNAJI	ASX 200 Industrials Accumulation Index	15.32%	23.85%
XTOAI	ASX 100 Accumulation Index	30.04%	9.13%
XJOAI	ASX 200 Accumulation Index	26.86%	12.31%
XAOAI	All Ordinaries Accumulation Index	23.74%	15.43%
XK0AI	ASX 300 Accumulation Index	25.20%	13.97%
XTLAI	ASX 20 Accumulation Index	35.29%	3.88%
XMDAI	ASX Midcap 50 Accumulation Index	7.39%	31.78%
XSOAI	ASX Small Ordinaries Accumulation Index	-18.06%	57.23%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

Minimum investment \$1,000,000

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IRESS's quality is well known to the market. It has an annualised average total shareholder return (including dividend investment) of 20 per cent over 10 years – an excellent result given sharemarket volatility during that time. Over one year to 28 November 2013, IRESS had returned 28 per cent, after strong price gains in the second half of the year. Not even the 2008 GFC, which dented demand for market information data screens, could stop IRESS's long term gains.

Has the market got ahead of itself with IRESS, as has been the case with so many other tech stocks this year?

But has the market got ahead of itself with IRESS, as has been the case with so many other tech stocks this year? IRESS's ROE, almost 31 per cent in FY12, fell to 24 per cent for the interim FY13 result and is expected to hover around 20 per cent for the next two years, based on the consensus of nine analyst earnings forecasts.

Declining ROE is never a good sign. After comfortably exceeding 40 per cent between 2003 and 2006, IRESS's ROE has drifted lower, despite total shareholder equity remaining fairly constant until FY12. Declining ROE is often a precursor for declining intrinsic value and a lower share price.

Montgomery Investment Management values IRESS at around \$8.50 per share. Compared to a \$9.83 share price, IRESS is about 15 per cent overvalued.

IRESS traded around \$6 at its 2012 low and just above \$7 in July 2013. Then it raced to as high as \$10.38 as investors became more bullish about the wealth management industry's prospects.

Although IRESS has recurring revenue, demand for its information services is affected by the cyclical nature of the wealth management industry. A rising sharemarket over

12 months and more fund managers finally having positive net fund inflows has boosted wealth management stocks. Combined with its UK deal, IRESS has quickly returned to market darling status.

The Avelo acquisition looks like a good long term move. It gives IRESS a strong footprint in the financial services technology market in the UK, and is expected to be more than 10 per cent earnings-per-share accretive in 2014. Regulatory change in the UK financial services industry has created an opportunity for IRESS, by boosting demand for technology that helps investment providers with reporting and compliance.

IRESS has scope for stronger long term growth in the UK, South Africa and Asia as it rolls out its technology platform or potentially acquires businesses. But there is a threat of rising competition for market data and from specialist wealth management technology providers.

On balance, IRESS has some powerful tailwinds in the coming decade: continued mandated growth in wealth management industries as Australian and overseas investors contribute more to their retirement savings; potential to enter fragmented offshore markets, many of which are a long way behind Australia in terms of financial services regulation, compliance and disclosure; and continued regulatory change and higher demand for technology reporting services.

Combined with a high-quality company, an excellent business model, and a strong management team, IRESS has a platform for long term sustained earnings growth and share price gains. But unless there is a significant change in its earnings outlook, IRESS is overvalued on a short-term view.

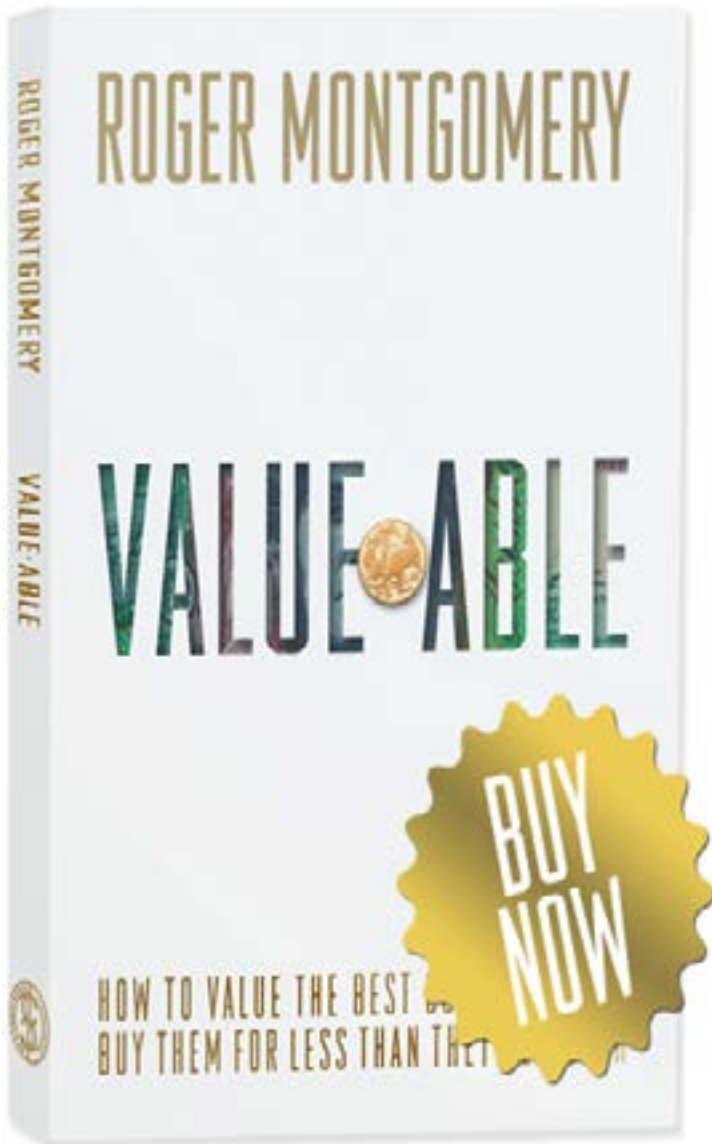
Even so, IRESS is not nearly as overvalued as sexier technology companies that have seduced the sharemarket with their global growth aspirations, scalable business models, and rampant insurgency in established industries. IRESS, at least, is an exceptional company over a long period, as determined by profits and performance, not potential or promise.

The challenge is buying IRESS at a bargain price – rare in companies of its quality – or at least closer to fair value.

The Montgomery team wishes you a wonderful Christmas and new year. We look forward to sharing our next subscriber-only white paper with you in 2014.



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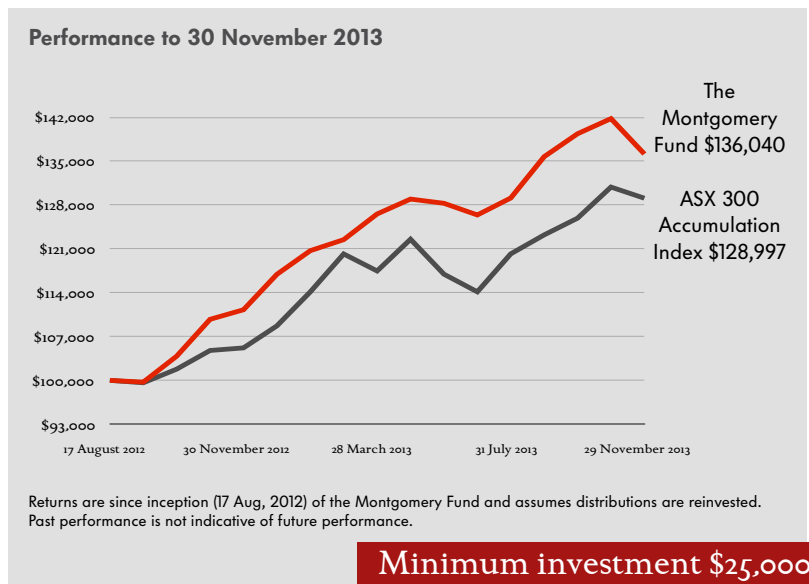
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