SECTOR GLOBAL TECHNOLOGY

The makings of greatness

With its huge e-commerce market, China is busy creating the Amazons and Facebooks of the future

There has been a lot of buzz around American technology stocks and the so-called "FAANG" (Facebook, Amazon, Apple, Netflix and Google). Most of these high-performing tech companies have hit all-time high share prices. Given the recent excitement, it is important to remember not to expect to generate outsized returns if one overpays for an asset – no matter the quality of this asset.

The emergence of dominant businesses such as Alibaba, Facebook and Tencent stems from a truly great business model: the online technology platform (OTP).

We believe there are four major sources of advantage for owners of OTPs:

1 SCALE

Research and development, sales and marketing and capital investments can be spread across a larger base of revenues stemming from the cumulative sales of the entire ecosystem. Furthermore, the platform's bargaining power over vendors will be larger than that of any single individual business from within the ecosystem.

2 DATA

The owner of the platform has sole access to the data generated by all of the users, applications and/or services within the ecosystem. Such data is critical for designing intelligent and highly valuable algorithms to enhance marketing, advertising and customer utility.

3 NETWORK EFFECTS

As more businesses, applications and/or services are added to the platform, more users and customers are attracted to the ecosystem, thereby increasing the value of these businesses, applications and/or services, as well as the platform itself. Furthermore, the more revenue that is generated by the ecosystem the greater the investment in the platform by the owner, which further enhances the ecosystem and encourages new members to join.

4 MERGER AND ACQUISITION VALUE EXTRACTION

The benefits of acquired technology can be shared across a larger base of businesses, applications and/or services. Therefore, newly developed value-adding technology is more valuable to platform owners than to any other owner. Platform owners can, in turn, rationally outbid competing suitors for the same target.

Lion's share of advertising

Did you know that the largest e-commerce market in the world is not in the US?

While most global investors are lured first to the US in search of these opportunities, one should consider that China already has over three times the online population of the US and with GDP per capita of $13,000 China is expected to account for 120 of the *Fortune* Global 500 by 2025.

Like Facebook, the China-based Alibaba and Tencent are emerging as great global technology businesses.

Alibaba is the world's largest e-commerce platform, upon which more than $US500 billion worth of merchandise is transacted each year, more than three-quarters via a mobile device. What is particularly interesting about Alibaba, however, is that today more than half of its revenue comes from a completely new business: online marketing services.

With more than 500 million highly engaged monthly active users, Alibaba has complete access to all user and merchant data and can create highly effective marketing algorithms to target consumers based on highly specific criteria. This, in turn, significantly increases the "return on investment" of marketing spend via Alibaba's online channel. As a result, Alibaba now attracts the lion's share (around 30%) of Chinese mobile advertising spend.

Tencent, on the other hand, owns WeChat, China's most popular messaging app. Around 900 million active monthly users spend nearly two hours a day, on average, on Tencent's mobile properties.

Tencent's "app-within-an-app" model creates significant network effects: app developers want their apps to be on WeChat to access the enormous customer base while at the same time, consumers are attracted to Tencent's ecosystem to interact with other users, as well as access the millions of apps that exist within the WeChat app.

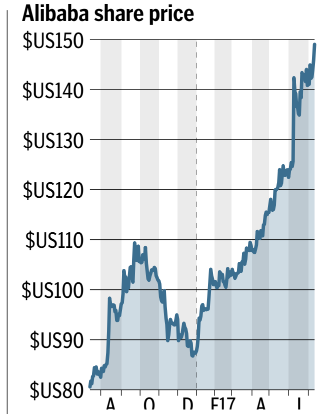
Like Alibaba, Tencent has also created a new mobile advertising business in recent years. Owning the most popular mobile properties in China makes Tencent the natural future leader of Chinese mobile advertising. While still in its infancy (less than 19% of total revenues), Tencent's online advertising business is growing by more than 50% a year. This side business will be the future Facebook of China.

Alibaba and Tencent are becoming the duopolies of Chinese mobile internet traffic. This means that they stand to dominate many industries as they move online: payments, video, gaming and cloud computing to name a few. They also manage what are essentially very active venture capital funds focusing on third-party payment platforms, a food delivery service, an Indian online marketplace and the Uber of China.

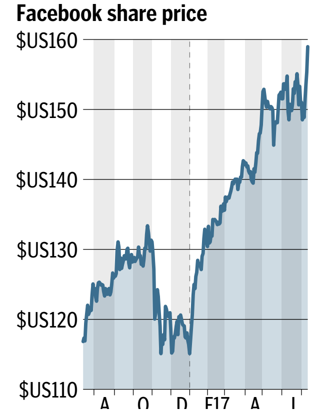
The point is this: not only will Alibaba and Tencent be among the great global businesses of tomorrow, they are also likely to participate in the growth of other great businesses of tomorrow.

Andrew Macken is the portfolio manager and chief investment officer for the Montgomery Global Fund and Montaka Global Fund, working alongside Roger Montgomery. Montgomery Global owns shares in Facebook and Alibaba.

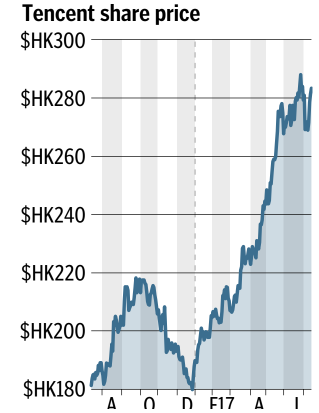
Alibaba share price



Facebook share price



Tencent share price



1 Alibaba

ASX code BABA.US
- Price: $US140
- 52 wk ▲ $148.29
- 52 wk ▼ $77.68
- Mkt cap $US360bn
- Dividend: N/A
- Dividend yield: N/A
- PE ratio: 60

BUY

The world's largest e-commerce platform, upon which more than $US500 billion of merchandise is transacted in a year. Founder Jack Ma is targeting $US1 trillion of annualised transacted value over the medium term. More than 75% of current transactions are effected via a mobile device. The network effect means the more merchants that join the Alibaba platform, the more consumers that become attracted to the platform, which in turn drives more merchants. Half of Alibaba's revenue comes from online marketing services, with 500 million monthly active users. With highly effective algorithms targeting consumers and their specific data, the return on investment for advertisers means Alibaba attracts around 30% of China's mobile advertising expenditure. Alibaba has enormous "optionality" via its equity interest in several investments, including Ant Financial Services, the largest third-party payment platform in the world.

2 Facebook

ASX code FB.US
- Price: $US151.04
- 52 wk ▲ $156.50
- 52 wk ▼ $112.97
- Mkt cap: $US438bn
- Dividend: N/A
- Dividend yield: N/A
- PE ratio: 40

BUY

Facebook is the clear global leader in social mobile marketing with 2 billion monthly active users, with the company also comprising 600 million users on Instagram, 1.2 billion on WhatsApp and more than 1 billion on Messenger. This is an excellent example of a business enjoying network effects with revenue growth at 50%pa leading to 90% incremental margins. Facebook's potential move into television-quality shows will keep an upward trajectory on the cost of high-quality programming. Advertisers chasing a higher return on their expenditure are increasingly attracted to specific users' interest groups produced from Facebook's highly valuable algorithms, and this is likely to see increasing pressure on many free-to-air television and pay TV businesses.

3 Tencent

ASX code 700.HK
- Price $HK280
- 52 wk ▲ $288.40
- 52 wk ▼ $173.00
- Mkt cap: $US340bn
- Dividend: HK61¢
- Dividend yield: 0.22%
- PE ratio: 49.1

HOLD

Tencent is a near China monopolist in social mobile and a duopoly (with Alibaba) in Chinese mobile internet traffic. WeChat is China's most popular messaging app and Tencent's "app-within-an-app" model has created significant network effects whereby app developers want their apps to be on WeChat to access the enormous customer base. At the same time, consumers are attracted to Tencent's ecosystem to interact with others, as well as the millions of apps that exist within the WeChat app. Internet users in China spend nearly two hours a day, on average, on Tencent's mobile properties. And with 900 million monthly active users, Tencent has built large-scale platforms in video, social media, games and banking. Tencent has created a new mobile advertising business in recent years, and is the natural future leader in Chinese mobile advertising. (Placed on hold due to the recent strong share price performance.)

Prices as at close of business, 5-Jul-17.