SECTOR TECHNOLOGY

Towards the pain threshold

The higher that stocks such as Amazon and Uber go, the further they have to fall

As the bull market progressed, an over-dependence on a hyper-narrow band of technology stocks has transpired. The investment universe has not seen so much capital concentrated in a single sector which, through ETFs, can be sold at the click of a mouse. Meanwhile, the emerging perception of increased regulatory risk for FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) has not only capped prices, it has served as an important reminder that excess profitability cannot be extended indefinitely and will always come up against an opposite force. That may be competition but it may also take the form of societal rejection or regulatory backlash.

Listed among the 10 most valuable companies in the world, Google dominates search with a 90% share, Facebook commands 88% of social media traffic in the US and by some accounts nearly half of Americans obtain their news from Facebook. By 2016, the share of online US consumers bypassing search engines in preference for Amazon was 55% and the biggest Chinese tech companies, including Tencent and Alibaba, command similar or even larger shares.

As recently as February, the NYSE FANG+ Index (also including Baidu, Netflix, Alibaba, Nvidia, Tesla and Twitter) was collectively valued at multiples of three times that of the broader market. The divergence is even greater than during the peak of the tech bubble in 2000. While the S&P500 has advanced a phenomenal 331% in the nine years since 2009, Amazon is up over 2100%, Apple 1100%, Netflix 5300% and Google 586%. Add Facebook, Microsoft and Nvidia to that list and eight stocks now account for over 15% of the entire S&P500 and just shy of 50% of the NASDAQ-100 index.

At the time of writing, Netflix trades at a PE of 218 times earnings and Amazon.com trades at 312 times. Facebook and Google-parent Alphabet, both of which have been directly linked with privacy concerns, now trade at valuations near 52-week lows.

While much of the commentary during the recent technology boom lauded the superiority of everything from the disruptive asset-sharing models of Uber and Airbnb to 3D printing, the underlying business models of many operators remain unviable without the support of private equity injections at increasing valuations. Where this is the case, investors need to be especially cautious. By way of example, Tesla and Uber continue to be loss-making despite despite valuations of about $US51 billion ($64 billion) and $US60 billion respectively.

Meanwhile, Amazon is being openly attacked by the US president on Twitter, Tesla and Uber's autonomous vehicles have killed people, setting back projected start dates for an autonomous driving future, and Airbnb hosts are being levied with conditions that limit short-term leasing.

It was inevitable that as these companies gained unprecedented power there would be a societal or regulatory response.

In the US, the Democrats, who were arguably defeated at the last election because they cosied up to big business, are returning to their roots with an election blueprint and new economic agenda ahead of the November mid-terms called "A Better Deal". The section of "A Better Deal" entitled "Cracking Down on Corporate Monopolies and the Abuse of Economic and Political Power" is focused entirely on antitrust enforcement and merger law, the most important but arguably weakest component of America's competition policy.

Meanwhile, in a decision with far-reaching consequences for many tech companies, Europe's highest court, the Luxembourg-based European Court of Justice, responded to a complaint by Barcelona taxi drivers who wanted to prevent Uber from setting up in the city. The court agreed that Uber drivers should be regulated like a transport company and not a technology service.

In Europe, a set of sweeping reforms under the banner of the general data protection regulation (GDPR) will be established shortly. Under the GDPR, European residents will have control over how their digital data is used and arranged, including the "right to be forgotten". They will have the power to remove or update data on company servers, be able to request the data and port it to another company.

Today, even with tech stocks reaching a threshold commonly described as correction territory, bullish sentiment remains. We note that, according to *The Wall Street Journal*, 91% of analysts maintained a "buy" or "overweight" recommendation for Facebook, Amazon and Google and, according to FactSet, tech companies in the S&P500 are expected to post year-on-year earnings growth of 22%.

There is no reason that tech stocks, especially unprofitable ones, are precluded from rising substantially after the recent conniptions are digested but the higher they go the greater the subsequent pain for investors who don't rotate into more defensive sectors such as healthcare and perhaps utilities.

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Prices as at close of business, 13-Apr-18.

Netflix share price

Tesla share price

51Job share price

1 Netflix

NASDAQ code NFLX	
Price	$US311.65
52wk ▲	$US333.98
52wk ▼	$US138.66
Mkt cap	$US135bn
Dividend	–
Dividend yield	–
PE ratio	218
SELL	

Netflix hit a record 117.6 million subscribers in the last quarter of 2017. This was thanks to the addition of 6.4 million international and 1.9 million US subscribers. International subscribers grew 11% in the fourth quarter from the third quarter and US subscribers grew at just under 4%. In 2017 the number of international Netflix subscribers surpassed US domestic subscribers.

While the company is expected to earn between $US1.88 and $US3.27 a share, the stock is trading at between 74 and 153 times earnings. It faces extra competition after Disney announced in November that its own two largest franchises, *Star Wars* and Marvel, will move exclusively to Disney's own streaming service from 2019. Fourteen Disney films have grossed more than $1 billion worldwide, including two *Star Wars* releases and four Marvel movies.

With 55 million Netflix subscribers in the US, compared with 94 million pay TV subscribers, and a steeper growth trajectory, 40 of the 56 analysts covering Netflix have a "buy" rating and only two have a "sell" rating. We believe the most expensive tech names are at the greatest risk of disappointment.

2 Tesla

NASDAQ code TSLA	
Price	$US300.34
52wk ▲	$US389.61
52wk ▼	$US244.59
Mkt cap	$US51bn
Dividend	–
Dividend yield	–
PE ratio	–
SELL	

Elon Musk has impressively built from scratch a car marketing and manufacturing machine that in 2018 is expected to generate sales of between $US14 billion and $US26 billion. The achievement is phenomenal.

More phenomenal is Tesla's market cap of about $US50 billion, having produced only about 100,000 vehicles last year. Ford has a market cap of $US44 billion and total global sales of 6.6 million units. Remember, these companies are in the same industry.

In 2017 Tesla burned more than $US2 billion and is expected to spend more in 2018. But the company has a cash balance of just $US3 billion. It has said that it won't need to raise money to ramp up model 3 production. But in 2016 Musk said Tesla wouldn't need to raise capital, but then raised money twice in 2017 to the tune of about $US3 billion in mixed equity-debt offerings.

In 2018 the company is expected to lose between $US0.64 and $US12.58 a share. This compares with a share price of $US289 at the time of writing. We believe Tesla's bond investors, who have been selling aggressively, have the picture right and equity investors have yet to catch on.

3 51job

NASDAQ code JOBS	
Price	$US91.27
52wk ▲	$US92.63
52wk ▼	$US37
Mkt cap	$US5.6bn
Dividend	–
Dividend yield	–
PE ratio	95
BUY	

Founded in 1998 and listed in the US, 51job Inc is headquartered in Shanghai. The company provides human resource outsourcing and consulting, as well as recruitment solutions, training and assessment.

51job has a long runway of revenue and earnings growth ahead as more employers migrate to online advertising for jobs. Meanwhile, the company has put through a range of price increases of up to 45%. Previously, and for six years, a one-month membership with 20 job listings would cost an advertiser 600 yuan ($123). As of February 1, the price increased to between 800 yuan and 1000 yuan.

These price increases carry no incremental costs and will boost margins beyond the strong increases of 2.5% year on year in the fourth quarter of 2017.

Despite a 128% increase in the share price in the past 12 months to over $US88, we believe there is value and currently estimate the company's intrinsic value at circa $US100.