EQUITY

PODCAST: Talking Tech in an Era of Digital Transformation

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Investors became more risk-averse in October amid a number of market uncertainties, causing sentiment to sour on the technology sector. In our latest "Talking Markets" podcast, Jonathan Curtis, vice president and research analyst with Franklin Equity Group, opines on factors causing the market's recent volatility and why he sees tech-sector valuations as reasonable today. He also discusses the digital transformation that's reshaping nearly every industry and creating new areas of opportunity for investors.

Here are some highlights of Johnathan's views presented in the podcast:

- Our belief is that every business is going to need to go on a digital transformation journey. If they don't do that, they are at risk of being disrupted by either a digital disruptor who comes ino their market or an incumbent who is willing to make investments in technology.
- There are a number of sub-themes below digital transformation, including artificial intelligence and cloud computing.
- There are always subsectors in technology that are overvalued and undervalued, that's just how markets operate. But broadly, we think valuation is actually quite reasonable.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks.

Ahead on this episode, the technology sector in focus. Jonathan Curtis, vice president and research analyst, Franklin Equity Group, breaks down the factors causing the volatility, plus, opportunity as a result of businesses transforming digitally. Speaking with Jonathan is Franklin Templeton's Lee Rosenthal, Lee take it away.

Lee: Thanks Richard. Jonathan, let's start with the current state of the market for the technology companies, obviously a lot of volatility of late. How do you view it?

Jonathan: We really work hard at trying to understand what these businesses look like at maturity but certainly there's a lot of volatility in the space right now. We think that some of that is being driven by interest-rate concerns.

If the Fed [US Federal Reserve] moves too fast, all sectors are going to be hurt, not just tech. We think that the highest-quality secular growth businesses in tech will outperform even in a fast rising-rate environment. Certainly, there is risk around a trade war. We think that's the biggest problem for enterprise IT hardware companies that need to get their hardware out of China into the US and it's also creating some demand and volatility for semis [semiconductors]. Certainly, there are some China macro concerns but outside of semis and Alibaba and Tencent, the Chinese economy doesn't consume a lot of tech from the US tech companies. Certainly, there is some selling of the winners at cycle end. We still think that focusing on the secular winners is the right way to go, and that they are going to outperform really in any market context. There have been M&A speculations. We saw IBM buy Red Hat and so certainly we have seen some volatility around that as folks try and figure out where the next area of spending or M&A is going to be. And then there is a lot of regulatory uncertainty out there. Does GDPR (General Data Protection Regulation) come to the US? Will we see a digital tax? And then, just what is happening with the Chinese government and what are they doing with companies like Tencent and Bidu and Alibaba?

Lee: But overall, you still view the global landscape as healthy?

Jonathan: We think the global economy is strong right now. The one caveat is what we are seeing in China right now, certainly the GDP numbers there came in a little bit below expectations, but outside of that, we think enterprise spending is very robust, especially for those vendors that, again, are enabling digital transformation. We think consumer IT spending is actually pretty stable across PCs and smartphones. We are seeing very good growth in new media and gaming.

Our belief is that every business is going to need to go on a digital transformation journey, and ultimately they need to build relationships with their customers that are service-oriented, subscription-oriented and recurring and ultimately to have at their center data and then they need to operationalize that data to extract more value out of their customers. If they don't do that, they are at the risk of being disrupted by either a digital disruptor who comes into their market or an incumbent who makes the investments in technology they need to make to become digital.

Lee: You talked about a digital transformation journey—but can you get more specific or take us deeper on that?

Jonathan: So we believe this is a multi-year, 10-plus-year investment opportunity. There are a number of really important sub-themes below digital transformation, one of which is AI [artificial intelligence], but there's also cloud computing—we think a tremendous opportunity of $3-5 trillion in size. IoT [Internet of Things], we think is a stealth opportunity around data and around digital transformation, certainly fintech and digital payments. Just the amount of data that flows off of that is super exciting.

The subsectors we like in technology right now are cloud computing. We like application software. We think that's a stealth play on AI with all the data that they collect around usage and they get to have their own customers' data when they deliver their software-as-a service model. We really like the Internet, e-commerce and advertising companies and the companies doing new media on the internet. We like financial IT services and then we like semi-cap equipment, we think that's a deep value play on AI and cloud.

Lee: What about valuations, some worry they've gotten too rich.

Jonathan: Listen, there are always subsectors in tech that are overvalued and undervalued, that's just how markets operate. Broadly, in tech, we think valuation is actually quite reasonable. If you look at the next 12-month price-to-earnings multiple on a broad basket of tech stocks, it's trading at 7% premium to the S&P 500 Index.[1] We think you find some of the highest quality business models in tech. If you look across the 11 subsectors of the S&P 500 Index, tech is the third or fourth most profitable across all the sub-sectors. And then finally you have a catalyst around corporate tax reform. We know that the single best leading indicator for enterprise investment in IT is changes in corporate profitability and every US company just got more profitable as a result of corporate tax reform. And we still haven't had a full budget cycle from enterprises under the new tax rates. And then secondly a lot of that capital that was overseas in these big US tech companies has come back home and is being applied for two very shareholder-friendly things and a third is dividends are being increased pretty broadly. We are also seeing really strong share repurchase activity, and we are also seeing a bit of M&A. So, we think the tech space offers really good valuations, some of the best quality and really structural growth around this idea of digital transformation.

Lee: So with everything we've talked about—volatility, the global landscape, the digital transformation journeys of businesses, and valuations—there's a lot going on, how do you approach this type of environment?

Jonathan: What we try and do in these environments is we focus on the fundamentals and really try and stick to understanding what these businesses look like at maturity. We don't think that tech is overvalued. We think there is a lot of very high-quality businesses that can be had in this space. We think the margin structures are excellent and we think that investors were going to need to start thinking about tech as core—not just a sector but really something that they need to own for the long run.

Lee: Jonathan Curtis, vice president, Franklin Equity Group—thank you, Jonathan.

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1. Source: FactSet. As of September 30, 2018, the forward price-earnings (P/E) ratio for the S&P 500 Index (next 12 months) was 18.3x vs. 19.6x for the information technology sector, for a premium of approximately 7.1%. See www.franklintempletondatasources.com for additional data provider information.