EQUITY

Why Digital Transformation Should Remain Resilient in 2020

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Jonathan Curtis
Vice President, Research Analyst
Franklin Equity Group®

Franklin Equity Group's Jonathan Curtis explains why he thinks businesses will need to invest significantly more in digital technology in the coming years to better understand and service their customers and to reduce costs.

As we begin 2020, some equity investors seem to have concerns about the valuations for technology stocks. Those concerns are understandable considering the information technology (IT) sector has offered the best growth profile in the S&P 500 Index over the past three years, and topped all 10 other equity sectors by a wide margin in 2019.

While there are always industries within the IT sector that are overvalued or undervalued, we do not believe that we are in a 1999–2000 style bubble. Instead, we believe the overall IT sector is appropriately valued for the good growth and quality that it offers. In our view, the IT sector has many excellent established, cash- and earnings-generating businesses. It's also important to recognize that we are in a period of transition as major new growth drivers emerge in the form of IoT (internet of things), big data and artificial intelligence (AI). Over the next decade, we expect hundreds of billions of "edge devices" to be deployed, an explosion of data generation, and new approaches to computing to sustainably process and create value from all the data that's available.

That said, we are more optimistic about the long-term prospects for certain companies in the IT sector than others. We are particularly excited about the outlook for those companies enabling the digital transformation (DT) that is taking place across industries.

Digital Transformation and its Subthemes

> "We remain focused on the highest-quality businesses aligned with the DT theme and its associated sub-themes of AI and machine learning; cloud computing; data science and analytics; IoT; intelligent machines; cybersecurity; software-as-a-service (SaaS); e-commerce; fintech (financial technology); digital advertising; customer insights; next-generation workflow; and software development.

Embracing Digital Transformation

In our view, select companies enabling DT are likely to outperform competitors in the years ahead. According to research firm IDC, worldwide DT investments are forecast to approach $7.1 trillion, based on a compound annual growth rate of 17.5% for the four-year period through 2023.[1]

Essential to DT is the ability to collect and use data to better understand customers, and then to use software and cloud technologies to serve customers at lower costs. While there is a looming risk that some of the large internet platforms will have their ability to collect and use data curtailed through regulation, we believe these businesses can still operate with only modest amounts of data if need be.

Furthermore, these businesses are not only about the data they collect. They work because they aggregate user attention through attractive search, social networking and entertainment services. They then use the collected data to segment and generate insights about the audiences they have built, and make those audiences available to advertisers in an anonymous manner. Their businesses work well because they get the complete value chain right—not just because they collect and combine data.

Technology Themes Outside of DT

We don't think the future is quite as bright for those companies in legacy technology categories such as personal computers and "on-premise" data center infrastructure. Although some of these companies may trade at lower valuation multiples, we think they have lower growth prospects and are likely to struggle in this DT era.

Another concern is increased investor expectations within parts of the software industry. Valuations for many software companies rose significantly in 2019, despite growing signs of economic weakness in Europe and general weakness in legacy enterprise IT spending after a particularly strong 2018.

Though we have adjusted our software holdings to reflect our valuation concerns, we remain optimistic about the industry's longer-term prospects. Conversely, we are seeing better prospects within the semiconductor industry and among US and Chinese internet companies, where valuations have become more attractive to us.

Potential Risks to Our Outlook

Over time, the IT sector has experienced bouts of short-term volatility. Looking forward, we do expect continued volatility in the semiconductor industry, particularly while the US-China trade conflict remains unresolved.

Although the United States and China reached a "phase-one" trade deal, we anticipate the possibility of tariff headwinds for US IT hardware companies, some of which build US-bound hardware in China. We are also closely monitoring how the regulatory landscape may be changing for many of the large US internet companies.

We believe that if a technology company has a solid business model with inherent leverage, strong management, and some viable and meaningful competitive advantage, then it can grow sustainably for a long time if it's in a sufficiently large market.

In terms of valuation, as long-term investors, our work always focuses on what a business will look like at maturity—*not* how the market is valuing its near-term earnings, cash flow or revenue performance. We believe investment processes that focus solely on these near-term metrics fail to capture the substantial benefits of sustainable, compounding revenue growth and operating leverage.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in fast-growing industries like the technology sector (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement or regulatory approval for new drugs and medical instruments.

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1. Source: International Data Corporation (IDC), Worldwide Digital Transformation 2020 Predictions, October 2019. There is no assurance that any forecast, estimate or projection will be realized.