M&A Activity in Technology Heats Up

May 13, 2015

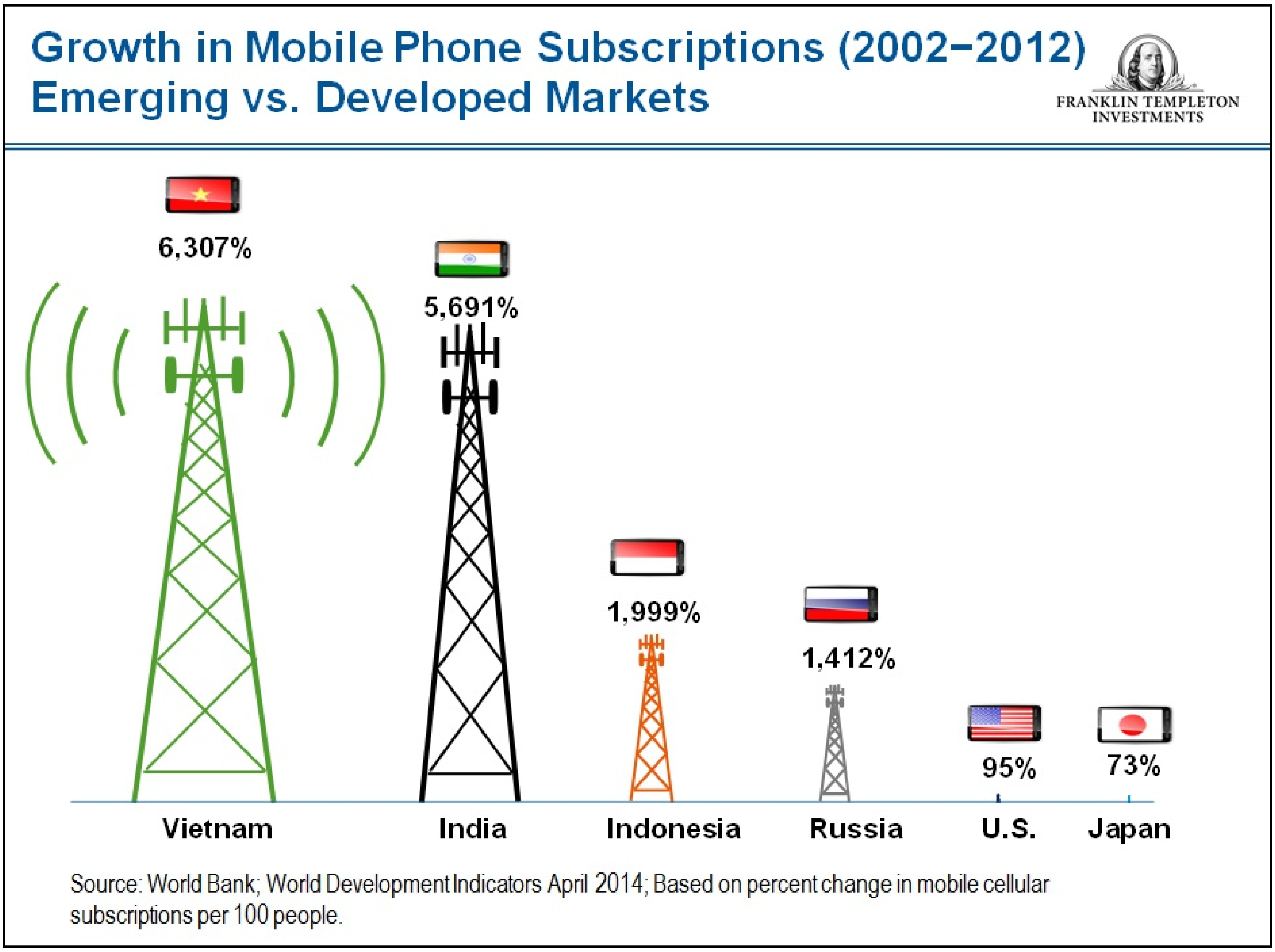
The technology-heavy Nasdaq Composite Index finally hit a new record high in April, eclipsing the old record set 15 years ago in 2000. Naturally, when historic peaks are hit, bubble talk starts to circulate. However, Franklin Equity Group's J.P. Scandalios says the market and economic environment today are quite different from how it was in the late 1990s, when everyone seemed to be chasing anything "dot com" on pure speculation. He believes the long-term outlook is positive for the tech sector (and related areas like biotech), and says valuations still appear reasonable. In fact, low valuations have contributed to a wave of merger and acquisition (M&A) activity in the space, which he expects could continue to fuel investor interest.

We believe the multiyear outlook for the information technology (IT) sector looks favorable for a number of reasons. Select, well-positioned technology companies appear fundamentally sound, with attractive secular growth prospects. And, from a valuation standpoint, the IT sector is among the most attractive in the S&P 500 Index when growth is taken into account (as illustrated below). The low price being asked for growth in the sector has not gone unnoticed, even among IT companies themselves. Many technology companies have large amounts of cash on corporate balance sheets and have shown an increasing willingness to return cash to shareholders. That being the case, we expect to see ongoing opportunities for continued mergers and acquisitions (M&A) that could serve to consolidate and strengthen the IT sector.

Secular Themes Support Technology Companies

There are several secular themes in the global economy that we think look supportive of the tech sector. There are multiple examples of new technology underpinning developments that have led to earnings and cash flow growth for innovators. Lately, we have been looking at new potential opportunities linked to network security, wireless data growth, SSDs (solid-state hard drives) in servers and notebooks, the proliferation of e-commerce, the "Internet of things," LED light bulbs, the adoption of SaaS (software-as-a-service) products, and 3D printing. A recent hot topic in the sector is transaction security, and we are also looking at firms that can benefit from the shift away from old magnetic strip credit cards to NFC (near field communications) and chip-and-pin based cards as well as the upgrade to payment terminals that use these technologies.

Outside of the traditional "technology" space, we are also finding interesting applications of technology. For example, the growing global Internet user population in both emerging and developed markets, combined with the proliferation of smartphones and tablets (see graphic on mobile phone subscriptions below), has been helping transform the travel industry as consumers are increasingly planning and booking travel online. Elsewhere, several health care equipment companies have developed medical devices that enable diabetics to better measure their blood glucose levels or ease the daily burden of this disease by improving the automated, consistent delivery of insulin.



Valuations Still Look Attractive

Themes such as those described above have helped drive high growth rates among IT stocks. According to the most recent FactSet Earnings Insight Report, 2015 revenue growth rates for the sector are second only to health care among the 11 sectors in the S&P 500 Index.[1]

Despite the positive earnings growth outlook, information technology remains attractive on a valuation basis, with fiscal year two (FY2), price/earnings (P/E) ratios (which use consensus earnings estimates for companies' fiscal year two years out) below that of the overall index. In general, a lower P/E suggests that investors are expecting lower earnings growth in the future compared to companies with a higher P/E.

Calendar Year 2015 Revenue Growth

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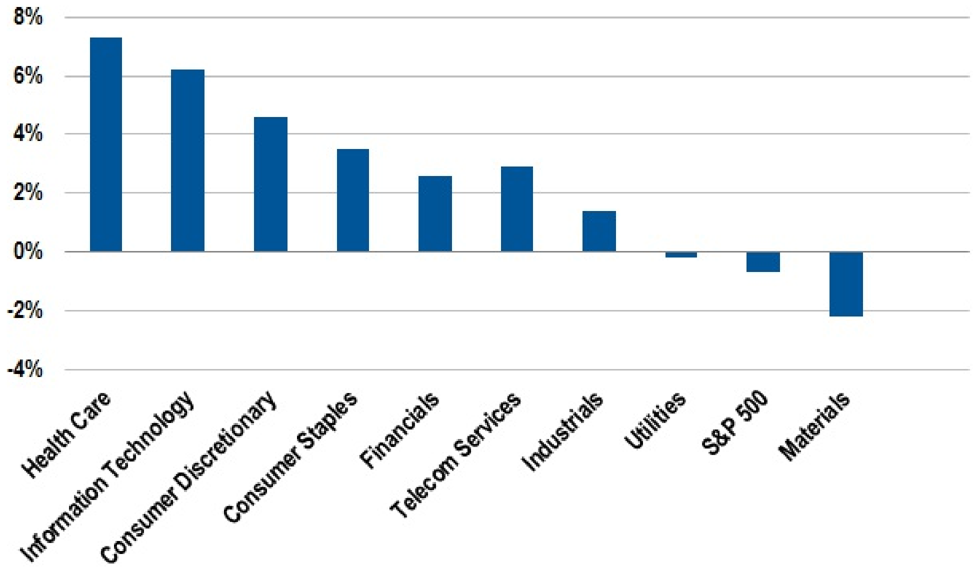
As of March 31, 2015 (Forecast)



Source: FactSet, Earnings Insight Report, 04/24/2015. Data based on the S&P 500 Index. Energy sector, not shown on the chart, had revenue growth estimate of -29.2%. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged and one cannot directly invest in an index. There is no assurance that any projection, estimate or forecast will be realized.

The combination of strong growth prospects and reasonable valuations has given information technology the lowest price/earnings to growth (PEG) ratio among all the S&P 500 Index sectors as of March 31.[2] The lower the PEG ratio, typically the more a sector may be undervalued given its earnings performance.

Price/Earnings-Growth (PEG) Ratios

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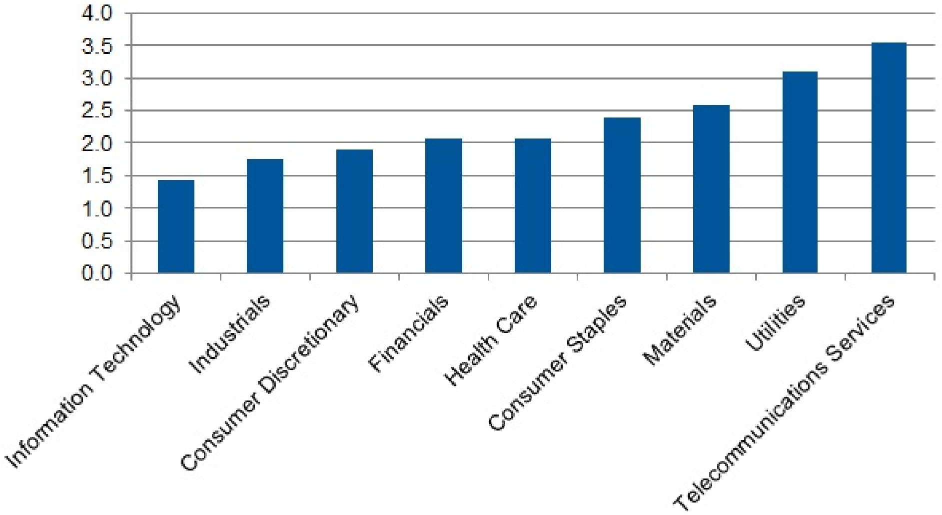
As of March 31, 2015 (Forecast)



Source: FactSet, as of 3/31/2015. Energy sector, not shown on chart, had fiscal year two (FY2) PEG ratio of 8.62. FY2 uses consensus earnings estimates for companies fiscal year two years out. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged and one cannot directly invest in an index. There is no assurance that any projection, estimate or forecast will be realized.

We have not been the only ones to notice attractive valuations in the tech sector. Many IT firms are flush with cash, and, as companies are maturing in the space, they are expanding the ways they return value to shareholders. Buybacks and the initiation or growth of dividends have been common, but increasingly M&A activity is seen as a strong option for technology firms looking to increase their value. Acquiring smaller firms with cutting-edge technology can be a cost-effective way for larger technology firms to expand their capabilities into new areas and potentially increase their earnings power going forward, or to realize efficiencies and streamline operations.

In a recent example, two major semiconductor companies announced a plan to merge in a deal the markets lauded, as it appeared to be immediately beneficial to the combined entity. While in our view, both firms were attractive investments before the merger—being key players in semiconductor components that are vital to the growth of mobile payments and connected devices—the combined entity will also likely benefit from cost savings and possible synergies between the product lines. We believe the immediate positives seen in this deal are both an indication that M&A is a strong option for semiconductor and other technology companies and a signal to other firms in the space that this is an area of growth they may want to consider.

While we do not specifically invest in companies looking for M&A activity—we prefer to invest in companies we believe can achieve sustainable growth on their own over the long term—it does occur as larger firms often also evaluate their own growth, quality and valuation prospects and those of their peers. In our process, growth, quality and valuation are key tenets of our investment approach as well. We seek to identify companies that we believe are uniquely positioned to capitalize on superior growth and profitability resulting from secular technology trends and innovation. We then incorporate detailed financial analysis and strict valuation discipline to initiate and build positions at what we believe are attractive risk-adjusted levels.

As investors in the technology space, we have a bias toward growth and innovation, as we believe innovation should ultimately lead to superior growth and profitability. It is important to look at valuations as well, and take advantage of situations where the broader market may misprice a company in the short term. This combination of high growth and attractive valuation continues to make technology an interesting sector to invest in, and, as both of these attributes persist, we expect robust M&A activity in the sector to continue.

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What Are the Risks?

All investments involve risk, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. The technology sector has historically been volatile due to the rapid pace of product change and development within the sector. Technology companies can be small and/or relatively new and unseasoned. Smaller companies can be particularly sensitive to changes in economic conditions and have less certain growth prospects than larger, more established companies.

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1. Source: FactSet, as of 4/24/15. Indexes are unmanaged, and one cannot directly invest in an index. See www.franklintempletondatasources.com for additional data provider information.

2. Source: FactSet as of 3/31/15. Indexes are unmanaged, and one cannot directly index in an index. See www.franklintempletondatasources.com for additional data provider information.

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