Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Information Technology: Winners and Losers

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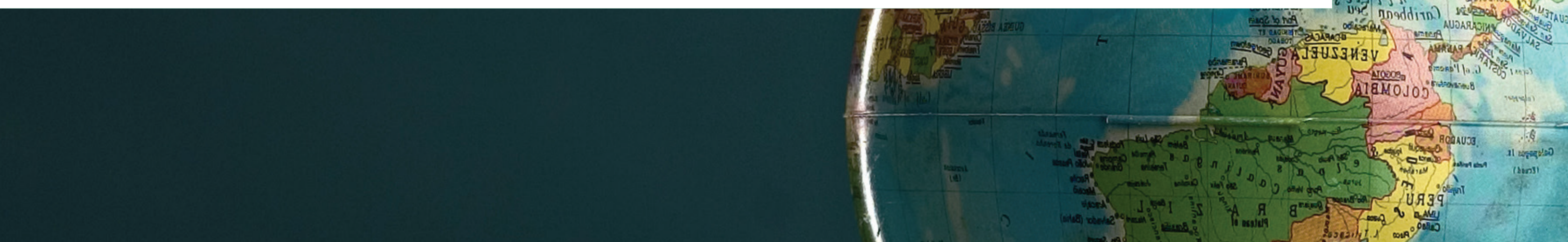
Over the last decade, the philosophy of our global equity strategies has remained unchanged, as has the pivotal role of Consumer Staples, which continues to be over half of the portfolio. Something that has evolved is the inclusion of Information Technology stocks in the pool of high-quality compounders that we invest in, with the portfolio weight going from zero ten years ago to close to 25% today. It may not be intuitively obvious that an industry so associated with radical change is a natural source of compounders, particularly when that industry is shifting so fast, not least with the Digital Revolution, also known as SMAC (Social, Mobile, Analytics and Cloud). However we would argue that these changes carry more threat for the profit pools in other industries, not least for the weaker parts of Media, Advertising Agencies and Retail, than for the highest-quality parts of the Information Technology industry itself.

In our view, the highest-quality part of Information Technology is within Software and IT Services rather than Hardware, which is more cyclical, has far higher capital intensity and is constantly threatened by commoditization. This has been aggravated further by the rise of public cloud providers, companies that are more efficient users of hardware, and which make their own machines, or at best exploit their massive buying power to procure those of others. In addition, companies historically in the switching and router business have to adjust as software erodes their relevance. In contrast to hardware, software is winning, even if you do not go as far as Marc Andreessen - founder of Netscape and co-author of Mosaic, the world's first internet browser - who claims it 'is eating the world.' The position of IT Services is more nuanced, split between the winners who are in the high-end business of helping corporates through their complex digital transitions, and losers who are finding their low-end outsourcing businesses commoditized or

"…the Digital Revolution…has the ability to create winners and losers depending on the speed and effectiveness of the adoption of new business models."



even automated by Artificial Intelligence. A good example of this is a Dublin-based global management consulting and professional services company which is amongst the winners on the back of the strength of its Strategic Consulting business and its industry-leading program of investment in Digital.

As with any major change, the transition to the Cloud does carry risks for the incumbent software providers, given the arrival of new 'Cloud-native' competitors. Managements need to be prepared to invest in the change and potentially cannibalize elements of their existing businesses. Any shift forces their clients to rethink their provision, potentially hitting retention. The providers also face costs with the move, with a rise in capital intensity (server farms and data centres), the deferral of payment (as firms get a regular subscription rather than an up-front lump of cash on sale) and the need for the Cloud offerings to reach scale. As a result, margins have been under pressure at more traditional software companies over the last few years. The good news is that this process is now fairly well advanced, with consensus expecting both companies' margins to reach their trough over the next 12 months, with room to recover thereafter as their Cloud offerings continue to gain scale and bring with them the positive effects of increased operating leverage.

"Post the transition [to the Cloud], software businesses are more stable and predictable…making results less volatile and vulnerable to economic downturns."

Post the transition, software businesses are more stable and predictable, as one-off license revenues are replaced by subscription driven annuity streams, making results less volatile and less vulnerable to economic downturns. A German maker of enterprise software for managing business operations and customer relations aims to have 70-75% of its revenue recurring by 2020 as its Cloud businesses grow. In addition, there is the opportunity to grow faster, as it is far easier to 'upsell' clients in a Cloud environment than install the additional module machine by machine, as had to be done in the past. This is effectively demonstrated by a Washington State-based, market dominant technology company which is already seeing the benefits with its latest subscription offering, giving customers access to its well-known software plus other services, all via the Cloud. This is aside from the fact that the higher stickiness raises the NPV (net present value) of clients.

The other positive the Information Technology sector offers versus 2007 is valuation. It is one of the few sectors cheaper in absolute terms than a decade ago. The premium on forward earnings versus the MSCI World Index has fallen sharply from 34% to 14%, even with the pricey early stage companies included. Elements of the sector are performing extremely strongly, notably particular hardware and social media companies, along with a readily familiar Seattle-based e-commerce and Cloud computing company (in the Consumer Discretionary sector).

"…those companies that can deliver predictable growth and compound steadily, even if the environment deteriorates, are a valuable part of a portfolio."

We see the world as a very uncertain place at present, and do not see this reflected in valuations. The MSCI World Index is trading on 16.6 times the next 12 months' earnings, which includes an assumption of double-digit growth. Even tougher to justify is the VIX, a measure of S&P volatility, which at below 10 is near to all-time lows. In this world, where the potential for things to go wrong seems to be being ignored, or at least insufficiently weighted, those companies that can deliver predictable growth and compound steadily, even if the environment deteriorates, are a valuable part of a portfolio. Our belief is that the right kind of Information Technology companies, with the right management, are amongst the select group that tick these boxes.

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