JANUS CAPITAL Group

POINT OF VIEW SERIES

Is the Slide in Technology Stocks a Buying Opportunity?

Certain Segments are Attractive over the Long Term

Technology stocks have fallen significantly in early February, with the S&P 500® Technology sector down -7.13% from February 1 through February 9. Stocks tied to high growth areas such as cloud computing and Software as a Service (SaaS) have fallen even further, with the ISE Cloud Computing Index down -9.48% over the same time period. At Janus Capital Group we believe the recent sell-off in technology sector stocks reflects fear of high growth companies with low current period earnings, not underlying fundamentals. In fact, we think the sell-off provides an attractive buying opportunity for growth companies in the sector.

The momentum that drove valuations for cloud and social media companies higher since 2013, a hype-cycle we approached cautiously at the time, reversed itself in early 2016. In our view share prices in several disruptive companies overcorrected, and as a result we see upside in many cloud computing and SaaS companies.

Key Takeaways

- We believe share prices in several disruptive companies within the tech sector overcorrected.
- We are at the beginning of a decade-long transition to the cloud, in our view. As businesses adopt cloud technology platforms, the long-term growth outlook for these companies remains intact.
- Interest from strategic acquirers provides cloud stocks with valuation support, and firms could trim operating expense investment, translating into earnings growth.

Newer Companies raise Valuation Challenges

Younger technology companies with new business models may be difficult to value. Many of these companies have yet to produce earnings, are just beginning to generate earnings, or their earnings are quite volatile. Instead, such companies often trade on multiples of revenue. Investor comfort with valuations is a function of comparing various stocks using their revenue multiples as a measurement tool. However, just a bit of bad news appears to be all it takes for that momentum to unwind. The companies that have little or no earnings or free cash flow typically fall sharply.

Some names tied to high growth themes such as SaaS or big data recently announced weaker-than-expected earnings growth and weaker guidance for the rest of the year. These forecasts left some investors questioning the growth trajectory of the aggregate technology sector against the backdrop of a sluggish economy.

Many high multiple growth stocks have sold off since then. While the change in momentum could lead technology stocks down further in the coming weeks or months, as long-term growth investors we believe there is plenty of support for some names at these new levels, particularly cloud stocks.

Favorable Dynamics are Visible in the Tech Sector

We see two key supportive factors in this space. Strategic acquirers of innovative SaaS and cloud companies typically assigned valuations of these firms two to three times higher than today's levels. Given valuations in the wake of the tech sell-off, these firms may look even more attractive to potential suitors. If economic growth slows, many of these high-growth SaaS and cloud companies could reduce their level of operating expense investment. That, in turn, would enhance margins, translating into earnings growth well beyond what is implied in current valuations.

In reality, the landscape for technology companies has not changed. We are at the beginning of what we think will be a decade-long transition of enterprise IT services to the cloud – something we highlighted in our Market GPS 2016. Security concerns about on-premises data centers and the quick adoption and success of Microsoft Office 365, which is critical to many business functions, is only hastening cloud adoption of more IT functions.

Companies that offer valuable cloud platforms to a sales team, a finance office or other business vertical create win-win propositions for their customers by offering software that is cheaper, more secure, mobile-accessible, and easier to update than purchasing packaged software and downloading it onto an internal server.

Adoption of some of these platforms may slow at the margins if the economy weakens, but in our view the long-term rationale for these services remains compelling. As businesses adopt disruptive cloud technology platforms, the three- to five-year growth outlook for these companies remains intact. This recent sell-off may have finally provided an attractive entry point for investing in them.

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