Warakirri
ASSET MANAGEMENT

May 2023

Australian Equities: The Return of Profitable Tech

In this paper our investment partner, Northcape Capital, share their observations on the current state of play in the Australian technology sector. They argue that the tech sector is undergoing a shift as investors focus more on companies with strong business models and a path to profitability as opposed to the previous preference for growth at all costs. In Northcape's view, companies that are unable to adapt to the changing environment are likely to be left behind.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Concentrated and Ethical Australian Equities Funds.

What's Happening?

During an extended period of declining and low interest rates, investors were willing to pay up for growth at any cost. This led to a boom in valuations for all types of tech companies, regardless of their business model or profitability. As a result, it was less important for investors to differentiate between tech business models during this time.

As interest rates have begun to rise, investors have needed to adapt. The opportunity cost of holding profitless investments is now significantly higher, and investors' tolerance for sponsoring new ideas with merely vague aspirations for earnings in the distant future is far lower. **This has been a painful transition for investors in the sector, as many technology shares fell heavily and somewhat indiscriminately during 2022.**

Silver Lining

The silver lining for investors from these events is threefold.

Firstly, valuations in general became far more attractive than they had been, creating a better risk vs. reward opportunity than had existed during 2020 and 2021.

Secondly, barriers to entry increased as access to funding dried up for hopeful new entrants. Markets that were crowded with well-funded competitors have begun to consolidate. Higher barriers to entry will help tech players who are already established to consolidate their market shares.

Finally, the incentives for established tech businesses are shifting in a way that is favourable for shareholders. Where previously companies had an incentive to demonstrate the highest growth in user numbers or revenue, they now face demands for operating discipline and cash flow generation. Announcements of layoffs at tech companies both locally and in the US are a sign of this shift in priorities and typically follow years of unrestrained spending.

Echoes of the Past

We saw something similar play out for the Australian mining sector in the aftermath of the Global Financial Crisis. Chinese stimulus caused commodity prices, particularly iron ore, to enter the stratosphere in the early 2010s. Faced with far higher operating cash flows, the major mining companies committed to grandiose expansion plans that absorbed much of these windfall gains.

As commodity prices contracted around the middle of that decade, the miners' cash flow positions were crunched. This was a painful experience for investors at the time. However, this proved a blessing in disguise for astute investors as management and board renewal led to a heightened focus on operating efficiency, investment discipline and capital returns to shareholders. When commodity prices recovered toward the end of that decade, shareholders were rewarded with far higher profits and dividends than they had in the earlier boom.

The potential for a similar renaissance in shareholder value for tech investors exists today. However, there is an important caveat. The advantages of the changing investment landscape will only accrue to the highest quality, most resilient tech businesses. The rest of the sector will find the environment far more challenging. This is a favourable development for investors like us who are more focused on business model strength than growth in user metrics.

Recent Case Studies

Xero is a leading provider of cloud-based accounting software to small businesses. For 15 years the business has generated strong growth in customer numbers and revenue but has never earned material profits. **We think Xero is a highly resilient business that is well placed to benefit from the changing tech landscape.** In March, new management announced they would be cutting up to 15% of its workforce (after years of rapid growth in staff numbers) and targeting a lower operating expense to revenue ratio compared to recent years. This decision signalled to the market an inflection point in strategy where strong growth would now also be balanced with profit-generation, and the stock rebounded by 27% during the March quarter.

Seek is another example of a high quality business that got caught up in the general sell-off of the tech sector, but had potential to adapt its strategy. In this case, excessive focus on the short term outlook for the economy also placed pressure on the share price. The company has responded by simplifying its business mix and implementing cost initiatives and price increases that should lead to both revenue growth and strong margin expansion in time.

Performance Implications

Overall, we have been pleased with the outperformance and resilience of the tech names in our portfolio, which has avoided much of the carnage that has befallen former market darlings. In many cases these companies had weak business models with questionable network effects, high competition, and lower barriers to entry and switching, and this has been exposed by the tougher economic environment and less forgiving financial conditions.

Formerly loved tech names like Bravura, Appen and Zip Co (all not owned nor on our approved list), are all down by more than 80% from their peaks given emergency capital raises and/or concerns around the viability of their business models.

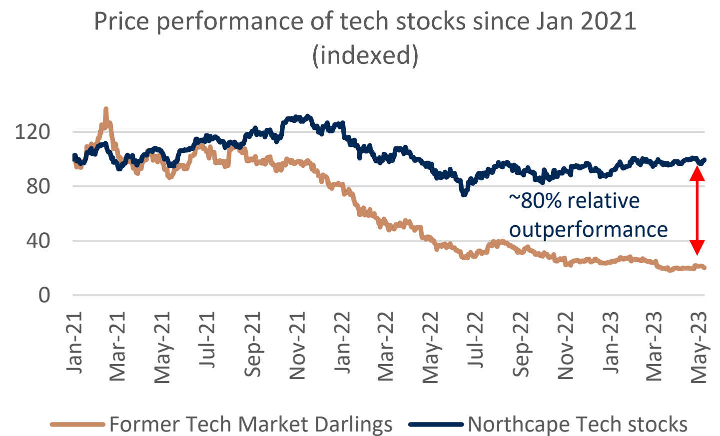
Megaport, another example, was down 35% during the March quarter (and down more than 80% from their peak), with the sudden resignation of the CEO (and forfeiture of more than a $1m worth of shares in the process) adding to market concerns on their ability to pivot to profitability and stem persistent cash burn. We had been cautious on their ability to generate strong cash flows and returns given questionable network effects, high competition, and lower barriers to entry and switching, despite positive exposure to a growing cloud adoption thematic.

Even more extreme examples can be found in the unlisted market where some of the start-ups that attracted venture capital funding never looked like they had a chance of making money. This includes businesses that offered to deliver groceries in 15 minutes at virtually no extra cost to the customer. The demise of these services is a loss for the consumer but a more painful blow for their investors.

A disciplined process has allowed us to not only protect investors' capital during times of market turmoil but to also generate strong overall performance in our portfolio even after the market peaked in late-2021.

Going forward, we believe increasing bouts of market volatility will continue to favour careful active managers and a focus on quality names, and believe our investment process will continue to generate value for investors through the market cycle.

Performance of Tech Stocks[1]



Source: Northcape Capital

1. Price performance assumes continued holding of all basket stocks and doesn't reflect trading of these stocks during the period.
2. Former Tech Market Darlings include Afterpay/Block, Appen, Bravura, Megaport and Zip.
3. Northcape Tech stocks include HUB, NWL, REA, SEK and XRO.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

The information in this document is published by Warakirri Asset Management Limited ABN 33 057 529 370 (Warakirri) AFSL 246782 and issued by Northcape Capital ABN 53 106 390 247 AFSL 281767 (Northcape) representing the Northcape's view on a number of economic and market topics as at the date of this report. Any economic and market forecasts presented herein is for informational purposes as at the date of this report. There can be no assurance the forecast can be achieved. Furthermore, the information in this publication should only be used as general information and should not be taken as personal financial, economic, legal, accounting, or tax advice or recommendation as it does not take into account an individual's objectives, personal financial situation or needs. You should form your own opinion on the information, and whether the information is suitable for your (or your clients) individual needs and aims as an investor. While the information in this publication has been prepared with all reasonable care, Warakirri and Northcape do not accept any responsibility or liability for any errors, omissions or misstatements however caused.