Part 5. Internet and E-Commerce: the headwinds and tailwinds with Ryan Joyce, CFA, Co-Head of Technology, Communications and Media

Video Transcript (May 2020)

Ryan Joyce, CFA, Co-Head of Technology, Communications and Media
Jennifer Herbert, Key Account Manager - Listed Funds

Jennifer Herbert:

Hello and welcome to our investment insights series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, Key Account Manager at Magellan, and over the next 10 minutes, I'll be talking with Magellan co-head of technology communications and media, Ryan Joyce, about our views on the internet and ecommerce platforms we currently hold in the portfolio. Thanks for joining us, Ryan.

Ryan Joyce:

Thanks, Jen. It's a pleasure.

Jennifer Herbert:

Ryan, Magellan has exposure to Alphabet and Facebook in the cyclical part of the global portfolio. How have these businesses performed today?

Ryan Joyce:

The first thing I would say is that, for the most part, performance has been in line with what we would expect in this environment. The large advertising businesses of Alphabet and Facebook have seen a significant impact, with Facebook's growth slowing from 20% to 25% before the impact of covid-19, to flat in April, or a 20- to 25-percentage-point deceleration. While Alphabet's search advertising business slowed from high teens to negative mid-teens, or a 30-percentage-point deceleration. The better relative performance of Facebook is interesting and can be explained by a few factors. First is the increased time being spent on Facebook's platform during this period, particularly among older users. Second is that Facebook's feed advertising format is more flexible than Alphabet's search advertising format, which is dependent upon the commercial intent of users. So what we've seen is that while some of Facebook's advertisers like auto and travel companies have withdrawn, companies that are faring much better during the lockdown, such as ecommerce or online gaming companies, are stepping into that void.Alphabet also has a much larger exposure to travel, which is under immense pressure. While we expect Facebook's outperformance to continue for several quarters, as restrictions ease and consumer behaviour more closely resembles normal recessionary conditions, we do expect this to normalise. Now while Alphabet's search advertising business has been a bit more impacted, it does have some other key businesses that have continued to perform well. These include its cloud business GCP, which maintained 52% growth in Q1 and reported accelerating traction. It also includes its high-margin app store business, Google Play, whose growth accelerated in Q1 as engagement and spending in mobile apps increased while people have been stuck at home. Finally, while growth in YouTube did slow, it exited the quarter with high single-digit growth as it also benefited from increased viewership.

Jennifer Herbert:

And given the economic exposure, what gives you the confidence in the outlook for these businesses?

Ryan Joyce:

There are a few key reasons we remain confident in the long-term prospects of both businesses. First is that covid-19 doesn't change our view on the quality of the businesses, including Google's dominance of search, or the strength of Facebook's platforms. Nor does it change our view on the significant embedded value of Google Cloud Platform, Waymo, or WhatsApp, which remains heavily under-monetised. Second is that we expect both businesses to remain highly cash generative, even in a very adverse economic environment, which provides them with the flexibility to continue to invest in important strategic areas and distinguishes them from many other companies scrambling to aggressively cut costs. Third, in the medium to longer term, we think both companies may benefit from certain structural shifts as a result of covid-19. Those include increased online activity more broadly, as well as a shift in video viewership away from ad-supported linear TV to ad-free streaming services like Netflix, which have seen subscriber growth accelerate, and which should see a further shift in TV ad budgets online. Finally, both companies have pristine balance sheets with

110 billion and 60 billion in net cash respectively, and that provides further downside protection. It allows them to be more measured in their short-term response, and puts both companies in a strong position to repurchase shares, an attractive process to the benefit of its shareholders.

Jennifer Herbert:

Magellan also has direct exposure to China and to the Chinese consumer via Alibaba and less so by Tencent. How comfortable are you with these holdings?

Ryan Joyce:

We're very comfortable with these holdings and I'll deal with each in turn, starting with Alibaba, and I'll focus on its dominant ecommerce businesses, Taobao and Tmall, which generate the bulk of its profits. In contrast to the US, where we have seen Amazon and eBay performing quite strongly during lockdown, Alibaba was impacted by a combination of logistical issues and greater exposure to discretionary categories such as fashion and luxury. In terms of the logistical issues, these related to the timing of the covid-19 out right around the Chinese new year holiday, when many delivery drivers had returned home, often to rural areas. When the Chinese government then acted quickly to limit travel and enforced very strict quarantine, many were unable to return to work, which saw logistics capacity heavily impacted. While that did take some time to resolve, logistics are now back to full capacity, and ecommerce in China has since recovered and was up 10% year on year in March and more in April.

Notwithstanding the disruptive short-term impact on Alibaba and potential for some near-term earnings pressure as it helps reinvigorate the Chinese economy, we expect covid-19 to accelerate ecommerce penetration in China, particularly in areas like grocery, where Alibaba had already been making significant investments. Further, the early steps and other measures taken by the Chinese government appear to have put the country in a strong position to reopen its economy and manage potential future outbreaks. Shifting to Tencent, it is one of the few companies that we actually expected to perform well during the lockdown phase of covid-19 and to derive long-term structural benefits. During the lockdown phase, Tencent is seeing a meaningful increase in engagement in its online gaming business, which remains the largest profit engine for the company. Its other digital entertainment services are also benefiting as people are stuck at home. We expect this to largely or fully offset the expected near-term weakness in its cloud businesses. Interestingly, in contrast to its Western peers, Tencent's other key business, which is online advertising, has performed remarkably well.

While much of the increase in time spent on digital entertainment will prove temporary, we expect there'll be some structural benefit as Tencent has observed during prior virus outbreaks, even as those other more impacted businesses see improved results. As I mentioned, we also expect Tencent to benefit in the longer term from changes in consumer and merchant behaviour resulting from covid-19, and the key role it played in helping to mitigate the spread of covid-19 and society continue to function by enabling things like online healthcare and online education. Some examples of these include accelerated merchant adoption of its many programs for ecommerce, as retail has sought new online channels to offset a loss of foot traffic, and which will then benefit its payment and advertising businesses in the future.

Jennifer Herbert:

So projecting forward, both the shape and the timing of the recovery may look quite different in the US and in China. Which of these stocks should outperform and why?

Ryan Joyce:

Certainly it would appear that China is better positioned for a less severe recession or faster economic recovery than the US, given its apparent containment of covid-19, the easing of restrictions we've seen, and the additional leaders the government has available. However, given its large export sector, China is not immune from economic conditions in other countries. We think the range of economic outcomes moving forward remains quite wide. That is why it's critical to be invested in companies that we think can perform well in a broad-range scenarios, and hopefully emerge stronger from covid-19. We think each of Alphabet, Facebook, Alibaba, and Tencent meet that requirement.