



(UBS)

Revisiting five key questions for the tech sector

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In November 2023, the Chief Investment Office proposed five key questions that they believed would determine IT sector investments returns over the next year. Here we revisit those key questions...

1) Can Microsoft keep up the pace?

In our view, 3Q FY24 results and guidance were generally supportive of our bullish stance. Microsoft reported a solid quarter, highlighted by +31% growth in Azure revenue, which was an acceleration versus the prior quarter and better than expectations.

Guidance was somewhat mixed relative to consensus, as management said capital spending will increase significantly in the next quarter and going forward, and revenue guidance was slightly below expectations.

Microsoft's valuation, in our view, is the biggest challenge to a bullish view. MSFT currently trades at 33x NTM EPS relative to the five-year average of 30x. Relative to the S&P 500, MSFT carries a 62% premium, essentially inline with the 62% five-year average. While its valuation is certainly not cheap, we do believe it is justified by Microsoft's positioning, execution, high levels of annuitized profit pools, and balance sheet quality.

2) Do smartphones recover in 2024 and beyond?

Global smartphone shipments increased 7.8% year over year in 1Q24, according to industry analyst IDC. We previously wrote that early indications point toward better smartphone growth in 2024 after the segment returned to growth during 4Q23. This recent data point confirms the broad smartphone recovery. Furthermore, IDC looks for roughly 3% growth annually between now and 2028.

Looking ahead, we believe the industry may outperform IDC's outlook, particularly in 2024. We expect consumer demand to improve through the year, and look for inventory re-stocking to drive growth a bit higher. Longer term, the impact of on-board AI remains to be seen, but it is at least a small incremental positive.

3) Can the AI tide keep rising?

Alphabet, Amazon, Meta, and Microsoft all recently announced during first quarter earnings calls they plan to increase capital expenditures to continue investing in AI. Consensus estimates for aggregate CapEx among the three have increased significantly for both 2024 and 2025.

While there may be some digestion at some point in demand for GPUs and other AI semiconductors over the next 12–24 months, these strong revisions to cloud capex estimates likely provides a clear runway for continued growth over the next six to nine months.

4) What about the rest of semiconductors?

While investors have been captivated in AI-related semiconductors, the YTD performance of the rest of semiconductors has been more mixed. Semicap equipment stocks have gained +16% on average YTD

through 14 June 2024, while chip stocks related to PCs and servers are -16%, smartphone chip stocks are +25% YTD, analog chip stocks are +9%, and memory chip stocks are +58% YTD.

Our Most Preferred stocks are generally exposed to improving trends in PCs, smartphones, servers, and memory. Industry analyst Gartner expects a recovery in PC demand in 2024 and even better growth in 2025. While the adoption of AI in PCs is undoubtedly a positive, we believe the overall demand driver is simply a refresh of an aging installed base along with the upcoming end of support for the large Windows 10 installed base.

We remain overweight semiconductors relative to other groups in the IT sector on a combination of healthy fundamental drivers (both secular and cyclical) and the prospect for strong positive EPS estimate revisions, which typically helps drive chip stock performance through a cycle.

5) What happens to the rest of the IT sector?

We previously wrote that IT demand appears to be improving and that chief technology officer survey results point toward IT budget growth in 2024. While we remain confident in this view against a positive backdrop of economic growth, inflation trending lower, and eventual easing of interest rates, our high-level takeaways from some companies suggest discretionary spending on IT services is worth monitoring.

Does sluggish software revenue growth signal a sea change in what had been a secular growth profile for software? Is the growing interest in AI cannibalizing traditional IT spending? Or are purchase decisions simply being pushed out as IT departments pause spending as they settle on their AI strategies?

These questions are the great debates among investors. At this point, we lean toward the view that the current sluggish demand environment is not a structural change for the software industry. Rather, we believe that while there may be some slight cannibalization of traditional IT budgets by AI, the biggest driver is simply indecision. We believe IT buyers are pushing out decisions until they have better clarity on an AI strategy and the implications for their IT operations. Our expectation is that IT spending, which is historically back-half-loaded, may be even more concentrated this year, resulting in an outsized “budget-flush” in the calendar fourth quarter.

How to be positioned

We believe investors should first and foremost pay careful attention to both sector exposure and individual position sizes. This is the most basic form of risk management, especially in more difficult environments.

Second, we continue to focus on reasonable valuations, quality balance sheets, and strong free cash flows.

Third, we focus our exposures on companies more exposed to enterprise IT spending, especially those with recurring revenue.

Fourth, while AI will require significant investment, our expectation is that the real value of AI will be driven by proprietary data. In this light, we look for companies with vast piles of proprietary data or that facilitate the management of data.

Lastly, in semiconductors we prefer to focus on companies that have leverage to the PC, smartphone, and server markets, where we expect a cyclical recovery off depressed levels.

For more, see our latest report - [Equity preferences: US Equities Information technology](#), 17 June 2024.

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