

Notes from the CES: As ‘Old’ Tech Tries to Stay Relevant, Investors Need to Be Careful

Last month, I traveled to Las Vegas to visit the world’s largest annual technology trade event, the Consumer Electronics Show (CES). My goals: Preview technologies and gadgets before they become mainstream, meet with corporate management teams and, on behalf of PIMCO clients, determine whether we are being fairly compensated when investing in investment grade (IG) bonds of technology companies, particularly those that are struggling with innovation or that have uncertain long-term technology paths. (Hint: Be careful.)

I came across a number of developing technologies (e.g., augmented virtuality, OLED TV sets, etc.), but didn’t see any particularly hot product category. I did see many old tech companies trying to launch “me too” products and disguise them as innovations.

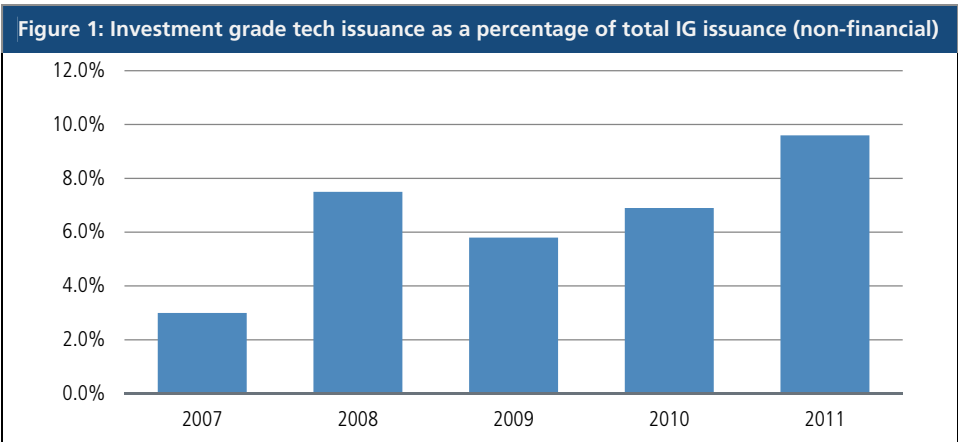
Arguably, many companies at CES are on a path to becoming obsolete. We saw one CES attendee, Eastman Kodak, file bankruptcy recently, and as I toured the many smartphone booths at CES, I was constantly reminded about the 12- to 18-month average smartphone replacement cycle.

Over the past few years, banks and investors have generally become more willing to lend to large-cap technology companies, as many of the companies’ business models have matured, their free cash flow generation has increased and their cash balances have swelled. According to ISI, the technology sector had accumulated 32% of the non-financial cash in the S&P 500 by the end of the third quarter last year. We also saw record investment grade technology debt issuance in 2011, with over \$44 billion of supply – up more than 50% from the prior year, according to Dealogic and Bank of America.

Additionally, investment grade technology new issuance in 2011 accounted for almost 10% of non-financial investment grade issuance, up from 3% four years ago (Figure 1).

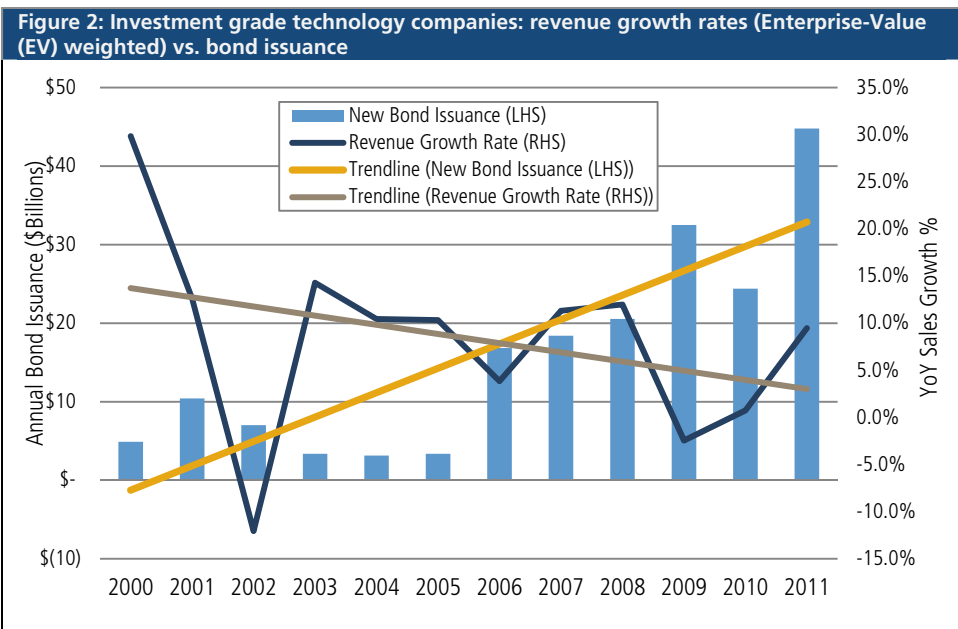


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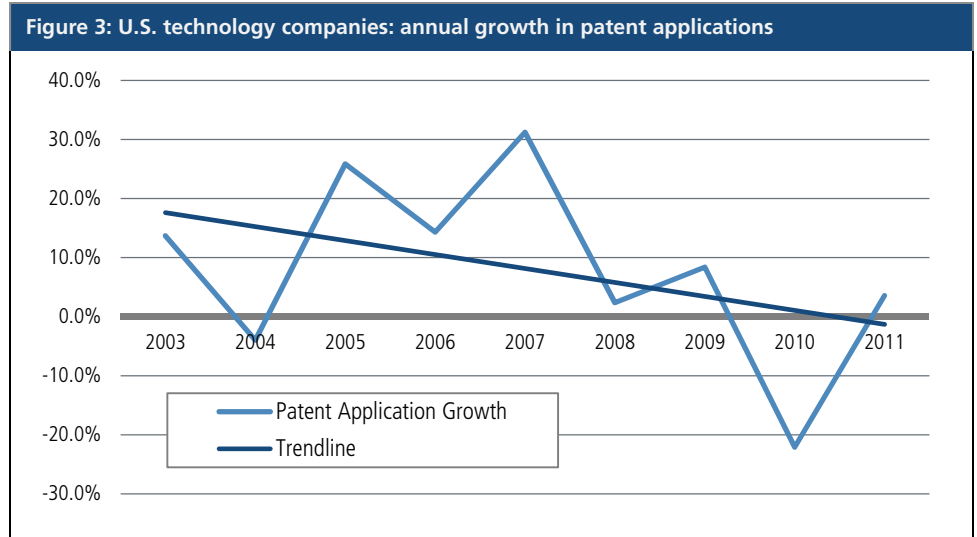
Source: Dealogic and Bank of America, as of 31 Dec 2011.

We analyzed the revenue growth rates and the debt issuance for technology companies in the IG17 index over the past 11 years and found slowing revenue growth trends and increasing debt issuance (see Figure 2). One of the main reasons for slowing growth is the nearly full level of penetration in certain high-tech product markets. For example, developed countries tend to have near 100% personal computer (PC) penetration, and some countries have over 100% mobile phone penetration. Lack of innovation could also be a contributing factor to slower growth, as well as the fact that it is increasingly challenging to continue to grow large-scale multibillion-dollar companies.



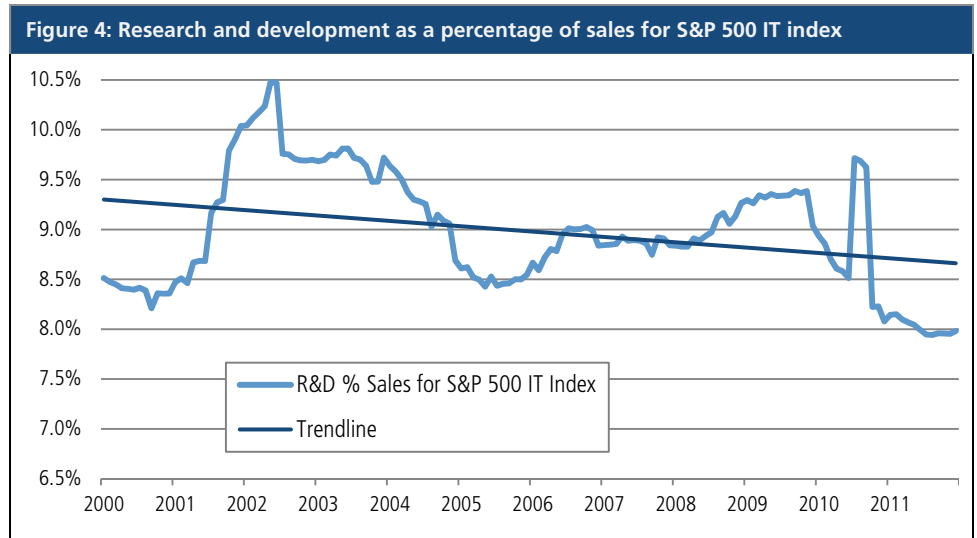
Source: Dealogic, UBS, PIMCO; Revenue growth is for IG tech companies in the IG17 index, as of 31 Dec 2011.

We believe that innovation remains a key driver for future revenue growth for many of these investment grade technology companies. As shown in Figure 3, patent application growth has varied annually but declined over the last eight years for U.S. technology companies, indicating less innovation and future growth for many of these investment grade technology companies.



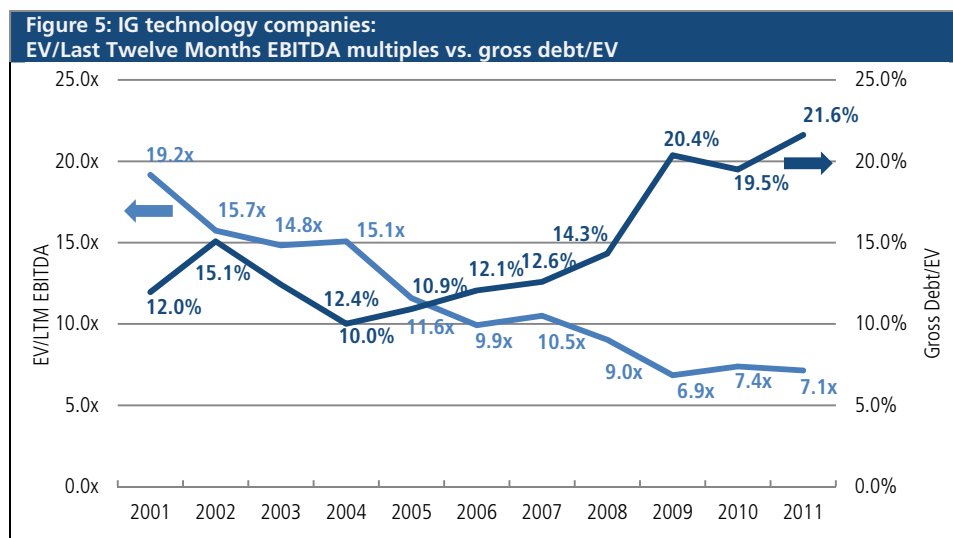
Source: WIPO, as of 31 Dec 2011

Research and development as a percentage of sales has also been declining, and is now only approximately 8% of sales for S&P 500 IT companies, down from over 9% in 2002–2004, as seen in Figure 4. The decline in research and development is most likely due to companies managing their margins and earnings per share (EPS) in recent years.



Source: Bloomberg, as of 31 Dec 2011

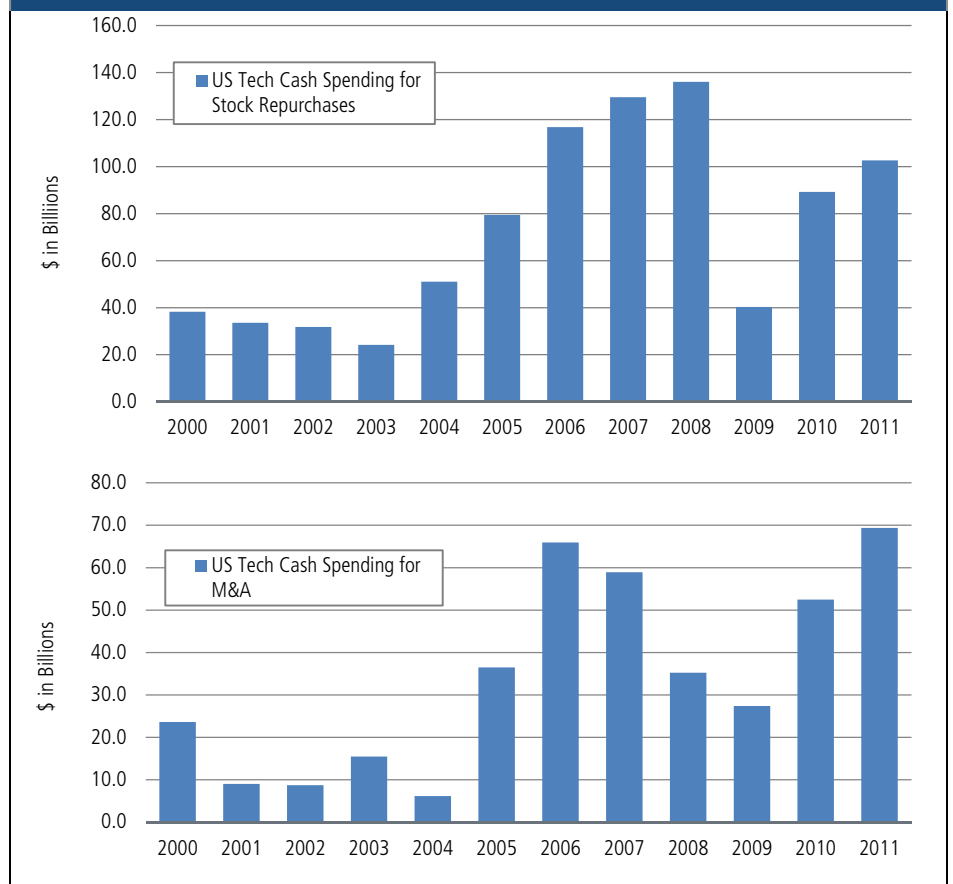
The Enterprise Value (EV) to EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) multiples for investment grade technology companies have also consistently tracked lower through the years as growth and innovation has slowed. EV/EBITDA is a commonly used financial metric that is used to gauge the value of a firm; comparing the value of the firm to the company's operating cash flow, generally the higher the multiple, the more valuable the company. The declining valuations of IG technology companies are somewhat troubling, as debt levels and gross debt-to-EV ratios continue to rise in the investment grade tech sector, implying an increasing use of debt leverage (Figure 5). However, many of these tech companies tend to generate significant free cash flow and have net cash positions.



Source: Capital IQ, PIMCO, as of 31 Dec 2011

As tech companies struggle to reinvent themselves, many investment grade tech firms have resorted to buying their technology instead of building it themselves. These companies have used the debt markets to fund stock buybacks and acquisitions. We believe the growth in investment grade technology issuance will likely continue, as many of these companies have the majority of their cash trapped overseas due to repatriation taxes (based on ISI and our own data, we estimate 67% of tech company cash is trapped overseas), acquisitions are expected to continue due to increasing technology growth needs, and share buyback programs are expected to increase as equity valuations continue to drop.

Figure 6: Cash spending by U.S. tech companies

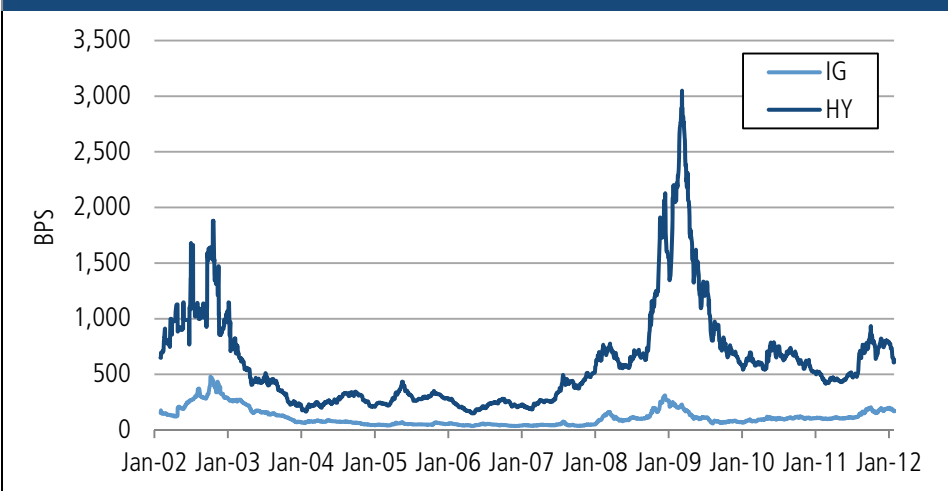


Source: UBS, Capital IQ, as of 31 Dec 2011

We continue to monitor the increasing use of leverage and decreasing EV/EBITDA multiples in the IG technology sector. In a downside scenario, a company could have an EV/EBITDA multiple that is less than the leverage (total debt/EBITDA), which implies impairment of the company's debt. Many former technology giants with obsolete technology platforms now trade in the 2.5x to 3.5x EV/EBITDA range. Thus, if a company's leverage goes above 3.5x, the company's bonds would be impaired.

When comparing the high yield tech credits in the HY17 index and the investment grade tech credits in the IG17, the credit default swap (CDS) spread differential is large. (Credit default swaps allow investors to transfer the default risk of an issuer's bonds to other investors who are willing to take that risk for a fee. Higher spread levels on a company's or sector's CDS generally mean higher perceived default risk.) The differential is due to the higher leverage of tech companies in the HY17, but also to the tech obsolescence issues that many of these companies face. The HY17 index outperformed the IG17 in January with total returns of 5.24% and 0.94% respectively, and when removing Kodak from the HY17, high yield technology companies in the HY17 have tightened more than investment grade (IG17) technology companies. The CDS spread differential between HY17 technology companies and IG17 technology companies is currently 454 bps vs. the average of 646 bps over the past five years, which implies that many of the IG17 tech companies may be overvalued. We did not include Kodak in our HY17 tech spread analysis, since it recently defaulted and would have even further skewed HY17 tech CDS spreads to more than 1,500 bps.

Figure 7: Investment grade vs. high-yield tech CDS spreads: Jan. 2002-Jan. 2012



Source: PIMCO, Markit Partners, IG17 and HY17 indexes, as of 31 Jan 2012

Although it is rare to see an investment grade technology company migrate to high yield, there have been a few occurrences (e.g., Eastman Kodak, Unisys, Jabil, Solectron). Additionally, a few companies have dipped into high yield only to return to investment grade (e.g., Xerox and Avnet). For these companies, the ratings migration to high yield was mainly due to a combination of tech obsolescence issues and increases in leverage.

Investment conclusion

Although the large technology companies have the biggest displays at CES as well as most of the flashy commercials and buzz, many of them struggle to reinvent themselves every few years. The old technology companies are trying to stay relevant and are finding it difficult to innovate in an increasingly competitive global technology market where a few companies dominate particular technology subsectors.

In our opinion, these trends of slowing innovation, cash trapped overseas, the need to pursue acquisitions in order to enhance their technology platforms, and the need for share buybacks and dividends to drive shareholder returns all point to higher levels of debt and leverage in the future. This increasing use of financial leverage is coupled with technological obsolescence risks.

We believe investors need to be compensated for the obsolescence risks that are inherent in many of these technology-based business models. While the pace of technological change may have slowed recently, paradigm shift can occur quickly, and therefore we continue to evaluate disruptive technologies and their potential impacts.

PIMCO tends to favor technology companies with strong and growing patent portfolios in areas of secular growth with strong free cash flow generation and low leverage. We continue the hunt for value within the technology sector and – based on our long-term feasibility analysis and the demonstrated technology obsolescence risks as well as our financial analysis – remain very selective in the sector.

Biography

Mr. Ing is a senior vice president in the Newport Beach office and credit analyst responsible for U.S. telecom, media and technology sectors. Prior to joining PIMCO in 2007, he was a senior analyst in Wells Fargo's securities investment group, covering telecom and technology. He also previously worked as an associate equity research analyst at Credit Suisse First Boston, helping to cover technology companies in Asia. He has 13 years of investment experience and holds a master's degree in mathematics of finance from Columbia University and an undergraduate degree from the University of Southern California.

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