The *buy* side

What investors want to know *about technology businesses*

When looking at the fast-moving technology sector, investors are particularly keen to gain insights into companies' long-term strategy. Richard Clode, portfolio manager on the global technology team at Janus Henderson, tells *Tim Cooper* why.

From an investor perspective, technology companies have improved their corporate reporting in recent years. But there is still much room for improvement, according to Richard Clode of Janus Henderson. He encourages companies to disclose more strategic information and says the market is rewarding those that are starting to do so.

In particular, some major online retailers have started using their annual letter to shareholders, written by the CEO, to give investors genuine insight that is lacking elsewhere.

"In technology, it is hard to find a company with a unique, differentiated offering and sustainable barriers to entry," says Clode. "We aren't just looking for companies with the best products or services today, but those that will still be in that position in five years.

"We don't have insight into companies' research and development laboratories, so it's important to find management teams that are spending money in the right areas to keep evolving. Most company reports don't give the best insight into that. Most simply help us build our financial models, but we don't use them for insight. The financials are just a snapshot of what's happening. [Long-term value] is much more intangible."

Clode and his team therefore travel the world regularly to meet companies and their trading partners, customers and competitors. They also attend regular investor and analyst events and use third parties for proprietary research.

Other sources of reported information come from funding round prospectuses, but these also usually offer limited insight, says Clode. "We do look at commentaries around the reported numbers for evidence that the management understands its competitive position, where technology trends are going and how it needs to prepare," he explains.

"All too often, that commentary is public relations fluff. But these new types of annual shareholder letter show how to educate investors and lay out where the company is in a much more strategic, big-picture way."

For example, he explains, they might detail how the company runs the various businesses in its group. They might not just talk about the next big thing in technology, but also about the company's development process, such as how it uses "fail fast" systems to limit the damage of an unsuccessful project, or how it starts with the customer experience and then works backward.

"That helps us understand how the company thinks, what they will do next and whether we agree with those moves," says Clode. "These are more interesting insights, so we encourage companies to take control of them and say something more meaningful in them."

SEGMENTAL REPORTING

Another welcome development is more segmental reporting – for example, splitting out information about a company's cloud department in its quarterly earnings report, which some have done in recent years. Some major online retailers and software providers give much more disclosure around segmental reporting and the progress of new initiatives in each segment, says Clode. "It's helpful to understand their successes. If [information about segments is hidden], we can't see how they're progressing."

Many other companies still do not report segments in a useful way, he adds; they are usually a function of accounting rather than how an investor would look at the company. "But there is a push toward more segmental reporting now and we encourage companies to split out the parts that are key to share price and longer-term value, to give more insight."

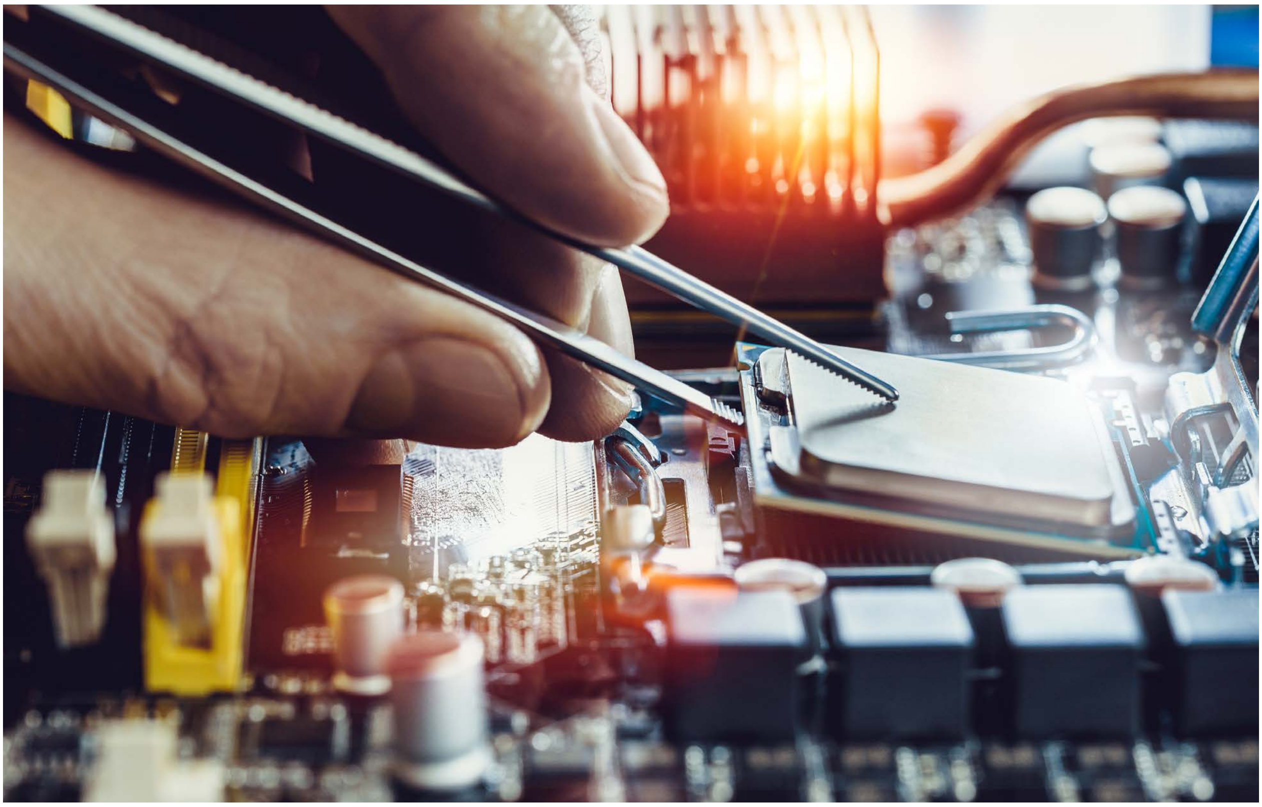
He says increased segmental reporting can sometimes be a response to companies feeling that their stock price and story is misunderstood.

"For example, with one retailer, people were frustrated with it being in a long-term investment phase," he explains. "So the next year, it disclosed that its cloud service had a much higher margin than its e-commerce business and was growing much faster. In fact, it now accounts for the majority of its profits, with e-commerce in the minority. That initial disclosure was helpful to understand that this was possible, so we could judge what we'd want to pay for the company in the longer term."

BACK TO GAAP

A further area of improvement in the last two years has been the refocus on Generally Accepted Accounting Principles (GAAP) reporting by technology companies, according to Clode.

In technology, a large part of many executives' compensation packages comes from stock options. This can dilute other shareholders' investments. "Most big technology companies are moving back to focusing on GAAP numbers, which is a positive trend that cleans up [compensation reporting]," says Clode. "Historically, most technology companies focused on another set of adjusted numbers in their



reports. These non-GAAP numbers would often exclude share-based compensation.

"We encourage this move toward GAAP accounting and more disclosure around the targets that managers have to achieve to receive their – often large – stock options. Investors still need companies to be more transparent about these performance targets, as it allows better alignment of management and shareholders."

He adds that many technology companies did not report quarterly cashflow statements, but most now do. Cashflow statements are important in assessing whether adjusted numbers resemble the true state of the company because, in unscrupulous hands, they are prone to manipulation. They are a good sense check, Clode says.

"The move toward focusing more on GAAP accounting numbers also makes technology company financials more comparable to peers and other sectors," he adds. "We are a long way from everyone reporting in a similar way, but companies have moved toward that in the last year or two."

He also encourages the communication of longer-term targets and the wider impact of company policies and strategies on environmental, social and governance (ESG) factors. Poor decisions related to ESG can affect finances and factors beyond the company, he says.

BEYOND THE HYPE

This kind of information is crucial for avoiding what Clode calls the hype cycle, where technology companies' share prices become overpriced due to market speculation.

While it is hard to know precisely which technologies will provide the best return on investment in future, Clode says some major disruptive shifts are clear; for instance, in automotive technology and artificial intelligence. The way they report several aspects of their business will be important, he says.

"For example, ride-hailing through an app, and electric and autonomous vehicles, are all changing the way the car industry is run. Automotive technology companies are not particularly better or worse at disclosure. However, when autonomous driving takes off, they will need to evolve their disclosures as the liability for accidents moves from a human to an algorithm and from the individual to a corporation. Shareholders will need to be clear about the potential risks." ■

PROFILE

Richard Clode is one of three co-managers of Janus Henderson's Global Technology Fund and Horizon Global Technology Fund, two of the longest-running and largest technology funds in Europe. Janus Henderson is an active investment manager formed in 2017 by the merger of Janus Capital Group and Henderson Global Investors. It manages £265b of funds and has more than 2,000 employees and offices in 27 cities worldwide. Clode has 15 years of financial industry experience and has been a portfolio manager on the global technology team since joining Henderson in 2014. Before that, he held positions with Gartmore, Moore Capital Management and Pioneer Investments.

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