ATLANTIC
FINANCIAL GROUP

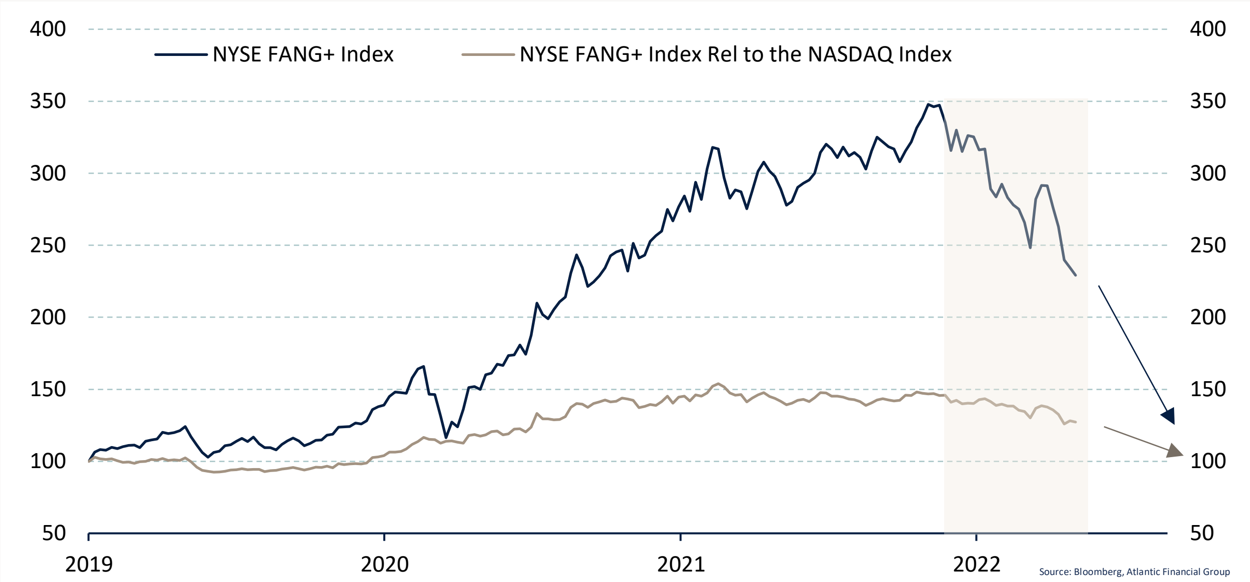
Weekly Investment Focus

16 May 2022

"FANG'S ON THE VERGE OF A BANG!"

- Does the deceleration in growth rates explain the loss of momentum in the FANG?
- Or are there other headwinds challenging their supremacy?
- Following the recent price correction, are valuation multiples more attractive?

CHART OF THE WEEK: "Underperformance of the FANG compared to the NASDAQ"



FINANCIAL MARKET ANALYSIS

The FANG (Facebook, Amazon, Netflix, Google) are tech behemoths, each a leader in its field. Until recently, they had the characteristic of double-digit growth rates and a less volatile share price than other growth stocks.

The FANG have been underperforming the NASDAQ since November 2021 (see Chart of the Week). The first company to fall was Amazon (July 2020), followed by Facebook (October 2021), Netflix (November 2021), and more recently Alphabet (April 2022). For Netflix, the underperformance may have already started in May 2020, but the stock recovered between August and November 2021. (see Fig. 2)

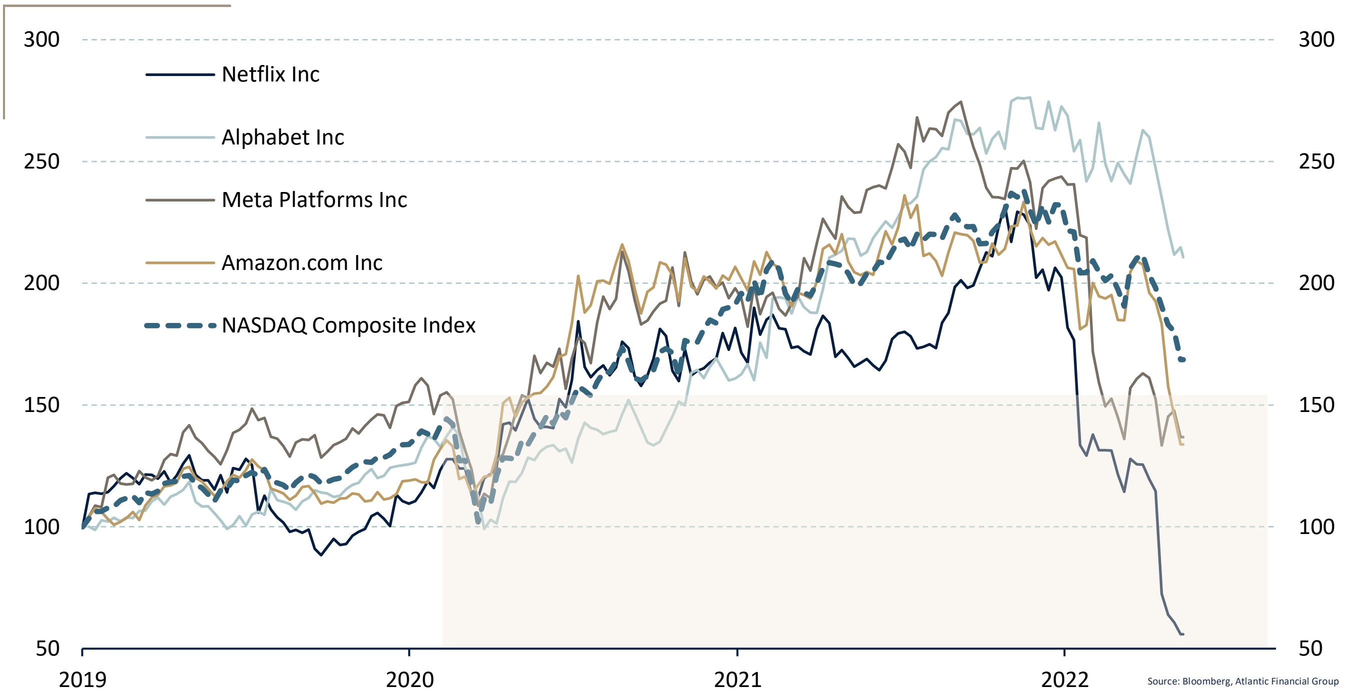
♦ Does the deceleration in growth rates explain the loss of momentum in the FANG?

One of the main reasons for this underperformance is the **expected slowdown of growth.** FANG are increasingly dependent on the health of the economy and less on their ability to gain market share. **Analysts' estimates have been overly optimistic** and based on their ability to replicate their business model abroad with the same success and margins as in the US domestic market.

Moreover, the latest quarterly results show that **these companies are also experiencing inflationary pressures.** Amazon explains the pressure on its margins from rising wages and fuel prices but also from excess capacity at its fulfillment and transport centres. Unlike previous years and the massive surge in online shopping during the Covid-19 pandemic, **the normalisation of demand is putting pressure on** Amazon's **margins**. In addition, **competitors have emerged in e-commerce** (e.g. Shopify, Walmart and Target) that are putting further pressure on margins. Netflix, on the other hand, is losing subscribers while the cost of producing content is increasing and competition is intensifying with the entry of new players on the streaming video market such as AppleTV, Amazon prime, Disney+...

These companies are reinvesting much of their cash in research and development of new businesses. Meta Platform is investing heavily in Metaverse, which is a drag on margins but could also lead to even more lucrative new businesses. Google Cloud still only accounts for 9% of Alphabet's revenues but growth in this area is stronger than the current business lines.

Fig. 2 - Meta, Amazon and Netflix have erased the Covid-19 pandemic outperformance



Source: Bloomberg, Atlantic Financial Group

- Other headwinds are challenging the supremacy of big-tech?

Beyond the economic aspect, the FANG are under increased pressure from regulators. This sword of Damocles has been hanging over their heads for several years now. Whether it is about antitrust practices, the protection of consumers' private data or the taxation applicable to their digital business model, investors have many reasons to worry.

For a long time, and unlike the energy or banking sectors, big tech had been relatively insulated from political pressure. For some years now, investors have been wondering about the risk of politicians and regulators dismantling big tech, as AT&T was in 1984 with the forced creation of the "baby Bells".

The number of complaints filed against these large online platforms varies by jurisdiction, but one thing is clear: **the power wielded by these online platforms in all aspects of life is immense, and equally troubling for antitrust enforcement agencies.**

In the United States, the CALERA bill, initiated by Senator Klobuchar, is an example of antitrust development for better regulation of online platforms. Many governments are considering strengthening the regulation of technology companies that have become even more powerful since the COVID-19 pandemic.

Big-tech regularly use their advantage to influence the market:

- **Apple removed Fortnite from the Apple Store** when it decided to create its own in-app purchase system. The price of the game quickly dropped following the removal from the Apple Store. After a complex legal battle between Fortnite's publisher, Epic Games, and Apple, a US federal court ruled that Apple had violated California's unfair competition laws and ordered it to let game developers direct customers to third-party payment systems outside the App Store for in-app purchases.

- **Amazon's platform** allows multiple retailers to sell their products online. However, the company uses the analytical data collected by its services to determine which products generate high profits. The company also sells these products on its website, which competes with its retailers.

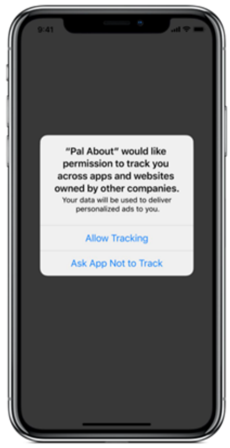
- **Facebook is said to have bought its rival company, Instagram, to control the growing mobile consumer market.** The Federal Trade Commission (FTC) alleges that while Facebook's acquisitions of Instagram and WhatsApp have not led to higher prices, but they have led to lower quality services and less choice for consumers.

- **Google search engine.** It appears that Apple and Google have repeatedly violated the country's antitrust laws. Last year, to remain dominant in iPhones, Google gave Apple $15 billion on top of the $50 billion already paid since the deal was sealed. The agreement calls for Apple to give up developing its own search engine, allowing Google to secure a large amount of traffic each year.

The CALERA bill aims to regain control and implement regulations that will put small and large technology companies on an equal footing. In Europe, **the Digital Services Act** should help to better supervise these giants by imposing control obligations, in particular to force them to remove illegal content (disinformation, incitement to hatred and violence, pornographic content, etc.) and to monitor more closely the goods sold on their platforms (counterfeits, dangerous products, etc.). **The text also aims to fight against the abuse of personal data and to impose more transparency on the algorithms used by these sites.**

Major reforms of the advertising industry need to take place and quickly. Investors may have finally woken up to the scale of the challenges facing the ad-tech giants. **Facebook's advertising business would be highly exposed to any regulatory hurricane against permissionless internet tracking, as it does not offer its own users the option to opt out of behavioural targeting**.

Fig. 3 - iOS privacy protection



Source: Apple, Atlantic Financial Group

Changes to the iOS privacy system that limit third-party tracking on Apple mobile devices are also weighing heavily on the ad-tech giants. Apple now requires tracking permission for displaying targeted ads, sharing device location, sharing a list of emails, ad IDs or other identifiers used for targeting and/or placing a third-party SDK (Software Development Kit) in the app that combines an app's user data with the user's data to target advertising (see Fig. 3).

On the other hand, **G7 finance ministers are considering new tax laws to target these multinationals and better reflect the digital economy.** Under current international tax rules, multinationals generally pay corporate tax where production takes place rather than where consumers are located. However, thanks to the digital economy, companies (implicitly) derive income from users abroad but, without a physical presence, are not subject to corporate tax in that foreign country. To address these concerns, **the Organisation for Economic Co-operation and Development (OECD) has held negotiations with over 130 countries to adapt the international tax system.** The current proposal would require some of the world's largest multinational companies to pay part of their income tax where their consumers are located. **The tax rate could be higher than it is now.** Meta Platform has an effective tax rate for the 2021 tax year of around 17%, 16% for Alphabet, 12.5% for Amazon and Netflix, which is significantly lower than the official rate of 21% in the US and 21.8% in Europe on average.

♦ Following the recent price correction, are valuation multiples more attractive?

FANG have strong balance sheets and generate huge amounts of cash. The market correction is bringing them close to historically low valuation multiples (see Fig. 4), reflecting potential downward revisions to earnings or investor concerns about regulatory, political or economic developments that lack visibility.

The 2023 PE for the FANG ranges from 29.8x for Amazon, 15.9x for Alphabet, 15.2x for Netflix and 12.6x for Meta for expected double-digit growth rates, admittedly below those of previous years, but well above international companies such as l'Oréal or Clorox, whose PEs are significantly higher at 29.8x and 29.3x respectively.

Fig. 4 - Ratio table

NAME	META PLATFORMS INC-CLASS A	AMAZON.COM INC	NETFLIX INC	ALPHABET INC-CL A
Ticker	FB US Equity	AMZN US Equity	NFLX US Equity	GOOGL US Equity
Mkt Cap (mio)	537 530	1 150 268	83 364	1 531 505
Currency	USD	USD	USD	USD
Price	198.62	2 261.10	187.64	2 321.01
Perf YTD	-40.9%	-32.2%	-68.9%	-19.9%
Perf 1YR	-37.1%	-29.8%	-62.0%	1.9%
Perf 3YR	6.2%	18.5%	-47.8%	95.9%
FCF Yield	33.7%	-5.2%	-0.1%	26.8%
ROE	21.3%	12.4%	30.8%	20.2%
Net Debt / EBITDA	-0.5	1.0	1.7	-1.1
PE 2023	12.6	29.8	15.2	15.9
P/Sales 2023	3.6	1.9	2.4	5.3
P/Book 2023	3.1	5.6	3.4	4.4
Credit Rating	na	AA	BBB	AA+

Source: Bloomberg, Atlantic Financial Group

The business models of some companies are starting to show signs of weakness. For example, **Meta Platform seems to be suffering more than Alphabet from the iOS changes Apple has made to its phones. Advertising growth is greatly affected**, but Meta Platform is investing heavily in the metaverse, making it clear that it is trying to dominate a segment of the internet ahead of its main competitors, Google and Apple. This frantic race is likely to put a temporary strain on its finances. **The hardware investment to build this virtual universe is substantial** and could have other usage than those announced, notably in artificial intelligence, virtual reality and machine learning. Estimates vary, but the metaverse could represent a financial opportunity of $1.6 to $30 trillion beyond 2030.

Alphabet is much more broadly positioned than e-commerce company Amazon or streaming company Netflix, and while the growth of rival companies has slowed, Alphabet's core businesses continue to grow at rates of over 20%. Alphabet is one of the highest free cash flow generators with $69 billion in the last 12 months alone. Amazon and Netflix can't say the same: they burn more cash than they generate over the same period of time. Facebook also continues to perform well, having generated almost $40 billion in free cash flow and a margin of almost 34%, higher than Alphabet (27%).

Finally, strong cash generation is allowing these companies to implement share buyback programmes, including $70 billion for Alphabet, which should support the share price.

Conclusion:

Big-tech stocks have contributed to the NASDAQ's strong rise over the past 14 years. They are also among the last to correct, accelerating the indices’ rate of decline.

The platforms' business model is largely based on advertising revenue, a highly cyclical area that caused Google to lose 68% of its market capitalisation in 2008, even though revenue growth was ultimately largely positive (+8.5% in 2009 compared with +31.3% in 2008) and net earnings per share increased by 25.5% in 2008 and 21.2% in 2009. Today its business model is more diversified thanks to the Cloud offering. Thus, even if growth were to weaken, this should not affect the group's profitability.

Inflation could still cloud the picture and the resolution of the conflict in Ukraine or the end of the lockdown in China will not be enough to convince investors to return to technology and growth stocks.

The market has entered a "bear market" which will probably end when the Fed becomes "dovish" again. Until then, the FANG sector is probably not the place to hide.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	629.2	35.00	-2.2%	-9.4%	-15.9%	19.0%	16.9%
USA (S&P 500)	4 024	38.81	-2.4%	-9.4%	-15.1%	28.7%	18.4%
USA (Dow Jones)	32 197	38.79	-2.1%	-6.7%	-10.8%	20.9%	9.7%
USA (Nasdaq)	11 805	38.73	-2.8%	-13.4%	-24.3%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	413.3	46.35	1.7%	-2.1%	-12.1%	23.5%	0.8%
UK (FTSE 100)	7 418	49.04	0.5%	-1.9%	1.9%	18.4%	-11.4%
Switzerland (SMI)	11 650	39.28	-0.5%	-5.5%	-7.1%	23.7%	4.3%
Japan (Nikkei)	26 538	46.50	-2.1%	-1.5%	-7.8%	6.7%	18.3%
Emerging (MSCI)	1 005	31.24	-2.6%	-10.1%	-17.9%	-2.3%	18.8%
Brasil (IBOVESPA)	106 924	41.69	1.7%	-8.4%	2.0%	-11.9%	2.9%
Russia (MOEX)	2 308	39.54	-3.6%	-8.5%	-38.6%	21.9%	14.8%
India (SENSEX)	53 299	27.26	-3.6%	-9.4%	-9.1%	23.2%	17.2%
China (CSI)	3 965	46.10	2.1%	-3.6%	-19.2%	-3.5%	29.9%
Communication Serv. (MSCI Worl	85.11	39.03	-0.5%	-11.5%	-22.5%	10.9%	24.2%
Consumer Discret. (MSCI World)	300.6	33.15	-2.7%	-14.0%	-26.4%	9.2%	37.0%
Consumer Staples (MSCI World)	272.9	42.00	0.3%	-3.6%	-5.5%	11.7%	8.8%
Energy (MSCI World)	231.6	53.46	-2.6%	-0.5%	24.5%	37.5%	-27.7%
Financials (MSCI World)	130.6	30.50	-2.7%	-9.4%	-12.1%	25.1%	-3.1%
Health Care (MSCI World)	326.6	35.92	-1.4%	-9.0%	-10.9%	18.0%	15.4%
Industrials (MSCI World)	274.6	32.41	-2.1%	-7.3%	-16.6%	16.6%	11.8%
Info. Tech. (MSCI World)	433.5	39.03	-3.0%	-10.7%	-24.3%	27.6%	46.2%
Materials (MSCI World)	327.0	31.56	-3.7%	-11.7%	-9.0%	15.4%	21.6%
Real Estate (MSCI World)	197.2	32.16	-3.0%	-10.8%	-15.2%	23.6%	-5.7%
Utilities (MSCI World)	155.9	40.20	-1.3%	-5.8%	-3.1%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	2.91%	43.12	1.4%	-1.9%	-10.1%	-2.4%	9.3%
Euro Area (7-10 Yr)	1.56%	44.20	2.0%	-1.8%	-9.4%	-2.9%	4.5%
Germany (7-10 Yr)	0.95%	43.71	1.4%	-1.4%	-8.0%	-2.7%	3.0%
UK (7-10 Yr)	1.74%	57.77	2.2%	0.9%	-5.0%	-4.9%	5.4%
Switzerland (7-10 Yr)	0.77%	53.64	1.9%	0.4%	-6.8%	-2.3%	0.4%
Japan (5-10 Yr)	0.25%	52.23	0.1%	0.1%	-1.2%	0.0%	-0.1%
Emerging (5-10 Yr)	7.20%	24.93	0.3%	-4.7%	-16.7%	-2.3%	5.2%
USA (IG Corp.)	4.38%	36.52	0.3%	-2.5%	-13.4%	-1.0%	9.9%
Euro Area (IG Corp.)	2.24%	35.07	0.8%	-1.9%	-8.1%	-1.0%	2.8%
Emerging (IG Corp.)	7.07%	20.73	-0.5%	-3.2%	-14.0%	-3.0%	8.1%
USA (HY Corp.)	7.61%	17.26	-0.3%	-4.1%	-10.4%	5.3%	7.1%
Euro Area (HY Corp.)	6.71%	28.33	1.1%	-3.2%	-8.4%	3.4%	2.3%
Emerging (HY Corp.)	10.03%	21.85	-0.3%	-4.6%	-12.4%	-3.2%	4.3%
World (Convertibles)	364.1	28.64	-2.7%	-9.6%	-16.9%	2.4%	38.8%
USA (Convertibles)	484.0	31.04	-3.1%	-11.5%	-18.4%	3.1%	54.5%
Euro Area (Convertibles)	3 609	27.44	-1.3%	-3.8%	-12.1%	-0.3%	6.1%
Switzerland (Convertibles)	178.3	54.22	0.9%	0.3%	-4.1%	-0.5%	0.5%
Japan (Convertibles)	196.0	46.36	-0.5%	-0.4%	-2.4%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	726.7	61.31	n.a.	2.4%	n.a.	8.2%	6.4%
Distressed	966.8	72.22	n.a.	0.4%	n.a.	12.5%	3.8%
Event Driven	812.3	66.62	n.a.	0.3%	n.a.	12.9%	7.0%
Fixed Income	393.5	63.02	n.a.	-0.3%	n.a.	5.2%	3.6%
Global Macro	1 205.0	80.58	n.a.	8.8%	n.a.	9.6%	6.5%
Long/Short	927.5	59.20	n.a.	0.5%	n.a.	8.3%	7.9%
CTA's	341.6	77.41	n.a.	8.5%	n.a.	8.2%	1.9%
Market Neutral	290.1	66.23	n.a.	0.2%	n.a.	6.2%	1.7%
Multi-Strategy	696.9	75.78	n.a.	2.3%	n.a.	7.0%	5.6%
Volatility							
VIX	28.87	50.61	-4.4%	32.3%	67.7%	-24.3%	65.1%
VSTOXX	29.11	45.12	-11.2%	0.9%	51.1%	-17.6%	67.5%
Commodities							
Commodities (CRB)	630.0	n.a.	-0.4%	-1.4%	8.9%	30.3%	10.5%
Gold (Troy Ounce)	1 809	29.23	-2.5%	-8.6%	-1.1%	-3.6%	25.1%
Oil (WTI, Barrel)	110.49	57.57	7.2%	6.0%	43.5%	58.7%	-20.5%
Oil (Brent, Barrel)	109.90	52.57	-1.9%	2.9%	44.6%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	104.514	68.84	0.8%	4.2%	9.2%	6.4%	-6.7%
EUR	1.0404	30.19	-1.5%	-3.5%	-8.5%	-7.5%	9.7%
JPY	129.00	43.28	1.0%	-1.6%	-10.8%	-10.2%	5.1%
GBP	1.2249	28.56	-0.7%	-5.9%	-9.5%	-1.0%	3.1%
AUD	0.6888	33.42	-0.9%	-6.3%	-5.2%	-5.6%	9.6%
CAD	1.2958	40.39	0.4%	-2.7%	-2.5%	0.7%	2.1%
CHF	1.0026	19.00	-0.9%	-5.8%	-8.9%	-3.0%	9.4%
CNY	6.7896	11.75	-0.9%	-6.2%	-6.4%	2.7%	6.7%
MXN	20.131	53.30	1.3%	-1.5%	2.0%	-3.0%	-5.0%
EM (Emerging Index)	1 666.7	21.70	-0.8%	-4.0%	-3.9%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group — Total Return by asset class (Negative \ Positive Performance)

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