

QV UPDATE

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Investing in Technology

Technology is discussed in almost every meeting we have with clients. Most of the discussion is around new technology platforms such as Netflix and Amazon, and which of these businesses QV would invest in. We have looked at many technology businesses over the years, and invested in some, but many exhibit high valuations and lofty expectations.

According to a recent study released by Bond, a leading investment technology firm, 3.8 billion people currently use the internet. That is over half the world's population! The penetration of people using the internet in Europe and North America is over 75%, while the Asia Pacific region, which contains India and China, has a penetration of only 53%. The opportunity for growth in internet-related companies looks extremely large.

We recently analyzed Canadian technology darling Shopify (SHOP), an ecommerce website builder that is a real beneficiary of the above trend. Shopify allows budding entrepreneurs and developed businesses to create their own online stores. A business owner doesn't need to be very tech savvy to create and run an ecommerce site using Shopify's tools. Moreover, this platform seamlessly translates into many different languages and easily integrates with Amazon and eBay to manage all product sales within one application.

Shopify has grown its revenues from \$50 million in 2013 to over \$1 billion in 2018. Regrettably, the company's losses have grown at an equally rapid rate. The 2019 guidance from the company predicts revenue of approximately \$1.5 billion with a record operating loss of approximately \$140 million. Given elevated costs in the business, we are unable to forecast improvement in operating losses, even when using significant growth estimates.

Selecting companies based on valuation allows us to choose businesses that have a higher probability of generating a return over time. We don't believe Shopify is attractive relative to other opportunities in the technology sector. As an example, Open Text, a software company held in QV's large cap and balanced strategies, trades at

less than half the market capitalization of Shopify, even though it generated \$708 million of cash flow in 2018. Open Text has used its strong cash flow to pay dividends, invest in organic growth and successfully complete acquisitions which have strengthened the business. On the other hand, Shopify has generated only \$46 million in cumulative cash flow over the past 5 years. Growth is an attractive attribute, but we also need to see profitable growth and a valuation that provides a better ability to generate a return.

Within our portfolios, the impact of technological innovation extends well beyond the technology sector. For example, at its recent investor day, Canadian National Railway discussed how it is using new technology to improve its century-old business.

If you have driven near train tracks in this country, you have probably seen white pickup trucks with red CN logos nearby. Inside these trucks are track inspectors who travel at a speed of approximately 15 km/hr to examine the rail, rail ties and track bed. Because they can't inspect the track when a train is near, an interruption is required to allow them to work safely.

At the investor day, CN revealed an autonomous track inspection boxcar that can scrutinize the track as it is pulled along. The positive implications are numerous. The human eye gets tired and has trouble seeing in certain light conditions. Humans also get cold and need to warm up in bitter winter conditions. The boxcar travels at 60 km/hr along with a regular revenue train, so no down time needs to be scheduled. It is a safer, more reliable and more efficient solution that allows more time to be spent fixing, rather than finding, issues. CN is using a similar technology to examine its cars to ensure they are in safe and reliable operating condition. In the 2 minutes it takes a human inspector to inspect one car, technology can review 120 cars.

Technological evolution is impacting every business in one way or another, and continues to drive improvements in revenue, profitability, reliability, and safety. Attractive opportunities to invest in evolving technology exist even outside the technology sector.