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WEALTH MANAGER

EXCHANGE-TRADED FUNDS

M&A activity puts tech-focused ETFs in the spotlight

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Technology deals have become the main driver of global M&A activity this year, with IBM's recent $33 billion (£25.7 billion) purchase of Red Hat the highlight, marking the world's second-largest technology deal ever.

Further sizeable tech-related deals are expected, as companies scramble to increase their share of the exploding cloud technology and artificial intelligence (AI) markets.

According to a recent Deloitte study, the acquisition of technology assets now ranks as the number one strategic driver of M&A deals, with 20% of completed deals citing the acquisition of technology assets as the principal reason behind the takeovers, up from 6% in the spring of 2016.

Although technology share prices have recently retreated from some of the lofty highs that have been seen, for many, it merely means there are buying opportunities aplenty.

Part of the reason for the M&A uptick in the tech sector is because US banks are still able to lend at historically low interest rates (ahead of expected Fed rises in 2019), providing cheap finance to complete deals.

Cloud computing in the spotlight

Red Hat's stock jumped 50% when the deal was announced, and US-based firms now account for six of the world's top 10 cloud-computing providers, according to research firm Canalys. The emergence and importance of cloud technology is fuelling the desire by tech companies to secure a sizable seat at the table. Without a cloud-based strategy, they fear they will be left behind.

To be considered a leader in tech today, it's clear a company must offer cutting edge cloud-based solutions to customers globally, and by buying Red Hat, IBM will be able to offer a one-stop cloud service, including physical servers, its own operating system and applications.

IBM is not alone. Alibaba, the Chinese online retail giant, expects cloud tech to become their dominant revenue stream within the next decade, and more than half of Amazon's full earnings in the third quarter came from its cloud-based services division (AWS), which saw revenues grow 46%, contributing more than $2 billion to operating profit.

Opportunities and dangers for investors

Given the longevity behind this trend, it offers thematic investors a huge opportunity. However, when it comes to ETFs, there are also some risks.

Further consolidation means tech-focused ETFs that are market cap-based run the risk of only being overexposed to the largest Faang-style companies. Couple this with the recent industry classification changes, with MSCI and S&P moving Facebook and Alphabet to the new communications sector, and investors risk having the wrong kind of exposure.

Tech ETFs are treating this reclassification differently, with iShares maintaining the two shares above in their main tech ETF, while the likes of SPDR and Vanguard are moving them out, potentially creating further confusion for investors.

However, some tech-themed ETFs, such as the HAN-GINS Cloud Technology ETF, are far more diversified, holding upwards of 50 shares or more and often capping the largest holdings at around 4%.

The real danger is that by concentrating on the Faangs for cloud exposure, many ETFs will have missed the fact the Red Hat/IBM deal has effectively catapulted the latter into the top ranks of cloud software competitors.

The deal boosts IBM's 107-year-old credentials overnight within the fast-growing and lucrative cloud market. Industry experts agree it has been playing catch-up to market leaders Amazon and Microsoft in offering computing and other software services over the internet. Many investors had therefore lost faith in IBM, as its stock had dropped more than 30% over the last five years. Warren Buffett sold most of his stake in 2017, while increasing his investment in Apple.

However, with this latest round of M&A from IBM, its fortunes may be starting to change. While Amazon and the other Faangs have come to dominate cloud computing, it should not be ignored that some of the older players in the tech sphere are beginning to re-emerge.

Capitalising on the trend

As well as the big deals in cloud computing, we continue to see many mergers in the telecommunications industry to help stave off the threat of more nimble players and ensure the behemoths have the ability to transform their businesses to take advantage of opportunities such as cloud computing.

ETFs that comprise an index of the leading companies, not just the largest, and that are active in fields such as cloud-based software and services, are ideally placed to benefit from the increase in M&A activity that many analysts expect.

It is also important to remember this is far more than just a US trend. While the focus is inevitably on the US much of the time, investors needn't look for the next Red Hat in order to generate returns from the tech market.

A well-diversified global index of pioneering companies that are poised to not only benefit from but create tomorrow's world should ultimately be the winners. •