THE LONG VIEW

Hard Drive

We consider Skerryvore's approach to disruptive technology and why we're finding opportunities created by the evolution of the automotive sector.

'… he returned to Melbourne a little before the Australian gold fields were discovered. Everybody that could rushed off to the diggings. The city was deserted; and then people commenced to pour through Melbourne from all parts, delirious with the idea that they would soon all be wealthy. Walter Powell had the good sense to stop at his store and sell shovels and pickaxes at a premium, and so he suddenly grew rich'[1].

The rush to find gold that ignited the imagination of many in the 19th century created a great deal of new wealth. However, as we know, it wasn't generally the prospectors who made their fortunes but, rather, those who enabled them – the store owners who sold them the hardware they needed to chase their dreams.

California's first millionaire, Sam Brannan, was an apt example of this, as was Walter Powell, half a world away in Melbourne. Luck played an outsized role in the prospectors' success, making it more than a little tricky to identify the best opportunities for striking it rich.

We are naturally cautious investors and believe that the best way to generate positive returns over the long term is to avoid losing money. Emergent sectors can be challenging because they are often heavily luck-dependent and rife with capital misallocation. This can make the selection of a distinct or eventual winner tough.

Our approach to the IT services sector provides a window on how we go about investigating new sectors in this context.

INVESTING IN THE PICKS AND SHOVELS

The potential in IT services first became apparent with the rise of the internet and the disruption this brought to the way people would do business. Even if we were not sure which companies might dominate online commerce in emerging markets, we did know that companies throughout the world would need assistance to become more 'digital'. Similar to those hardware suppliers by the gold fields, this made it possible for us to then back the trend without having to identify a single 'winner'.

IT services originated as a way to arbitrage the cost of labour in the developed and developing world, but it was clear they were evolving and growing in importance for enterprises at large.

Where once IT service companies focused their efforts on the chief technology officer at prospective customer firms, attention was shifting towards the chief marketing officer or even the CEO. The services on offer were becoming less about taking out cost and more about supporting core business operations. This led us to consider companies like **Infosys** and **Tata Consultancy Services (TCS)**.

THE IMPORTANCE OF REPUTATION AND PATIENCE

TCS has been one of the largest positions within the strategy since Skerryvore launched in 2019. In addition to being a digital 'pick and shovel' provider, TCS is attractive for a couple of further reasons.

Firstly, the owner of TCS, the **Tata Group**, is one of the most respected business houses in India. The group's focus on and understanding of the importance of reputation has underpinned TCS wherever it does business. The Tata family owns the same shares in the business as we do as minority investors and one of TCS's previous highly regarded and successful CEOs now leads the holding company.

Secondly, the business has one of the highest returns on incremental invested capital in the industry[2]. Rivals often buy their way into new technologies or industries, but TCS has the long-term patience to move organically into new areas. This is not easy and has meant that TCS has not always been at the leading edge of technological development within its peer group. However, investment in its own best and brightest employees to learn, sell and deliver on new opportunities has allowed the business to be resilient and to stay abreast of change. This investment has resulted in the added advantage of retaining great talent and is one of the reasons why the company has among the lowest attrition rates in the industry[3].

KEEPING UP WITH THE AUTO REVOLUTION

Technology, by its very nature, does not stand still and constant evolution creates both threats and opportunities. The development of the humble automobile is nothing short of a revolution. The first cars were mechanical in nature, and compared with today's vehicles were simple in their construction, operation and repair.

The rise of the microchip led to a 'second age', which was electronic. Systems such as anti-lock braking and drive-by-wire assistance began to appear in support of braking and driving functions.

The 'third age' in automobile development, and the one that we now find ourselves in, appears at first to be all about how cars are powered, with a shift from internal combustion engines to battery-driven all-electric powertrains. Dig a little deeper, however, and you discover that cars are becoming progressively more software-driven.

One of **Tesla's** huge strategic advantages is that all of its auto systems are integrated into a central controller that allows the car to receive new features over the air[4]. Traditional or legacy car manufacturers can only dream of this, with their many disparate systems that have never talked to each other – why should the brakes care what the in-car entertainment system is doing?

In addition to this, cars are becoming more autonomous, moving up the curve from simple lane-assist features to full control. All of this presents a huge test for the big automakers, who for years have concentrated on designing hardware-based systems. The software programming that drives this new generation of cars presents a quite different challenge, requiring new skills and talent and the development of new corporate cultures.

Car companies have struggled to build this expertise internally, which has led to the rapid rise of a new kind of IT service provider, one that has a greater focus on engineering and products than on more general enterprise IT. An error in this kind of software could result in a crashed car rather than simply a crashed computer, making the stakes very much higher.

Relatively low barriers to entry have meant that pricing power in the IT services industry has never been particularly strong. Many of the efficiencies gained over the years have been given back to customers rather than being retained by the industry – which is visible in the US dollar revenue per employee.

However, in these new engineering IT services disciplines, there appears to be more pricing power and returns are considerably higher.

We have recently visited a number of the emerging players in this space, including **Tata Elxsi**, **KPIT** and **Cyient**, and have undertaken a significant amount of work to become comfortable with the franchise and quality of these businesses.

PROFITING FROM DISRUPTION

When considering threats to the IT services sector, artificial intelligence (AI), and specifically generative AI, is something that even those with only a passing interest in technology will be aware of. There has been some speculation that perhaps this will replace the armies of people all over the world who work in the industry. Although this is possible, it is not our expectation. Rather, we see this as a means of generating improved productivity, allowing people to do more rather than to be replaced.

IT services have shown themselves in the past to be able to absorb disruptive technology, such as cloud computing. They have provided the expertise to adapt this to hugely complicated systems and processes already in existence. Sadly, history also suggests that many of these efficiencies will be passed on to clients in possession of superior buying power. Consequently, although these companies are likely to continue to grow, we would not expect them to ultimately benefit from better margins.

EMERGING OPPORTUNITIES

When looking for attractive businesses to invest in, often the holy grail is a company that doesn't require a lot of capital, is difficult to copy and has a long runway for growth. We believe that we have found this opportunity in the IT services industry. Although these companies are not immune to business cycles, low investment requirements mean that the best examples run balance sheets flush with cash to protect them when bad news hits. When challenges do arise, we are fortunate enough to have the time horizon and comfort in the quality of these companies to add to our positions.

We will continue to watch for opportunity in the emerging automotive sector, remaining ready to avoid those 'sure-fire prospects' heavily reliant on Lady Luck!

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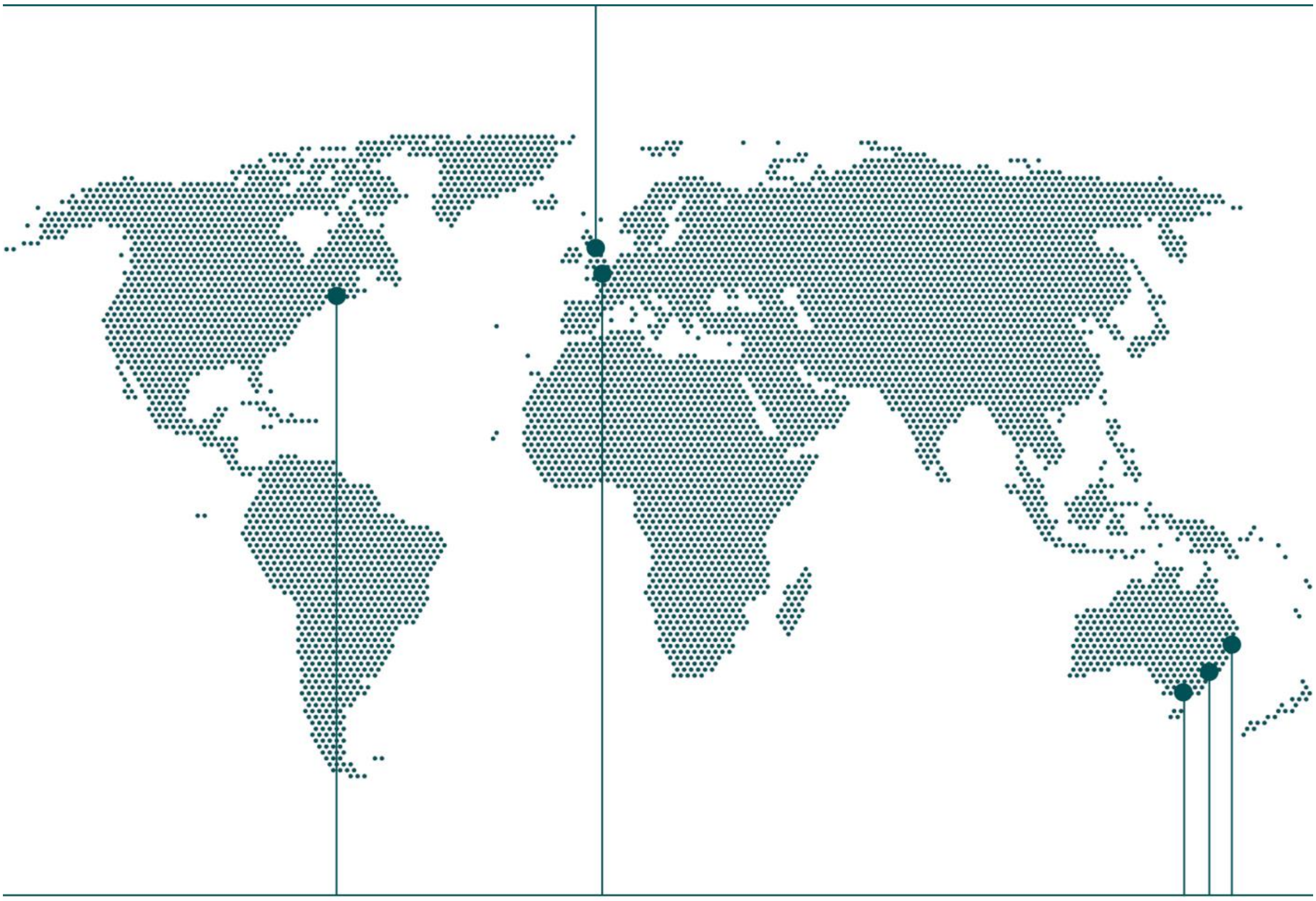

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