Weekly Report

Microeconomic Analysis

Twitter: #nottrending
Written by Himalee Tailor

When Twitter first traded on the stock market a year ago, investors' enthusiasm for their impressive, well-established user base and potential to be a global advertising medium, saw Twitter shares open at $26.00 and close at $44.90, an increase of 73%. Recently, Twitter shares fell 7% after it was given a junk credit rating due to underlying financial problems. Although revenue is up 114% year-on-year, Twitter remains unprofitable and according to Standard & Poor "may not generate positive discretionary cash flow until 2016." The real problem, however, lies in the fundamentals of its business strategy and this is reflected through the departures of key management, including Vice President of Product, Michael Sippey, and the Creative Director, Doug Bowman. The size of Twitter's audience drives its main source of revenue (targeted advertising); therefore can Twitter grow and hold its audience?

Recently, user growth has slowed, signalling concern amongst investors. When compared to the likes of Facebook, which has four times more users, and the growing popularity of WhatsApp and Snapchat, Twitter could easily fail to reach its one billion user goal and may not become the global digital advertising leader.

However, Twitter is heading in the right direction and at a recent analyst day conference, stressed the development of their private messaging services, new features and move towards making content more relevant to each independent user. Twitter's advantage is their targeted advertising which enables advertisers to reach users based on their specific interests. This is the area, especially on mobiles, that they should focus on. More precise targeting capabilities, such as promoted tweets, will attract advertisers. Furthermore, a new data analytics deal with IBM will increase this advantage by aiding businesses use Twitter data to help them understand their customers, businesses and other trends. Of Twitter's active users, user growth only fell by 1% this quarter, compared to the last. Although it may not reach Facebook's statistics, Twitter's opportunities for growth are still relevant – this bird hasn't lost its flight quite yet.

Munchies for Marijuana stocks
Written by Beni Ngwamah

The US midterm elections have dominated much of the media coverage in the US in recent weeks. However, whilst Americans were choosing their lawmakers, three states and the District of Columbia considered measures to liberalise the cannabis trade. The legalisation movement is gathering serious momentum and is causing many to speculate about a new market emerging for recreational cannabis ("canna-business"). The prohibition era was before the majority of our times', but market enthusiasts believe just as alcohol escaped the grasp of organised crime and became normalised, cannabis possesses a similar potential.

This provides an interesting backdrop for market analysis of "canna-business." ArcView Group, a marijuana research and investment firm, estimates the legalised pot business could generate $2.6bn in revenue this year, up from $1.5 billion in 2013. The firm believes that figure could swell to over $10bn in five years. Several publicly traded pot companies, such as Medical Marijuana and Cannabis Sciences, have beaten the market this year and have largely profited from the bullish US market, and its improving economic climate. These figures may seem impressive, but these stocks and many others in the industry are very volatile. For example, the Securities and

Exchange Commission temporarily suspended trading shares of GrowLife in April, highlighting the huge risks involved in investing in the cannabis trade.

Furthermore, should we focus on North America and specifically the US, the cannabis industry is, as the Economist puts it, “a legal no-man’s land.” Individual states may be jumping on the legalisation bandwagon and these benefits small businesses but, federally, it is still illegal which makes it hard to do business in more than one state, and hence severely limits the scope for growth.

It is, however, not all doom and gloom, Craig Ellins CEO of GrowBOX Sciences, a firm that manufacturers a household marijuana cultivation system, has now likened investing in shares of public marijuana companies to tech stocks. Many tech start-ups went belly up, but any early investors in companies such as Microsoft and Amazon, are obviously pretty happy. Should the case arise that the cannabis industry successfully tackles legal obstacles, there is a real possibility of a very lucrative market emerging.

Pharmaceutical M&A and why it will continue to rise

Written by Zain Mahmood

Within the pharmaceutical industry, mergers and takeovers have huge ramifications, especially the megamergers. Traditionally, this kind of behaviour has been looked upon disfavourably by market analysts. They claim integration between such large companies result in disruption for the organisation and research and development progress as efficiency is sought through restructuring and staff cuts. Such activity within a high risk industry is, however, inevitable given the challenges that big players in the drug making business and pharmaceutical sector must face: medicines failing to progress to the market, revenue reduction as a result of high development costs combined with low demand and patent loss.

There was a period, of ‘patent cliffs, FDA setbacks, health care reform angst and a dearth of both IPOs and M&A activities’ but it is safe to say that this has now passed. Big players are actively employing a mergers-for-growth strategy that previously only benefited companies in the short term (by improving their bottom line and EPS), but now offers renewed optimism for long-term growth. For example emerging market economies are becoming more consumption orientated, fuelling demand for healthcare services. Firms are taking advantage of this trend by executing cross-border deals that will allow them to enter new markets. Furthermore, cross-border deals offer significant benefits where tax inversion opportunities are applicable. Actavis (ROI), for example, purchased Forest Laboratories Inc. (USA) for $24.2bn which gained them a balance portfolio split between both branded and generic drugs, and also allowed profits to be moved from the US to Ireland to take advantage of the lower corporate tax rates.

The US Treasury has implemented a new set of rules in an attempt to discourage redomiciliation for tax purposes. The $54bn merger between AbbVie and Shire was quashed in response to these rules. As Shire is based in Dublin, AbbVie could have moved their legal address to Britain, allowing them to take advantage of Irish tax legislation. AbbVie’s Chairman was critical of these laws when he commented that ‘the US tax code is outdated and is putting global US-based companies at a disadvantage to foreign competitors … comprehensive tax reform is essential to create competitiveness and to stimulate investment in the economy.’ The rules are also likely to prevent Pfizer to make a fresh bid for AstraZeneca, however Pfizer has said that they will continue to consider alternative inversion deals to benefit their shareholders. Many experts believe the rules will lead to a number of smaller domestic deals.

These rules will not completely stop cross-border deals from taking place; Medtronic is still able to buy Covidien of Ireland, however they must stump up an extra $16bn. In many cases, a large initial cost can be recouped. A McKinsey report outlines three reasons to why pharmaceutical megamergers are successful; the increase of shareholder value as acquirers emerge post-deal with increased revenue base and a leaner cost structure, consolidation deals which generate greater economic profit and growth-oriented deals that modify expectations in the long term.

It is difficult to emulate these kinds of goals with smaller domestic acquisitions and so many big players will continue to reap the benefits of megamergers; Actavis is in talks with Allergan, headquartered in California, to acquire them in a deal worth over $60bn. How this will benefit Actavis is clear; Allergan would bring with them, dermatology treatments, a number of eye drugs, but also their flagship product: Botox. Another fruitful cross-border co-venture can be seen in the £11bn asset swap between GlaxoSmithKline and Novartis which saw Glaxo offload its cancer treatment division for the vaccine units of Novartis. This is an ongoing trend in the most successful pharmaceutical companies, where mergers, acquisitions and bolt-ons are used to build strengths in a select number of areas.

M&A activity is cyclical and the pharmaceutical industry is enjoying their current boom. The efforts by the US Treasury Dept. will not significantly affect this. Big firms will continue to employ their mergers-for-growth strategy that will allow them to consolidate their business activities and strengthen key areas which will benefit them and their shareholders.

Macroeconomic Analysis

Sweden's other problem: Mortgages

Written by Edward Matthews

On the surface, Sweden seems to be in a similar situation to much of the rest of Northern Europe; very low inflation, historically low interest rates and skyrocketing house prices. Shockingly, Sweden's household debt is currently over 170% of net income.

To tackle ongoing deflation, the Swedish central bank, Riksbank, gradually reduced the interest rate until it could fall no further; since October it has been 0%. The Swedes have taken advantage of rock bottom interest rates with glee, but not in the way Riksbank's intended. Rather than using low interest credit to increase consumer spending, the Swedes have been loading up on cheap mortgages. As a result, Swedish house prices have more than trebled since the mid '90s. House price inflation has been especially noticeable in Stockholm, as it has been experiencing the second largest city population growth in Europe.

However, similar scenarios are occurring all over Europe; why is Sweden's household debt particularly so large? The answer lies in mortgage repayments; Swedes never get around to paying them off. Rather than amortising more than the required 25% of their mortgage, homeowners finance the interest with the intention to save or invest the potential amortisation money elsewhere. At current amortisation levels, it would take Swedes an average of 140 years to pay off their mortgage debts. Debts are currently either being passed down to the next generations or homes are being sold to repay debts.

Any problems in the mortgage market are a big deal for the Swedish financial system. Domestic mortgages currently account for 47% of Swedish bank lending, a percentage which has more than doubled since the start of the millennium. Covered bonds, with mortgages as collateral, presently form the main part of the banks' funding through issued securities which, in turn, is a large part of the banking system's total funding. At the end of 2013, the volume of covered bonds issued by Swedish banks amounted to 1,930bn krona (over €200bn), more than half the Swedish GDP. These covered bonds make up the biggest bond market in Sweden with a 36% ownership from foreign investors and close ties to Swedish insurance companies, mutual funds and pension funds.

Moving in the right direction, financial authorities in Sweden are starting to propose legal requirements that borrowers amortise down to at least 50% of the mortgage. Unfortunately, this is a long-term solution; fiscal disincentives for property investment should additionally be introduced to further slowdown the borrowing rate's current growth.

As Swedes are still not amortising, despite still having GDP growth and low interest rates to their advantage, Sweden may be in for a less pretty future than most assume.

Events

Libya: Governments and Oil

Written by Alexander Galt

This week has seen the reopening of the 120,000 barrel per day (bpd) Marsa al Hariga oil port after state-security guards ended a protest over their salaries. The largest oilfield, 200,000 bpd El Sharara, remains closed after attempts to restart production on Wednesday were aborted due to a blocked pipeline. El Sharara was seized on November 5th by Islamist militants, who shut down production.

This disruption comes as oil slipped below $80 per barrel, close to a 4-year low. Whilst most of this effect comes from the more powerful members of OPEC (notably Saudi Arabia), Libya has seen a 300% increase in supply from the start of summer now producing around 900,000 bpd. This is due to various structural issues with exporting oil being solved by the rivaling governments.

Libya currently has two governments jostling for control of the country and the oilfields. Islamist Operation Dawn militants restored the old National Congress after forcing the internationally recognised and elected government, the House of Representatives, out of the capital Tripoli and into the eastern city of Tubruq. The Libyan Supreme Court subsequently ruled the House of Representatives to be unconstitutional. The current violence has locked the country into a political stalemate, allowing oil exports to recover and stabilise from their previous levels of 200,000 barrels per day, however disruptions this month mean that estimates are that November production will be on average 500,000 bpd, somewhat lower than the 1.3 million bpd produced back in 2011.

As soon as one of the governments starts to make political gains it's likely that the opposition will target the oil infrastructure in order to undermine their opponents, therefore Libyan oil supply is set to remain volatile and will continue to have a small but significant impact on the global price of oil.

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Nikhil Kuplish
COO
nk652@york.ac.uk

Anna Murray
CEO
avm508@york.ac.uk

Ludger Pahler
CIO
lp870@york.ac.uk

Austė Vyšniauskaitė
CIO
av638@york.ac.uk

Lorna Simmonds
Co-editor of the Weekly
ls958@york.ac.uk

Thomas Falco
Co-editor of the Weekly
tf613@york.ac.uk

Sources used:
Reuters, Stratfor, The Economist, McKinsey, Riksbank, TradingEconomics.com, CNN, CNN Money, PwC, EY, Evaluate Pharm, The Guardian, Bloomberg, Trefis, The Telegraph,

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