

Part 3. A review of Magellan's enterprise software holdings with Adrian Lu, Investment Analyst

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Adrian Lu, Investment Analyst
Jennifer Herbert, Key Account Manager - Listed Funds

Jennifer Herbert:

Hello and welcome to our investment insights series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, Key Account Manager at Magellan, and over the next 10 minutes, I'll be talking to Magellan's investment analyst, Adrian Lu, about our views on the technology stocks we hold in the portfolio. Thanks for joining us, Adrian.

Adrian Lu:

Thanks, Jen. It's a pleasure.

Jennifer Herbert:

Adrian, Microsoft is one of the largest enterprise software companies in the world. How has it been impacted by the covid-19 pandemic?

Adrian Lu:

Microsoft had quite a resilient first quarter, and I'll get to why in a moment, but Microsoft owns quite a number of different businesses. Now, we're all familiar with Windows and Office. It also owns LinkedIn and a service line of laptops and anyone into gaming or with kids like me will, of course, know Xbox and Minecraft. What's really interesting is that only a fraction of what Microsoft makes comes from consumers like you and me. In fact, the lion's share of its profits comes from businesses. Now, in terms of how Microsoft has been impacted by the pandemic, I'd describe it in three areas. The first area relates to industry, the second area relates to smaller business customers and the third relates to global PC shortages. So firstly, Microsoft has a diversified exposure across a lot of industries and that includes areas like travel and hospitality that were hit hard by covid-19. What we saw was some customers in the most affected industries were holding off on larger IT projects and that's the uncertainty and the shelter-in-place also makes it harder for companies like Microsoft to close larger deals. But on the other hand, we also saw some marquee customer wins with the likes of Coca-Cola and the NBA showing that some customers are using this opportunity to accelerate their digital transformations. The NBA, for example, was actually making Microsoft the official technology for live broadcasting and on-demand streaming of its basketball games. I said the second area related to smaller businesses that have become more cautious with their spending, and rightly so. This has impacted areas like Microsoft Office licences, which you can think of basically as the non-traditional non-cloud version of Office. Office 365, on the other hand, which is the subscription in cloud-based productivity suite, has been a different story.

This business has been unaffected so far. In fact, consumer adoption has even accelerated with more people working and learning from home. Usage of the Teams-based collaboration product has absolutely surged and it's not hard to see why – even here at Magellan. Microsoft Teams, as you know, Jen, has become a primary method of collaboration for us. The third area I mentioned was PC shortages, and those of our listeners who have had the unenviable task of trying to get their hands on a PC in the past few months will know what I'm talking about. China is the centre of the worldwide PC supply chain so when the country was locked down, PC supply was crippled. This impacted on Microsoft because it sells a copy of Windows with every PC. The good news is that supply chains have been on the recovery so things are looking better.

But with all of that said, I think it warrants highlighting the other positives we saw in Microsoft's recent financial results. I already mentioned the marquee customer wins and the strength of Office 365, but on top of that its Azure Cloud and its service software business were still remarkably strong. We saw higher engagement in its gaming business. So overall an impressive financial result highlighting the strength of its business model.

Jennifer Herbert:

So has it been a similar story for the software company SAP?

Adrian Lu:

We've seen both similarities and differences in the way SAP has been impacted compared with Microsoft, but let me give you a little bit of background on SAP. Like Microsoft, SAP is one of the largest enterprise software companies in the world. Unlike Microsoft, it's not

what most people would think of or even recognise as a household brand name. Microsoft makes a lot of products that we touch and experience directly. SAP on the other hand has been in the business of back-office applications like financials, supply chain and HR. It's a broad category and it doesn't make for the most exciting dinner party conversation, but it is critical to the functioning of businesses.

Jennifer Herbert:

Right. So how have we seen SAP get impacted by the pandemic?

Adrian Lu:

Two-thirds of SAP software sales are generated from traditional on-premises software, which is effectively non-cloud software. The other third of its sales comes from cloud software and cloud has been the faster growing piece as SAP has made it a strategic growth priority. We've seen both these businesses get impacted by the recent pandemic. With the on-premises or non-cloud software business, sales are down because the chunk of this business comes from the sale of software licences, which are large upfront purchases. This is different from cloud or subscriptions where the cost is evenly spread over a term. It's like the difference between buying a car versus renting a car. If it's a large upfront purchase and your business has been impacted by the pandemic, you may not need any new software licences or you may try to defer that purchase to conserve cash flow.

Adrian Lu:

That's what we saw in SAP's most recent quarter. Now, keep in mind that SAP has exposure to customers in industries like resources and manufacturing that were more acutely impacted by the pandemic. As for SAP's cloud business, it's continued to grow quite well, almost 30% in fact, although we did see a couple of cloud products that were related to travel and supply chains and were more negatively impacted. But considering all of this, SAP's financial result was fairly resilient. Most of it is traditional on-premises software businesses and annuity business that continue to grow, which really speaks to the quality. And cloud, as I mentioned, was strongly helped by the fact that most of that business is contractually committed, which helps to insulate it from the immediate impact of a downturn.

Jennifer Herbert:

Adrian, you mentioned that customers have been becoming more cautious. How much is this going to impact IT spending?

Adrian Lu:

Well, for both of these companies, a lot of it's going to depend on the depth and duration of the economic recession, which remains very much uncertain. We are already seeing signs of a pullback in enterprise IT spending, particularly in discretionary spending, with new projects being postponed. Now, fortunately, and it is important to keep this in mind, Microsoft and SAP products tend to fit into the category of what you might think of as more like essential IT spending because they tend to be the software that keep businesses running. Now, obviously this matters less if customers are going out of business, but for customers holding off on expansions on new projects, I think this is an area where both companies are probably going to see some measure of impact on their growth opportunity, at least for the near term.

Adrian Lu:

I'd add that we're constantly evaluating the potential impact here at Magellan, recognising that it's not easy to predict, not just because of the unprecedented nature of the pandemic, but also because we've never seen Microsoft's and SAP's cloud businesses really get tested by a downturn. Their cloud businesses were practically non-existent during the GFC.

Jennifer Herbert:

So given all of this, what is the outlook for these companies?

Adrian Lu:

Let me start with Microsoft. As I explained earlier, it had a strong recent quarter, but we are seeing that the sales pipeline is not growing as quickly as it was before. What this means is that short of an imminent and sharp global recovery, which I don't think today is the most likely outcome, we're going to see some dampening of Microsoft's growth in the near term. But we care about the long term at Magellan and what we find promising are the areas of structural change that could see Microsoft emerge from this pandemic even stronger than it was before.

Jennifer Herbert:

Can you explain what you mean by that?

Adrian Lu:

Sure. I can give you two examples. The surge in adoption and engagement of productivity and collaboration tools could bring persistent and lasting changes to the way people and businesses do work. I'm personally impressed by how these tools have facilitated our very productive and collaborative transition to working remotely, but hats off to everyone who's also had to juggle home-schooling. This could be very favourable for Microsoft's productivity software. Now, the pandemic has also highlighted the value and power of cloud computing from a user perspective and the flexibility and efficiency of cloud computing from an operational perspective. This could really motivate businesses to accelerate their cloud transformation priorities. This would be a positive for Microsoft's commercial cloud business despite near-term uncertainty.

Jennifer Herbert:

That's very interesting. And what about the outlook for SAP?

Adrian Lu:

Well, SAP is also a company where we expect its growth to be dampened by the pandemic. To be sure, its existing customers will continue to spend on SAP where they need to, but if there's a pullback of activity and new projects, it's going to lead to slower growth in the near term. On the other hand, there could be some companies that see this as the right opportunity to undertake their transformation so they can emerge from the recession with stronger systems in place. So there are some puts and takes there. Just to be clear though, I'm viewing the impact on SAP as being a matter of what I consider a temporary dampening of growth rather than a matter of permanently lower growth. In other words, I'm saying its return to growth is not a matter of if, but when.

As an aside, the recent resignation of SAP's CEO among other executives has not gone unnoticed by us and it is an area we will continue to pay close attention to. But for Microsoft and SAP overall, in short, our expectations of the covid-19 recession has impacted our valuation of these companies. What it certainly hasn't done is change our view of the strength and attractiveness of their businesses. We still view them as two of the most competitively advantaged companies in the world. In fact, some of the changes brought about by this pandemic could even make them stronger.

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