Half Yearly Investor Report

Magellan High Conviction Fund | December 2014

Hamish Douglass
Chief Executive Officer, Chief Investment Officer and Lead Portfolio Manager

I am delighted to write to you as an investor in the Magellan High Conviction Fund (the 'High Conviction Fund' or the 'Fund') for the 6 months ended 31 December 2014.

Over the past 6 and 12 month periods, the Fund returned 21.5% and 19.8%, respectively, in Australian dollar terms after fees. We note that since the High Conviction Strategy's inception (on 1 January 2013), it has delivered an investment return net of fees of 34.7% per annum.

We feel strongly that people cannot retire on "relative investment returns"; only by generating investment returns that exceed the rate of inflation (ideally by a satisfactory margin) will investors increase their wealth. As such, we are happy to be judged by the Fund's absolute returns over time.

The current investment environment is extraordinary. US equity indices ended December at or near all-time record highs, 10-year US Treasury yields remain historically very low, the 10-year bond yields of Spanish, Irish and Italian government debt closed at or below 2%, credit default swaps on major banks are now below 2007 levels and the European Central Bank (the 'ECB') has recently reduced the interest rate it pays on deposits by banks to -0.2%. Investors appear to be transfixed by the potential benefits (to markets) of a large Quantitative Easing ('QE') program by the ECB involving sovereign bonds. While not underplaying the dangers of potential deflation in Europe, we believe that the benefits of QE will prove largely illusory.

Since the beginning of 2013, we have observed a massive compression in risk premia across multiple asset classes. Spreads between US Treasuries and German Bunds are at their highest levels in 15 years, while spreads between German Bunds and peripheral European sovereign debt have narrowed materially. The absolute level of yields across a range of credit markets, including US 5- to 7-year high yield corporate credit, remain close to historic lows, while high yield corporate spreads have also fallen sharply. All of this activity points to excessive reach for yield by investors in the prevailing low-rate world.

The multiple compression of spreads and historically low yields leaves open the prospect of a material, potentially disorderly, unwind in credit markets (with likely knock-on effects for equities). A normalisation of risk premia, potentially driven by rising US Treasury yields and normalising spreads, could cause asset markets to become highly volatile. This could potentially lead to large capital losses and self-reinforcing liquidity events in some less liquid markets, such as high yield corporate credit. As a consequence, we judge market risks to be elevated at present.

We believe that there is an elevated probability that the compression in risk premia will unwind over the next 12 months or so, as investors focus on a normalisation of US short-term interest rates. This, combined with rising long-term interest rates, emerging market instability, increased pressures in Europe and high yield defaults, could lead to a material correction in credit and equity markets. As a result, we raised the Fund's cash weighting to approximately 10% in August, in order to increase its defensiveness (the last time we materially increased the Fund's cash weighting was at the beginning of the European sovereign debt crisis in early 2010).

The experience of 1994 highlights that risk premia can unwind rapidly, even in a non-recessionary environment. Countries like Australia, and many others, could potentially encounter a 'double whammy' situation where rising US Treasury yields and widening spreads cause a sharp spike in the yields of their sovereign debt. This is exactly what happened to Australian 10-year government bonds in 1994, when yields rose over 350 basis points from February to December. Over this period, the price of an Australian 10-year government bond fell by approximately 21% (over the same period US corporate high yield (5- to 7-year) credit markets also suffered large valuation losses, with yields spiking 485 basis points).

Furthermore, European periphery nations are facing a potential 'triple whammy' scenario, consisting of rising US Treasury yields, a normalisation of the spread between Treasuries and Bunds and a widening of the spread between Bunds and the sovereign debt of periphery nations. Meanwhile, high yield, corporate and bank sub-debt credit also look vulnerable to a 'triple whammy' of rising US Treasury yields, a normalisation of these bonds' spreads and the impact of illiquidity if investors head for the exits en masse.

We believe the largest risk for investors is what will happen to the US yield curve when the country's short-term interest rates rise (most likely this year), as this is currently unknown. There is currently a large gap of over 150bps between the US Federal Reserve's (the 'Fed') forecasts of the long-run Fed Funds Rate and current market forward implied estimates. In our opinion, it is prudent to assume that the Fed will raise short-term interest rates by between 2.5% and 3.5% over a reasonable period commencing sometime in 2015. History suggests that a parallel shift in long-term interest rates may also occur when the Fed lifts short-term rates. Such a shift could lead to a fairly dramatic unwind of risk premia in credit markets around the world.

The consensus market view appears to be that longer-term US Treasury yields will remain close to current low levels, due to current expectations of continued low growth and inflation, as well as continuing strong demand for Treasuries from various sources. We believe it is unwise to base a long-term investment position on factors that could easily reverse over short to medium term, such as current inflation expectations, as these could change quickly (in this case if wage pressures emerge as a consequence of a continued improvement in the US employment situation).

A range of positive and negative forces could impact 10-year US Treasury yields over the next few years. These forces include:

- The Fed's QE exit policy, including the trajectory of Fed Funds Rate increases and the shrinking of its balance sheet.
- Inflation and growth expectations in the US and globally.
- The combined impact of QE in Japan, the forced sale of Japanese government bonds by the Japanese national pension scheme and possible sovereign QE in Europe.
- Central bank policy rate expectations globally and especially in the Eurozone.
- China's current account balance and foreign exchange reserves investment policy.
- The potential impact of deteriorating current account balances in other emerging markets, particularly oil and commodity producing nations.
- The impact of regulatory changes on bank demand, such as the conclusion of buying by US banks to improve Liquidity Coverage Ratios.
- Overall market sentiment and risk aversion.

Since August, we have witnessed a number of events that have the potential to further increase global macroeconomic risks. These include the dramatic fall in the price of oil and other commodities, the continued slowing of China's economy, the appreciation of the US dollar and the prospect of a destablising election in Greece (which could raise the probability of both a Greek sovereign debt default and the country exiting the euro). Meanwhile, other events have added further uncertainty to the economic backdrop, such as the Russian Central Bank increasing its main interest rate from 10.5% to 17% in December (in response to the collapse in the rouble and increased volatility in financial markets).

The fall in the price of the oil and other commodities, combined with the appreciation of the US dollar and rising short-term US interest rates, may destabilise a number of important emerging market economies, some of which have been large net buyers of US Treasuries in recent years. The current account balances and government revenues of major oil/commodity producing nations may deteriorate.

Furthermore, the unwinding of large oil- and commodity-producer currency carry trade positions may result in capital flight and currency depreciation, while unfavourable exchange rate movements have increased external debt burdens for emerging market borrowers of US dollar debt. Additionally, the falling oil price could trigger defaults on oil-related high yield debt that has been issued in large volumes to finance the shale oil and gas revolution, both in the US and elsewhere.

While the oil price's collapse could trigger some credit and emerging market risks, lower fuel costs also act as an important stimulus to consumers and businesses around the world. It has been estimated that a US$40 per barrel drop in the price of oil transfers approximately US$1.3 trillion from oil producers to consumers of oil. US households spent around US$380 billion, or approximately US$3,300 per household, on petrol in 2013 and it is projected that a sustained 30% drop in the petrol price would reduce this expense by US$980 per household per annum. This benefit is likely to be spent elsewhere by lower income households, therefore acting as a stimulus to consumer spending and further fuelling the US economic recovery. Notwithstanding some offsetting impact on growth from falling US shale investment and transitory inflation pass-through effects, falling oil prices should support the Fed in lifting US interest rates in 2015.

We are mindful that there are scenarios where US long-term bond yields do not rise, risk premia do not revert to more normal levels and markets remain benign or even strong. In such scenarios, the Fund's cash weighting will be a drag on short-term performance. It is unknown how investors will react when US interest rates start to normalise. Moreover, it is unknown how higher US interest rates will interact with other current macroeconomic risks.

While we are not predicting that there will be a market crash, in our view it is better to be prudent and cautious, given the current set of facts, than to be complacent. Investing is a long-term endeavour and if we give up some short-term return to protect our clients' capital, then so be it. As Warren Buffett has often reminded investors, "To finish first you must first finish." It may turn out that we are right to be cautious, but that we are too early in reducing the equity risk in the portfolio. Nonetheless, we believe it is better to be 6 months too early than 6 minutes too late.

Portfolio Summary

On 31 December 2014, the Fund held investments in 12 companies (compared to 11 at 30 June 2014). The top 5 investments represented 43.1% of the Fund, while they represented 50.7% at 30 June 2014.

Over the past 6 months, we have made the following major changes to the Fund:

- In August we increased the cash weighting to approximately 10%.
- We added new positions in Lloyds Banking Group, State Street and SAP.
- We exited the positions in Wells Fargo and DirecTV, and reduced the holding in Bank of New York Mellon.

Over the 6 months to 31 December 2014, the 3 investments with the strongest returns in local currency were Lowe's (44.7%), Target (32.9%) and Visa (25.0%) while the investments with the weakest returns were Tesco (-33.3%), Wells Fargo (-3.8%) and Sanofi (-2.5%). On an absolute basis, the 3 largest contributors, in local currency, were Lowe's, Target and Visa which added +3.7%, +2.3% and +1.9%, respectively. Conversely, the 3 bottom contributors were Tesco, Wells Fargo and Sanofi, which detracted -3.0%, -0.2% and -0.1%, respectively.

The table below sets out some key statistics for the Fund's portfolio, as at 31 December 2014:

Average market capitalisation (US$ billion)	110
Average daily liquidity (US$ million)	404
Number of companies	12
Concentration of top 5 Investments (%)	43.1
PE – 1 year forward*	16.5
Average return on equity (%)*	20.6
Beta*	0.87

* Magellan Asset Management Limited estimates

Tesco

On 30 June, I wrote that I considered Tesco to have limited downside risk at its then current share price. I was completely wrong; Tesco's share price has fallen by around 35% since 30 June (in local currency terms), following a number of profit downgrades primarily related to its core UK business. The company has also installed a new management team led by Dave Lewis (CEO) and Alan Stewart (CFO). I have had a number of opportunities to meet and speak with both Dave and Alan and have been impressed by their quick and capable grasp of the challenges facing Tesco.

Our investment in Tesco had been predicated on 3 principal drivers:

1. The sale, or exit, of 2 major loss-making businesses: the US and China.

Top 5 (alphabetical) as at 31 December 2014	
eBay Inc	Information Technology
Lowe's Co Inc	Consumer Discretionary
Microsoft Corp	Information Technology
Target Corp	Consumer Discretionary
Visa Inc	Information Technology

These businesses had been consuming around £700 million of cash per annum. Tesco has now effectively exited both of these businesses, which has substantially alleviated its cash outflow.

2. The option value of Tesco's high-quality businesses in Thailand, Korea and, to a lesser extent, Malaysia. We assessed these businesses to be worth materially more than was implied in Tesco's share price. We continue to believe that these businesses have a materially higher value than implied in the current share price.

3. A turnaround in the performance of Tesco's large-format UK Extra stores, over a period of 3 years or so. These large-format stores represent around 40% of Tesco's UK selling space and have experienced a dramatic fall in profitability.

We had underestimated the potential for a sudden and dramatic collapse in the profitability of Tesco's UK business in our analysis. The collapse in profitability that Tesco has experienced, together with the uncertainty this has created surrounding its balance sheet, has led to a very sharp fall in its share price over the past 6 months. These issues have caused us to thoroughly review our investment case. In doing so, we are reviewing the Tesco holding as we would a new investment and ignoring the price we originally paid. We are thoroughly undertaking the necessary work and want to ensure our decisions are based on an objective assessment of Tesco's prospects at this time. We are quite conscious of "loss aversion bias" and do not want to catch a "falling sword"; we are asking the question "What is the correct investment decision on Tesco today?" and will endeavour to act rationally in making correct decisions regarding the investment.

Our analysis involves assessing the following issues:

- The options for Tesco to recapitalise its balance sheet.
- An evaluation of the new management team led by Dave Lewis and Alan Stewart.
- The value that can be captured from a rationalisation of Tesco's entire portfolio of assets.
- The ability for Tesco to turnaround its core UK business.

On the first 3 issues we have reached a positive view. Tesco has numerous options to sell high-quality and non-core assets in order to recapitalise its balance sheet within our investment time horizon. We have discussed our views on Tesco's available options in detail with the company's new management and have confidence that they will act rationally to fix its balance sheet. On 8 January, Tesco announced a number of meaningful first steps in addressing its balance sheet issues, including: appointing advisers to evaluate a sale of its data analytics business (Dunnhumby), reducing capital expenditure to £1 billion in 2015/16 from €2.1 billion this year, reducing its final dividend to zero, commencing a process to close its defined benefits pension scheme, implementing plans to reduce head office costs by £250 million per annum and that it has sold a number of small businesses. We expect further asset sales in due course.

Given the conclusion we have reached regarding Tesco's balance sheet, we have decided, at this stage, to retain our holding in the company. We see further upside potential should management complete a rationalisation of Tesco's asset portfolio and want to evaluate the course of action that Tesco decides to pursue.

Over the longer term, our judgement of the potential for Tesco to generate further investment returns will depend upon our assessment of management's plans to turnaround the core UK business. At this stage, it is too early to make any definitive calls. There has been much written about the competitiveness of the UK market and, in particular, the impact of the discounters. While it is easy to simplify the issues down to price competitiveness against the discounters, there are other critical issues facing Tesco and other UK food retailers. It is natural that the discounters' market share will mature at a certain level and we need to assess the likely structure and profitability of the market when this occurs (in the medium term), as well as Tesco's competitive positioning within it.

Fundamentally, Tesco should benefit from significant competitive advantages in the UK over the longer term. These include it having: the largest market share resulting in economies of scale, an advantaged property footprint, the leading market share in the convenience store market, the leading market share in online food retail (including the only profitable internet food business), the largest market share in petrol retail and a leading data analytics capability. To win, it will be key that Tesco can develop a cost and price advantage over its 3 main full-service competitors (Asda, Morrisons and Sainsbury's).

We will need to reassess whether Tesco can turn around its large-format Extra stores. Ultimately we will need to gauge the timeframe for turning around this business, as well as determining the operating margin and return on capital that it is likely to be able to achieve. Historically, this business had earned strong margins and produced attractive returns on capital.

Lastly, our holding in Tesco needs to be viewed in the context of the overall portfolio. Over the past 12 months, Tesco has detracted -3.8% from the total portfolio return of +19.8% (in Australian Dollar terms). While meaningful, the impact of Tesco's share-price decline is relatively small in the context of the overall portfolio. In contrast, our best performing holding, Lowe's, contributed +4.9% over the past 12 months.

I take full accountability for the investment in Tesco. Mistakes are inevitable in the business of investing and what is critical to generating superior long-term returns is minimising the number of mistakes and maintaining a strong batting average.

Macroeconomic Commentary

Our views on the world's largest economic zones have not altered materially since my last investor letter (June 2014). China's growth continues to slow, with risks centred on the property market and shadow banking system. The United States' economic growth rate continues to strengthen, while the Eurozone remains in a structural and political muddle, which is hindering sustainable economic growth.

The prospect of "Abenomics" solving Japan's intractable problems appears as uncertain as ever, notwithstanding the favourable rise it has stimulated in domestic asset markets. Intensification of policy efforts, or indeed loss of market confidence, could spill over into dramatic yen depreciation. This could provoke "currency wars" with Japan's export competitors, including China. We consider the United States' inward-looking economy to be relatively insulated from these events.

Finally, emerging markets and commodity-exposed economies face a period of heightened uncertainty, as China slows and the Fed moves towards normalising interest rates.

China

We remain concerned about the short- to medium-term economic outlook for China, based on growing risks in its property market and shadow banking system. A range of indicators suggest that China's economy is slowing, perhaps somewhat more quickly than official figures imply. Furthermore, domestic weakness in China is starting to flow through to asset markets around the world (particularly commodity markets).

Although economic data out of China is problematic, there are a number of indicators that suggest a slowdown is underway. In residential property, national house prices fell 5% between April and November 2014 and residential real estate sales by property developers fell 8% over the year to November 2014. The evidence of a slowing business sector includes electricity consumption growth of only 3% over the year to November 2014, compared to 8% per annum a year prior. Steel production, auto sales and rail freight traffic growth have also slowed significantly (or are contracting).

Weak trade-growth data shows that imports have been contracting and export growth has been slowing. Some of the import weakness may be due to falling commodities prices, but the figures may also reflect domestic macro weakness. Slowing export growth could be due to a weak global economy and/or competitiveness problems associated with an appreciating renminbi. Chinese trade data should be treated with caution, however, as it can be volatile and may be affected by illicit capital flows disguised as trade flows.

The massive oversupply in China's housing market has started to feed through to a range of other linked sectors in the Chinese economy. We believe that the country's property boom may have created approximately 3 to 4 years of excess housing supply, comparable to recent property booms in the US, Spain and Ireland which ended in deep recessions and financial crises. China's massive growth in credit in recent years also poses its own risks, especially in relation to activity in the shadow banking sector (as I mentioned in my July 2014 investor letter).

The good news is that the Chinese authorities are aware of the problems in the property and shadow banking sectors and appear to be taking steps to slow credit growth and cool the housing market. Furthermore, almost all of China's debt is held domestically and the country's capital account remains relatively closed, which makes it easier for the government to manage large-scale defaults as it did in the late 1990s. The differences this time are that much of the credit growth has occurred in the poorly-regulated shadow banking system and that the government may not have the resources to bail out this part of the financial system. Furthermore, although the Chinese government has substantial resources at its disposal, it still may not be able to prevent a sharp slowdown in growth (or a recession) if the returns on incremental spending and investment are sufficiently low.

The recent appreciation of the US dollar may also prove problematic for China as it attempts to manage a domestic slowdown. The renminbi is effectively pegged to the dollar, trading only in a relatively narrow band, as allowed by the People's Bank of China (PBOC). This policy may weaken the competitiveness and growth of China's external sector, precisely at the time when additional support is needed to offset domestic weakness. Eventually, the PBOC may be forced to allow the renminbi to depreciate against the dollar in order to stimulate exports and support growth. Official data on China's foreign exchange holdings suggests that they may have already been tapped in the second half of 2014 to help keep the renminbi within the PBOC's target range. As interest rates in China have fallen, and with markets anticipating Fed rate hikes, we may also be seeing the unwind of carry-trade financing activity in and out of China, which could also put downward pressure on the renminbi.

China is a key driver of global growth and its importance to the global economy is only increasing with time. Since 2010, the country is estimated to have directly contributed around a quarter of total global economic growth, despite its economy only representing around 12% of world GDP. China is by far the largest consumer of commodities and accounts for around half of the world's consumption of iron ore, cement, coal and steel. Should China's economy slow down or face a hard landing, the global repercussions are likely to be significant, particularly within commodities markets. We believe that now is a time to be cautious about exposures to China, particularly in the commodities space, given the adjustment process that is currently underway in the property market.

We are also cautious about the prospect of the adverse knock-on effects of changing economic fortunes in China, including currency movements. A number of commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. In some cases these economies may also be vulnerable to the unwinding of commodities-linked domestic credit booms. The same can be said for a range of other commodity-exporting emerging market economies, including Chile and others in Latin America. Furthermore, while many emerging markets are net importers of commodities, these countries' currencies may also be vulnerable to commodity price falls in the short term, due to highly-correlated exposures among global asset managers and recent, broad-based emerging market credit booms. Other economies with major trade linkages to China, such as the emerging markets in Asia, Japan and possibly Germany, could also be affected.

Although China's international financial linkages are relatively nascent, links between Chinese banks and Hong Kong or Singapore could provide channels for the international transmission of a Chinese financial shock. Meanwhile, capital repatriation by Chinese investors could hit property markets in Canada, Australia, the UK and Hong Kong. China also has massive foreign exchange reserves and is one of the world's largest holders of US Treasury securities. However, as noted in my previous investor letter, the use of foreign exchange reserves for domestic purposes faces some practical limitations.

Although there are a number of reasons to be optimistic about China's long-term economic future, the excesses in its property market and credit system appear unsustainable.

United States

A wide range of key economic indicators continue to show that the household, corporate, banking and government sectors all continue to strengthen. The household sector is buoyed by improving labour markets and strengthening house prices. Average wages increased by 2.4% over the year to November 2014 and the number of people employed is now 147 million, 0.7 million more than the previous November 2007 peak. The improving household sector is supporting a growing corporate sector, with higher levels of consumption of goods and services, including a significant pick up in housing starts to 1,028,000 per year in November 2014, up from the 478,000 low in April 2009. Indeed, we expect housing starts to grow further to 1.3-1.4 million per annum, this being our estimate of normalised demand. The strengthening in the corporate sector is reflected in overall higher levels of investment, supporting rising capacity utilisation, which is approaching pre-crisis highs. The improvements in the corporate sector are flowing through to the banking sector, with total loans outstanding increasing by 7.7% per annum and, notably, commercial and industrial loans increasing by 13.6% over the year.

The federal deficit continued to narrow to 2.5% of GDP in November 2014, from 3.6% one year ago. The Congressional Budget Office expects the deficit to remain relatively stable in the next few years, which should lead to a further reduction in the federal fiscal drag. We believe that the pressure on Congress to force additional near-term expenditure cuts is reducing as the deficit is falling faster than expected.

Recent strength in the US dollar is unlikely to have a major adverse impact on the US economy. The real, effective trade-weighted US dollar exchange rate remains close to historic lows, while US wages remain highly competitive compared to those of the country's global peers. In addition, the US is a predominantly domestically-driven economy, with a relatively low reliance on exports (which account for approximately 13% of GDP).

Eurozone

Aggregate growth in the Eurozone has stalled in recent months (growth was only marginal (0.2%) over the 6 months to 30 September 2014), despite the periphery economies of Spain, Ireland and Greece all recording relatively strong positive growth, having stabilised from deep recessions. We believe the Eurozone's growth is likely to remain weak for the foreseeable future, as emerging deflationary pressures, together with structural political and economic impediments, are holding back any meaningful, sustained recovery.

Weak price growth and falling inflation expectations have increased the risk of deflation. Prices are currently falling on an annual basis in Spain and Greece. Entrenched deflation, or very low inflation, could be a major problem for certain Eurozone economies that are reliant on nominal GDP growth and inflation to reduce their very large debt burdens. The ECB is very aware of this risk and is responding, albeit slowly and belatedly, with its intent to expand its balance sheet by €1 trillion from 2012 levels. ECB President Mario Draghi has also signalled that sovereign QE may be deployed in 2015 if inflation remains weak, although there may be some institutional barriers to this policy.

Finally, half a decade after the financial crisis, the ECB's recent assessment of the major European banks' capital and loss provisions has provided comfort that the overall banking system is sound and that the ongoing period of bank deleveraging is closer to ending. Unfortunately, the tardiness of this process, dysfunction in monetary policy transmission and weak economic conditions mean that businesses and households are continuing to decrease their appetites to borrow and invest. Some small- and medium-sized enterprises in the periphery are continuing to find it difficult to borrow at reasonable rates of interest, further stymieing growth and employment.

Offsetting these stresses is the 13% fall in the euro against the US dollar (since March 2014) and signs of labour market stabilisation. This, together with material falls in relative unit labour costs in Portugal, Ireland, Greece and Spain over the last 5 years, will help increase aggregate external demand, thereby supporting growth and employment in the periphery. The difficult policy actions facilitating these improvements, as well as the long period of sub-par economic growth and accompanying high levels of unemployment, have supported the rise of Eurosceptic political parties in a number of Eurozone countries. These parties often threaten an exit from the Eurozone (and a dispensing of the euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets. For example, Syriza is currently ahead in the polls for the upcoming Greek Presidential election in Greece and any renegotiation of the country's bailout terms or debt restructuring could prompt a reassessment of Eurozone sovereign risk premia.

We continue to believe that many Eurozone countries face a prolonged period of sub-par economic growth, due to the combined effects of fiscal restraint by governments, deleveraging of bank balance sheets and unfavourable demographics. At present, the governance arrangements in the Eurozone are complex and conducive to policy paralysis rather than decisive action and reform. France and Italy, in particular, are key countries where structural reform is much needed, but has been fairly limited to date (although the Renzi government's recent passing of important labour market reforms is an important development and a promising sign for reform prospects in Italy).

The Eurozone remains vulnerable to major shocks, such as a potential escalation of the Russia/Ukraine crisis, the election of Eurosceptic parties, a China hard landing or a disorderly unwinding of QE in the US, each of which could trigger a dramatic uplift in Eurozone sovereign bond yields. Such scenarios would heavily test the resolve and mandate of the ECB to intervene in the sovereign bond markets of troubled countries in an unlimited way. We are guarded on the capacity of European governments to step in to save banks that may fail in such a scenario. As a result, we remain cautious about holding investments leveraged to a Eurozone cyclical recovery at this point in the economic cycle.

Key Stock in Focus:

SAP

SAP is the fourth largest software vendor in the world. It derives the majority of its earnings from the sale of software applications to enterprises, with its flagship application suite, the SAP Business Suite, running enterprises' core business processes such as payroll, human resources ('HR'), supply chain and financials. SAP leverages its strong position in enterprise applications to sell Business Intelligence software (which is used by companies to analyse data) and various database software products targeted at different use cases.

Entrenched Market Positions

SAP is the incumbent leader in core enterprise applications and Business Intelligence software, especially among large enterprise customers in mature markets. It is difficult for small vendors and non-incumbents to develop software to compete with SAP products, which have been refined over decades and operate across numerous business lines, industries and geographies (with, for example, intricate nuances in tax and regulatory structures). Furthermore, SAP maintains a global network of sales and support personnel and boasts significant software development resources. Its ability to service large enterprise application customers is matched only by Oracle.

In mature markets, many large enterprise customers have remained settled with the same application vendor for decades. This is because the costs inherent in switching enterprise applications are high, owing to investments made by users in customising applications for their needs, as well as the necessity to integrate systems with business processes and test them thoroughly. Additionally, the risk associated with changing systems is heightened by the fact that applications often perform mission-critical functions. As a result, customer attrition is low (SAP says that gross customer attrition averages 1% per annum).

Favourable Business Model

Software support is SAP's most valuable and dependable business, generating almost €9 billion and growing by 11% (excluding currency effects) in 2013. It accounts for 50% of the company's revenue and likely a materially larger portion of its earnings, as SAP's software support earnings margin likely exceeds 80%.

Almost all of SAP's 261,000 customers purchase software support contracts annually, as they are required to do so in order to access important product updates, software patches and technical support services. The recurring nature of SAP's software support revenue helps insulate its financials from adverse economic shocks, while it also allows the company to generate significant excess returns on its relatively small capital base.

Technology Risk

Enterprises have traditionally accessed software by purchasing licenses from software vendors and installing software programs on servers located on their premises. However, the development of the internet and advanced software tools has increasingly enabled enterprises to source software from "cloud" software vendors instead. Enterprises are now able to subscribe to software products hosted in large-scale, off-premise commercial data centres that they access via the internet.

Although cloud computing threatens to reduce the size of the addressable market for new on-premise software licenses, SAP was among the slowest of the legacy technology vendors to address the cloud threat. As a result, market concerns regarding the potential impact of cloud computing on SAP's business have weighed on the stock.

Despite these concerns, a number of factors mitigate the risk posed to SAP by cloud vendors. First, a significant portion of SAP's customers are likely to prefer to retain their SAP applications on premise, either because their applications are mission critical or because the benefit of shifting their applications to the cloud is less apparent. The competitive threat posed by cloud vendors also varies by business line; while Salesforce.com and Workday have rapidly penetrated the respective salesforce automation and HR software markets, there are few cloud-based alternatives to SAP's complex, industry and geography-specific financial and supply chain management software products. In addition, significant switching costs have historically inhibited enterprises' ability to change application vendors. In any case, it is foreseeable that continued demand for on-premise software in emerging markets may support SAP's on-premise license sales, despite the threat posed by cloud-based alternatives.

Notably, SAP has now made its flagship Business Suite applications available via the cloud with subscription pricing, optimised with the company's high-speed HANA database. The value proposition of the cloud Business Suite will continue to improve as SAP simplifies and modernises its application user interface, and as its HANA database product matures. We anticipate that SAP will continue to build out its cloud portfolio over time, offering its existing customers a manageable pathway to the cloud.

Summary

SAP boasts a solid on-premise software business and appears to be making progress transitioning its software assets to the cloud, although continued execution and patience are required. We judge the company to be well placed to deliver attractive returns to shareholders over our investment horizon given its current valuation.

Yours Sincerely,

Hamish M Douglass
Chief Executive Officer, Chief Investment Officer and Lead Portfolio Manager

9 January 2015

Contact Details

Magellan Asset Management Limited ABN 31 120 593 946, AFS Licence No. 304301
Level 7, 1 Castlereagh Street, Sydney, NSW 2000 Australia.
www.magellangroup.com.au

+61 2 8114 1888

info@magellangroup.com.au