Magellan Unplugged Webinar

Video Transcript (May 2020)

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Emma Kirk:

Hi. My name is Emma Kirk, and welcome to our webinar this morning, Magellan Unplugged, where we invite you to have a virtual morning tea with us and find out more about what's been happening in global equities and global listed infrastructure. We have over 2,500 people on our webinar today across Australia and New Zealand, so welcome to you all. Before we start today, we'd like to send out our warmest wishes to you and your family, and we hope that you've been keeping safe and well in what can only be described as unusual times.

Now more than ever, investors are wanting more information about what's happening in markets, and today's webinar is aimed at doing a bit of a deep dive into what's been happening in global equities and infrastructure, having a look at those sectors and companies that have been resilient and those that have found this to be quite a challenging time. We then want to have a look at what are the silver linings that might come out of this. For those of you that know me, you'll know that I'm an eternal optimist and I want to know what might be those second and third order effects that we think about at Magellan that may come through as a result of this.

Today I'm joined by two of my favorite portfolio managers. I have Gerald Stack, who is the head of our infrastructure. Gerald joined Magellan at the very start, and he actually set up the infrastructure fund back in 2007. He has over 25 years of experience in managing infrastructure portfolios. And joining him is Chris Weldon, who also joined Magellan back in 2007, and he is the co-portfolio manager on our high conviction strategies.

And finally, before we start, I just want to let you know that today's webinar is general in nature. It shouldn't be taken to be personal advice. Should you wish to seek advice, please speak to your financial advisor or your stockbroker. And I hope that you have all read that disclaimer very, very quickly. Okay, now let's get this webinar underway.

Chris and Gerald, both of our strategies in global equities and global listed infrastructure seek to find high quality companies that are going to have resilience over the medium to long term, whilst protecting investors' capital. Chris, can I start with you? I think our listeners would be interested to know which sectors are likely to be most impacted by this crisis, and are there any particular companies... Sorry, I want to know those ones. First, I want to know those ones that have been resilient and any companies that have really stood out to you. Could you take us through that?

Chris Weldon:

Yeah, sure. Thanks, Em. Look, you made a very good point in your question about Magellan always seeking to protect our clients' capital, and we seek to do that without ever knowing what's going to happen to markets in the short term. So I think the first point I'd make is that we reconcile those competing ideas, always seeking to protect clients' capital in all market conditions without ever knowing how markets will move in the short term, by deliberately and consistently doing two things.

Firstly, we constrain our investments to incredibly high quality and resilient businesses, and we purchase those at a discount to our assessment of fair value. And the second thing we do is that we're always thinking about portfolio risk through a series of different lenses. Now, that could be business or industry disruption risk, balance sheet risk, currency risk, macro risks, evaluation risks, and so on. And we're always running a risk-constrained portfolio in the global equities strategy. We think that approach offers us the best opportunity of protecting our clients' capital through all market environments, and in this market environment, which we'd characterize as highly uncertain and one in which there is still a very wide range of outcomes with respect to health developments, to economic developments, to policy developments, we have adopted an even more cautious than usual posture.

That has resulted in us increasing cash and increasing exposure to those businesses and sectors that we think will be most immune to both the initial shutdown period and the recessionary period that we expect to follow. As you can see from this slide, these would be sectors like, firstly, true defensives. I'm going to come back and talk through what we mean by true defensives. Secondly, enterprise software, and third, Chinese digital platforms. But let's start with the true defensive businesses. These would include utility and infrastructure businesses, and Gerald is far better placed to discuss those. But other businesses with a similar predictability and reliability to their revenue and cashflow streams, including quality healthcare and consumer defensive companies like Nestle, PepsiCo, Novartis, and something like Reckitt Benckiser.

The second sector we expect to be resilient will be enterprise software and businesses like Microsoft and SAP. They sell mission-critical software to companies all around the world, and many businesses simply couldn't operate without the software from either of those companies. And those software revenues are increasingly annuity-like, and so are very resilient and very defensive. Now incidentally, both of those companies are actually seeing large parts of their business accelerate, given these companies are enabling remote working, remote learning, and so on they're all engaged in at the moment.

And the third sector includes the Chinese digital platforms, and this would be businesses like Alibaba and Tencent. They're a little similar to Microsoft and SAP in the sense that large parts of their businesses are actually benefiting from this environment in which people are working from home, schooling from home, and just generally spending more time at home. We were initially attracted to those businesses because of the very long-term trends supporting their growth, like the growth in eCommerce and the shift to digital payments and cloud computing and online entertainment and so on. But what we've found is that a lot of these trends have actually accelerated through this period, and that acceleration is lifting the growth and lifting

the profitability of these businesses right now, when so many other parts of the global economy are being challenged by Coronavirus.

Emma Kirk:

Gerald, same question for you. Which sectors in infrastructure have acted the way that we have expected them to, and which companies are likely to be really well placed during this crisis?

Gerald Stack:

Thanks, Em. Well, I guess I'd start by defining what we mean by infrastructure, and there's two things that we look for. The first is that infrastructure are essential assets, assets that provide services that are essential for the efficient functioning of communities. What that means at the end of the day is that demand for the services they provide, the provision of energy, the provision of water, the provision of transport, is very reliable over the long term. There'll be blips along the way, but we should be pretty confident about the nature of that demand over the long term. So that's the first thing that we look for, and that means that, as I said, they've got a very reliable demand.

We're then looking for a second factor in that there's no external variables that mean, notwithstanding the fact that you have reliable demand, you don't end up experiencing reliable cashflows. The things that we're thinking about there are things that affect ultimately the price for the services they pay, so competition, commodity prices, or sovereign risk. And we end up with a world that really splits into two particular sectors. We've got a slide that sort of shows you that, which we'll put up on the screen now. The two sectors we focus on are the blue and gray section there, infrastructure, and the yellow and orange component, utilities. That shows you our portfolio at the end of March.

Now, if we think about those two broad sectors, regulated utilities have performed largely as we would have expected. Regulated utilities provide water, gas, electricity. They're regulated. The regulation works so that they charge us a price for their service such that they get a fair return, and a fair return's around about 9% around the world today, on the capital that they put into the business. They get a fair return, and it doesn't matter if things are really bad or really good. They'll charge a price that gets them to essentially that 9%. Some of these companies may face some issues in the short term, some small bad debts and the like, but we would be very confident that over any medium-term timeframe they'll continue to generate earnings in line with that underlying thesis.

And that's very much played out. Indeed, as we've gone through first quarter earnings for many of these companies, they've reaffirmed their earnings guidance for the year, so they're effectively saying that yes, there may be some small issues, but essentially they can make up the difference and they would expect to earn total profit for the year very much consistent with what they expected prior to the onset of COVID-19. So they've performed very much as we would expect. There's some exceptions to that, but broadly speaking they've performed as we would expect.

In the infrastructure space, infrastructure's about the movement, the transport of either people, goods, or indeed data. People and goods, clearly that's been affected. We can talk about that later on, mayhaps. But data, as Chris has sort of touched on, the movement of data across communication lines through internet networks and across WiFi networks, if anything has accelerated. The nature of this podcast-webinar that we're doing today is we're all at home. People are using the internet in a pretty rich and comprehensive manner. So what are the infrastructure companies or the infrastructure sectors that assist that? It's communication towers, the big mobile phone tower companies. They've performed very strongly through the year. Indeed, they've probably performed strongly than we would have expected before COVID-19, let alone after. So utility space, very reliable, consistent performance. Communications assets in the infrastructure space have done particularly well.

Emma Kirk:

Now I want to have a look at the other side of the coin. We've had a look at those companies that have been resilient and the sectors that have been resilient, but this is an unprecedented time for all of us and something that nobody could have predicted. I'm really interested to know which sectors and which companies are going to possibly struggle a bit with this challenge and it's going to impact them, both in the short term and the long term. Chris, could I ask you to talk us through those you think are likely to find this a challenging time?

Chris Weldon:

Let's separate that by discussing the investments that are in the portfolio and then the businesses and sectors outside the portfolio. You'll recall I mentioned earlier that we still see this as a highly uncertain macro environment and one in which there is still potentially a pretty prolonged and meaningful downturn as a realistic base case that we're considering at Magellan at the moment. So even within our very high quality universe of companies, we recognize there are some that are more cyclical and that are more exposed to economic developments at the moment.

Now if we go back to that earlier slide I showed, I'd say for the following businesses and sectors, we expect some moderate macro headwinds in the short to medium term. The first sector I'd call out would be digital advertising companies like Alphabet and Facebook. Advertising has historically been a cyclical industry, and we expect the industry to again be pressured during this economic downturn. And that will have some near-term impacts on Alphabet and Facebook. But importantly, given the many advantages of each business, we expect both companies will continue taking share of the total advertising pie and may actually accelerate during the downturn, while their traditional media and traditional advertising peers are pressured.

The second sector I'd call out would include the card network companies like Visa and Mastercard. Both of those companies earn very high margins whenever their cardholders travel and transact around the world, and with travel restrictions in place, that part of their business right now is obviously being impacted and will be challenged for at least the quarters ahead. Now, there are some notable offsets within those businesses. People seem to want to physically handle and accept cash less at the moment, which stands to reason. It also means people are increasingly transacting with their cards in a sort of tap-to-pay transaction. And we're also seeing eCommerce growth accelerate, and we all know that when we're transacting online, we can't use cash. We have to use a debit card or a credit card.

The third sector that's more challenged in the short term are the makers and sellers of discretionary goods, like LVMH or Estee Lauder. With concerns around household budgets and employment prospects, naturally we can expect some sort of change in consumer behavior. And we recognize consumers may defer purchases of discretionary products or that they may trade down within certain categories, which may impact the near-term prospects for those businesses like LV and Estee Lauder.

But for each of those six companies, Alphabet, Facebook, Visa, Mastercard, LVMH, and Estee Lauder, I'd quickly make two points. The first is that while we recognized the short-term cyclical challenges these companies confront, and we have moderated our exposure to these sectors somewhat, they all continue to operate in large and attractive industries that we expect will recover and will thrive over time. The second point I'd make, and this ties back to some earlier comments around our insistence on business quality across our universe, is that all six of those businesses have very strong balance sheets, many with very limited debt if not very meaningful net cash positions. This will allow each of them firstly to survive the downturn, but secondly and more importantly, potentially to do some opportunistic things to emerge even stronger through this period.

And the fourth and final area we'd highlight that may be challenged due to Coronavirus are businesses across nearly any industry with a high degree of non-China emerging market exposure. We're concerned that the health and the economic challenges associated with Coronavirus may be most acutely felt in those parts of the world.

And then in terms of sectors that we aren't invested in but which we also regard as being challenged by Coronavirus, I'd flag and note any business with a high amount of financial leverage and/or a high fixed cost base. They are likely to struggle in this period in which revenues are under pressure. Secondly, you can think about some structurally challenged industries, like traditional media and offline retail. Those structurally challenged industries may face an acceleration in their demise in this environment. And then thirdly, there are of course sectors like travel, and think cruise lines, think international flights, as well as businesses and industries reliant on the assembly of large numbers of people, so concerts, sporting events, and so on. And it's quite likely in our mind that those businesses will also be challenged until we have an effective vaccine or therapeutic such that people feel safe leaving their homes and gathering in large crowds again.

Emma Kirk:

Now, Gerald, we had Chris talk about the fact that we're not jumping on any planes at the moment. We're not traveling. I'm interested to know, I know that that's a sector that has definitely been impacted by Coronavirus, but could you give us some insights as to what other sectors have been impacted and why that is?

Gerald Stack:

Sure. Again, I'm going to refer to the slide that we showed before, looking at our portfolio and divided up by sectors on there. Again, if you look at the orange sections there in the utilities, you'll see four different segments, water, integrated power, transmission and distribution, and gas utilities. Water utilities naturally provide water. Transmission and distribution is the poles and wires that provide for the transport of electricity. Gas utilities are providing gas through the pipes. Integrated power is our term that we use to describe those utilities who do a bit of a few different things. They typically have some electricity distribution, quite often some gas, and quite often some regulated generation.

Now, the different utilities are facing slightly different things. Water utilities and transmission and distribution are entirely regulated and dominated, typically, in our world by retail or household customers. They're well positioned, as I touched on before. There are some integrated power and some gas utility companies who, because of the nature of their customer load, have some exposure to insolvency of their customers. If I think about their customer load, this is integrated power and gas utilities, to some degree transmission and distribution, the demand is reflective of three different types of customers, retail (households), commercial (offices), and industrial (manufacturing facilities). And given the lockout of physical commerce, there are many businesses that are not up and running today, many industrial facilities the same.

So in the short term, they're likely to see a reduction in the amount of volumes that are going through both those gas networks and electricity networks, if they have significant exposure to commercial and industrial customers. And therefore, there is some potential for some short-term bad debt issues. And indeed, if there was a profound long-dated recession, we could expect some bad debt issues over the medium term. Again, as I stand back from that, as I look over the longer term, we'd expect the regulatory compact that these companies have, that is, their agreement essentially with their communities, that they will invest significant amounts of capital on an ongoing basis, on the basis that they will get a fair return, we would expect that to hold up. It certainly has previously. If I look to the GFC, we gain some confidence in that. And therefore, in the long run those should be okay. But there are some of these utilities who will face in the short term small hits, but hits nevertheless, to their profitability. So they've been affected. That's in the utility space.

On the other side of that chart was the infrastructure companies and the different segments there, airports, communications, toll roads, rail, and energy infrastructure. I've touched on communications already. That's been the standout. If I think about airports, toll roads, and rail, these are businesses that are about the physical movement of people and goods, so in an environment where there's a lockout of physical commerce, these are companies that face a pretty profound reduction in their demand profile in the short term. Airports, broadly speaking, are facing something like a 99% hit to their passenger numbers in the short term. Toll roads, a significant hit but perhaps less.

If we think about roads as being within an urban environment or interurban connecting towns and cities, we're typically finding that interurban traffic is falling by, at the high, something like 80%. In particular, cars on those interurban roads. Trucks, a little bit less than that. And then traffic on urban roads falling something like 40 to 50%, something of that order on average. And then the third bit is rail, and again, with rail we've seen a reduction in the loads traveling across rail networks around the world.

Now, if I think about each of those three companies, we have a very different profile in terms of the way we expect these things to come back. If I think about airports, this is where there's the most uncertainty. Clearly, airlines are seriously financially challenged at the moment. People are concerned about travel. It will take some time for that to come back. Similar to utilities, if I think about the underlying customer base, we can split that customer base into... well, we could split it into domestic and international. Domestic passengers we expect to come back more quickly. International are going to take some time. Already we're starting to see airports talk about opening up sort of June, July, so we'll start to see some passengers come back, but the outlook, the longer-term outlook, is way more uncertain. Until we get some clarity around that, it'll take some time before we get confidence around the outlook for airports.

Toll roads, again, we're seeing traffic come back already in most jurisdictions. Slowly, but it's coming back, and we would be confident that ultimately, certainly with urban roads, that traffic is ultimately a function of the population that services that road or its catchment area, and the housing formation. We don't expect population's going to be significantly affected by this. There may be a crimping of population growth, but we expect over the long term that most population centers are going to continue their long data trends. In Australia, if I think about Transurban, Melbourne, Brisbane, Sydney, their three major theaters of operation all face long-dated population growth. Modest growth, but population growth nevertheless, and therefore that gives you some confidence about whether traffic comes back over the long term, notwithstanding the fact that we would expect some more working from home as we go forth. So toll roads, we see a quicker comeback compared to airports.

Rail, not dissimilar. Rail ultimately is about moving the goods from an economy. We're much more focused on industrial rail than passenger rail or goods rail. As economies progressively come back, we'd expect volumes similarly to come back. We see certainly a short-term hit, but the long-term prospects with rail remain pretty solid, just as they do for toll roads. So airports is where there's uncertainty. Toll roads and rail, sure they've been hit in the short term, but we remain optimistic about the way that they'll come back over the medium term.

Emma Kirk:

Now, I know we don't have a crystal ball and the future's very hard to predict, given that we've never experienced anything like this beforehand, but I'm still interested. Are there going to be any trends or opportunities that are going to accelerate off the back of this, given we've got changes to people working habits, changes to our travel, changes to consumer behavior. Is there anything that's actually going to take off out of this? Chris, what are your thoughts?

Chris Weldon:

Yeah, you're right, and we don't know exactly what the future holds, and particularly given there's no precedent for this, this type of global health and economic shock. It probably goes without saying that times like these reinforce the importance to us of all elements of our process working together. Firstly, that's investing in these very durable and high quality businesses at a discount to fair value. But then secondly identifying the risks and the

opportunities within the macro environment. And finally, sensible and risk-aware portfolio construction. And we do all those three things to try and maximize the likelihood of achieving the two objectives we have for clients in the global strategy, that 9% after-fee return over time and downside protection through all adverse market conditions.

Now, in terms of investment considerations looking forward, there are three areas of opportunity, or perhaps increased conviction, that I'd highlight. Firstly is around digital and online trends, and this ties back to something Gerald was just talking about with the lockout of physical commerce. We've touched on this a few times, but we think those businesses that have a meaningful exposure to online trends will do much better than those businesses without. And that can include things like exposure to digital or online shopping, digital payments, cloud computing, digital media, entertainment, digital advertising, customer engagement, education, and the list goes on and on. The businesses that are lacking those capabilities are being left behind in this environment, so that's something to think through.

Secondly would be the Chinese consumer. In a relative sense, we think the Chinese economy is likely to fare better than most advanced and emerging economies. Based on what we know today, the economic impact, in terms of unemployment levels or the GDP hit, should be less severe in China than other parts of the world. That should allow the growth within the consumption sector of the Chinese economy to experience less of a hit and less destruction than consumer trends in other economies around the world, which are facing greater impact from COVID.

And then thirdly, I'd say we have incrementally greater conviction that long-term interest rates are likely to remain at lower levels for a longer period of time. If risk-free rates are being held lower because of slower economic growth or because of central bank policy over the medium to long term, all else equal, that has a positive impact on the value of all assets, including equities, which we think investors need to consider. Then I'd say as a team, we're asking a lot of questions around long-term issues, and it's a long list, but it would include things like how government balance sheets will be restored once this crisis is passed. Will we see higher personal tax rates or corporate tax rates or large cuts to government expenditures?

Related to that, will there be some sort of permanent increase of the role of government in economies and societies going forward? I think even related to that is the question around whether citizens will be willing to forego some civil liberties in the future and allow governments to access their private data and to place apps on their phone, in exchange for better health outcomes. What will all of that mean for income inequality trends and the political environment? There are questions around what the long-term impacts from all of this recently announced and enacted monetary policy will be. Does that increase the probability of inflation or deflation?

Questions around what if we don't discover a successful or therapeutic? How will societies manage the pathway to herd immunity? Will global supply chains need to shift to favor resiliency and redundancy over efficiency, and will there be a diversification in supply chains so there's less reliance on a few geographies or a few providers? And does that in some way accelerate this seeming decoupling between the United States and China at the moment? So there's just a long, long list of very important questions confronting us, confronting our clients, confronting investors, that we're spending a lot of time as a team thinking through how they could impact or how they could benefit our current holdings. And also whether they present opportunities for new investments across our portfolios.

Emma Kirk:

Excellent. Thanks, Chris. That's a lot to think through. Gerald, the same thing for infrastructure. What are the opportunities that lie ahead in the infrastructure space?

Gerald Stack:

As Chris has said, we face a somewhat uncertain world, but I we would be confident that we're going to see certainly some changes in the way that people work. We'd expect people to be working somewhat more from home. We'd be expecting some reasonable changes in the way that people travel for quite some period of time. But having said all of that, we're of the belief that ultimately humans are social animals and that they will want to continue to travel and that they will want to continue to congregate together, to work together. And therefore, to the extent that I look at toll roads, while there may be come crimping of potential growth, we would be confident that in the long run that people will continue to use toll roads. There'll be demand for traffic. Much of this is because ultimately toll roads are a function of population growth in a catchment, combined with the fact that the government doesn't want to build the road and own the road themselves.

So toll roads exist in a catchment where the free roads are full because of the underlying population growth, and the private sector have built that road. Unless population is actually going to significantly reduce, while as I said, there may be some crimping of growth in the long run, we continue to believe that the opportunities for toll roads remain pretty attractive. So there's much of that opportunity there, but we don't see a fundamental threat to our thesis.

Similarly with airports, as I've touched on already, there's certainly some degree of uncertainty as we look to the outlook, but we know from history that there have been demand shocks before, and people have come back, they've come back to airports, that ultimately they want to travel and that the way that we travel changes over time. If we think about September 11, we have security arrangements in place now at all airports that are quite different to what existed pre-September 11. I wouldn't say that we don't notice them, but they're efficiently run. We continue to travel in an efficient manner. We'd expect similar things to come out of the pandemic and the way that we address the health concerns associated with COVID-19. So we don't see a fundamental threat.

The opportunities we see goes back to again, which is something that Chris touched on, interest rates are going to be low for an extended period of time, we would say with a high degree of probability. If you're invested in very long duration income streams, that is income streams that you're very confident are going to grow at a rate in line or greater than inflation for long periods of time, then movements in interest rates, in either way, can have a pretty profound impact upon value. When we think about the universe that infrastructure utilities are, we think that the provision of these essential services, demand for these things, does not go away.

As I said in the case of toll roads and airports, we have a short-term issue, but in the long run we're very confident about the nature of that demand, and therefore, the reduction of interest rates is an underlying force increasing value. In addition to which, the bulk of infrastructure assets have a pretty significant amount of their capital structure in debt, and therefore, reduced interest rates also improve their underlying financials. So we would expect fundamentally better financials and a lower discount rate to apply to those earnings over the long run. That throws up a range of different opportunities. In addition to which, obviously share prices have declined, so that makes it, there's some really interesting opportunities out there.

Now, those sectors where we've seen the most profound declines is where there's been the most significant challenges. I'm not pretending that's easy trying to work out which ones are going to work for us, but there's certainly opportunity there.

Emma Kirk:

Thanks very much for that, Gerald. We're now getting to questions from people who've joined us on our webinar, which I'm quite excited about. We've had a number of live questions come through, and I'm just going to have a look. We've got our first question is from David Jarrett, and his question's in relation to global, so Chris, this one is for you. In relation to the Global Fund, what are the key things you want to see before deciding to reinvest cash?

Chris Weldon:

Ah, good question. It's an important question, David. We've got, as you've probably noted in our recent disclosure, across our global portfolios we're sitting on quite a meaningful amount of cash at the moment. I think at the end of April, Global Fund was around 17% cash and High Conviction was, I think, 27% cash. So some meaningful cash balances there that we can deploy in the sort of opportunities as high quality businesses when we think that's appropriate. There's probably one of two things, to more directly answer David's question, that we're looking for.

I would say the first is quite a meaningful reduction in the risk associated with the macro backdrop, and that would probably come through one of those three channels that I mentioned earlier. Improvements in the health aspects of this crisis, a vaccine or something like that. The economic channel as well will be very important, whether policy can keep unemployment low and support businesses and support households and just provide a bit of a floor that allows the economy to recover from. And that ties directly to that third channel as well, is policy, whether we can continue to see supportive policy around the world. And as developments occur across each of those three different channels, the probabilities will move around. And if they were to reduce in a meaningful way, all else equal, I think we'd be comfortable deploying some of that cash into that market environment.

The second way I want to answer that question is whether all of those risks may still exist, but if they were all reflected in the price, and potentially more so, such that the risk-adjusted return profiles for equities were really attractive, I think we'd also be willing to start deploying some of that cash. But as we sit here today, I think we still have a very cautious view across the macro landscape, and for most equities, I'd say, we don't find the risk-adjusted return prospects that appealing at the moment. That's why we're sitting on those pretty considerable cash balances I mentioned earlier.

Emma Kirk:

Okay, excellent. Another one that's come through, once again it's for global. This is from David Goffage. He'd like to know, are tech stocks like Microsoft the new consumer staples?

Chris Weldon:

Interesting question. In a sense, I guess maybe they are. Some of them are. Some of them are, in the sense that might have that reliability and durability and predictability to their revenues and to their earnings, like legacy blue chip sectors. Maybe like consumer staples and consumer franchise and those sort of things. None of them are quite as immune and as robust as Gerald's space. He really has the businesses where you've got very clear line of sight in terms of their future economics. But I think there are businesses within that enterprise software space that could be the blue chips of tomorrow, and I say that because, let's pick a couple of examples that I mentioned earlier.

Microsoft, a big part of their commercial cloud business, and I think they disclosed in their last quarterly results, their commercial cloud business, which is their Azure cloud infrastructure business as well as Office 365 and a bunch of other parts of their business now that sit and support the cloud, those businesses, which is a very important and growing and large part of Microsoft today, I think they disclosed that 92% of the revenue of that commercial cloud business is annuity-like and therefore gives you that degree of predictability and stability in their revenues and in their earnings going forward.

We also spoke about SAP earlier. About 80% of so of SAP's gross profits still come from the sale of software, not in the cloud, sort of on-premise sales, where they sell a software license. But this is where it gets really attractive. When customers buy that software license to use SAP software, they then have to pay ongoing maintenance fees to get support and servicing and upgrades of that software package that they've paid for. And that maintenance stream is incredibly durable and robust. These are long-term contracts that again provide a lot of stability and defensiveness in SAP's overall profile. So there are some of these businesses that have that annuity and subscription-like revenue model, where potentially yeah, maybe they are some of the blue chips of tomorrow. I don't think all enterprise software companies and all technology businesses have that sort of revenue model, but you are seeing more and more companies move that way. And I think SAP and Microsoft would be two good examples.

Emma Kirk:

Excellent. Thanks, Chris. Gerald, we've got an infrastructure question. Very excited about that. This is from Rob Flynn. Rob has asked, how long can airports as businesses withstand a lockdown in air travel, especially international travel?

Gerald Stack:

Okay. All right, interesting question. I guess I'd come at that in three ways. I want to think about solvency and liquidity, I want to think about profitability, and I want to think about getting back to normal. If I think about solvency and liquidity and I look across the spectrum of airports in listed international markets, I'd say on average they've got something like 18 to 24 months worth of liquidity at the current time. That is, they've got enough debt and facilities and available cash to survive basically zero passengers for the next 18 to 24 months. There's going to be differences around that, but that is a broad brush. That's roughly where they sit.

Now, as I mentioned already in the webinar, we've started to see airports essentially looking or notifying that they'll look to open up themselves in the next couple of months. It will happen in a slow way, but you're definitely not going to get zero passengers over the next 18 to 24 months, so I think on a solvency or liquidity basis they should all be good. So that's step one.

Step two is about getting back to profitability. Again, I've touched on it earlier, that you can think about the passenger base as domestic-international. International passengers are worth a multiple of domestic. Again, differs by airport, but probably something around four to five times is what you get from an international passenger versus a domestic passenger. We expect domestic to come back more quickly. If I think about Australia and New Zealand, it's domestic markets that will be opened up first, followed probably by regional markets. So in the case of Australia and New Zealand, that's the Pacific and New Zealand. And then finally it will be international travel, intercontinental travel. So while we'll get passengers back to begin, that's not necessarily the most profitable components.

Again, it is going to differ by airport, but our analysis would suggest that most airports are going to be profitable pre-interest, pre-interest costs, at around about 50% of their passengers of what they were getting before. If they can get back to 50%, they'll cover their operating costs. Maybe 60 or 70%, they'll start to cover their interest costs and be profitable again. And that's roughly where they need to get to. Now again, it will be different from airport to airport. So that's about getting back to profitability.

The other thing, I guess, is to think about the passenger mix in a different manner, and that is to think about it as the purpose of travel, and the first purpose would be visiting friends and relatives. The second is tourism, the third is business. Visiting friends and relatives, that's the bit that we expect to happen most quickly. Business is the bit that we expect to happen latest in the pace. So that's solvency getting back to profitability.

Getting back to normal, that's a much longer run proposition. Again, as I mentioned earlier, we've seen plenty of demand shocks in the past, Iraq War I and II, September 11, SARS, the GFC, so we've seen these shocks over time. Typically, the demand shocks have meant something like a 5 to 10% hit to passengers, and that's come back within sort of a 6-to-12-month timeframe. Clearly, we've got a much more profound shock to passengers through the pandemic, and we're going to add to that, we would expect a pretty significant recession. And as a result, we don't expect passengers to come back in that sort of timeframe. It's going to take a lot longer.

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And as we look around the world, airports and airlines, IATA, the airline lobbying group, sort of suggesting something like 2022, 2023, 2024, so an extended and slow comeback to something that approximates normal. But we do expect normal to come back. So on solvency, they should all be okay. On profitability, we want them to get back to somewhere between sort of, I guess, 50 and 70% of passengers. Normality is going to take some time.

Emma Kirk:

I think you're right on that, Gerald. I think normality is a little way away yet. We've had another question come in. This is from Bill Clemens, and he has asked, given that earnings, i.e., the E in the P/E ratio, cannot be known, how can the equities you are buying be valued? Chris, could you answer that for us?

Chris Weldon:

I can try. It's a good question, Bill, and look, actually I'd say we've got a high degree of sympathy with the view that the earnings number over the next few quarters, even potentially the next few years, is very hard to, depending on the business and the industry, get some comfort around. Some businesses will be much more resilient than others, obviously. But that's not necessarily our game, is trying to predict earnings for the next couple of quarters or years, or trying to value businesses for that matter for the next few quarters or years. So in some ways, we get to cheat a little and not even concern ourselves too much with the prospects for a company's earnings this quarter, next quarter.

What we're really trying to think through in our valuation work is the cashflow streams for a business over its entire lifetime, and discounting those cashflows back to a present value today using conservative estimates. And then applying a big margin of safety when we're thinking about investing. That's the way we go about valuation. We also think sort of another medium-term lens on valuation that we use is thinking about where earnings per share might be sort of through the cycle or mid-cycle, so maybe three or four years down the track, once we get out of the bottom part of this cycle now. And think about where earnings will be three or four years from now and what an appropriate multiple we think for those earnings will be at that time.

And that gives you some sort of sense for where the share price might be, and we can reference the share price today to an expected future share price and think about that return profile as well. So there's a few different lenses through which we think about valuation, but none of them really consider earnings really in the next 12 months or price/earnings multiples in the next sort of 12 months or short-term periods like that.

Emma Kirk:

Excellent. Thanks for that, Chris. And the final question's from me. I want to know, what's the one thing that you want investors to remember at the moment? Gerald, you get to go first on this one, and then Chris can finish.

Gerald Stack:

I think to be patient, to be cautious and patient. People think there's more uncertainty in the world. Personally, I don't think there's more uncertainty in the world, I think it's just become evident. We've dealt with these issues as best we can on the way through. The prospects as we look out through the long run remain, I think, well within the viewfinder of where they were before, albeit we're going to have some short-term uncertainty. So be patient and consider the way that you proceed through this.

Emma Kirk:

Excellent. And Chris, your thoughts?

Chris Weldon:

I think, Em, you're sort of maybe characterizing, framing the question at least, in terms of decision-making and reflecting on markets here at the moment. I going to cheat a little and sort of offer hopefully a response that's a bit more evergreen. And it's not too dissimilar from Gerald's response either. It would be, as always, irrespective of market conditions, adopting that mindset of investing in shares of a business as if you were acquiring the whole company, and thinking through whether this investment opportunity is a business with the competitive strengths, with the industry prospects, with the management capabilities that you would want to own for the next few decades, as if you'd own that business for the next few decades. So thinking like a long-term business owner would be my response.

Emma Kirk:

Excellent. Thank you very much for that. Thank you very much both for your time today. I really appreciate it. I've missed hanging out with you guys, so it's lovely to see you on the screen. Thank you to everybody that has joined us today. We really appreciate it.

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