CREDO WEALTH

A good ear

As bottom-up stock pickers, we are conscious of looking at how a business is different from its peers. Businesses are rewarded for doing something well that others aren't. We are rewarded for finding what others have missed - for recognising value that isn't so obvious. For subtlety. Over time, an experienced analyst builds up a chest of 'stock stories' where lessons have been learned. The next time a similar situation occurs, the memory may be triggered. It is not the same song, but a few bars hint at a tune you have heard before.

Oracle was born 40 years ago and has been so successful, its founder Larry Ellison is one of the richest men in the world. Oracle designs, manufactures and sells software and hardware, and the services that support them. Better known to the public because of personal computers, fellow rich list member Bill Gates started Microsoft, just before Oracle, in 1975. Oracle focuses on Enterprise Software, which are the applications which help businesses run behind the scenes. Some are off the shelf (the equivalent of Microsoft Office) but over the years they have become more complicated as coders tweaked them for individual businesses. Often those coders move on and new coders maintain these systems without the 'there from the start' historical knowledge. Change is highly risky because there are bits you know you don't know. "Switching costs" are high if applications need to be rewritten. A lot of time (and money) has been spent over many years writing these historical applications which all speak to each other. Hence, it is unsurprising that companies tend to stick with their existing database architecture. The big recent shift in computing has been from individual computers with software on them, to cloud computing. Instead of the software being sold as a physical product for a licensing fee, users would need to pay subscriptions for access to software that doesn't physically sit on their device. Information Technology companies like Microsoft and Oracle have had to adjust.

To make matters worse, from an accounting perspective, the transition from an upfront licensing fee model to an annual subscription model has had the effect of artificially depressing revenues. By way of example; if you purchased a Windows 95 licence in 1995, Microsoft would generate a once off $100 of revenue from you in that year. Thereafter they would not book any revenue from you until you purchased the next Windows release in 2000. Had they sold Windows 95 on a subscription basis then you might have paid them $20 per annum over 5 years for the period 1995-1999. You can see from this example that whilst in 1995, $100 upfront would have been equivalent to signing a $20 per annum 5-year subscription, the revenue is "pushed back" in the subscription model.

While earnings at Microsoft stagnated, investors eventually began to realise the revenue accounting impact of the transition from license to subscription. Moreover, Microsoft's operating systems and applications would dominate in the cloud as they had done on premise. Adobe, another firm facing this change, saw earnings shrink (for now), but still the potential was recognised. The multiple (Price/Earnings) investors are prepared to pay for current earnings of both Microsoft and Adobe grew on the expectation that earnings growth would follow.

This didn't happen at Oracle, which made investors nervous. This is because of the complexity and risk of transitioning their core customers (large enterprises with legacy on premise database and applications) to the cloud. To mitigate these risks, most of their customers would typically adopt a hybrid model (on premise and cloud). Oracle was not short sighted, nor late in recognising this transition. It took a decade or so to rewrite complex applications, middleware and portions of their database so that they were all compatible with each other. It is these "switching costs" which are part of its sustainable competitive advantage. Chief Information Officers are very wary of the risks of shifting to the cloud and this is minimised by sticking with their existing technology "stack".

As a result, Oracle was bought for the Special Opportunities Portfolio in December 2015. Businesses will shift infrastructure to the cloud in a highly cost sensitive way. As a commodity. Oracle can sustain its competitive advantage in the technology that sits on top of that infrastructure.

After Microsoft split out its cloud business and earnings potential became clearer, they were rewarded. Oracle is not the same song but patient investors with a good ear could be similarly pleased. Oracle's recent results have started to show some of these benefits, hence the multiple has begun to rerate and we believe more is likely to follow.

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