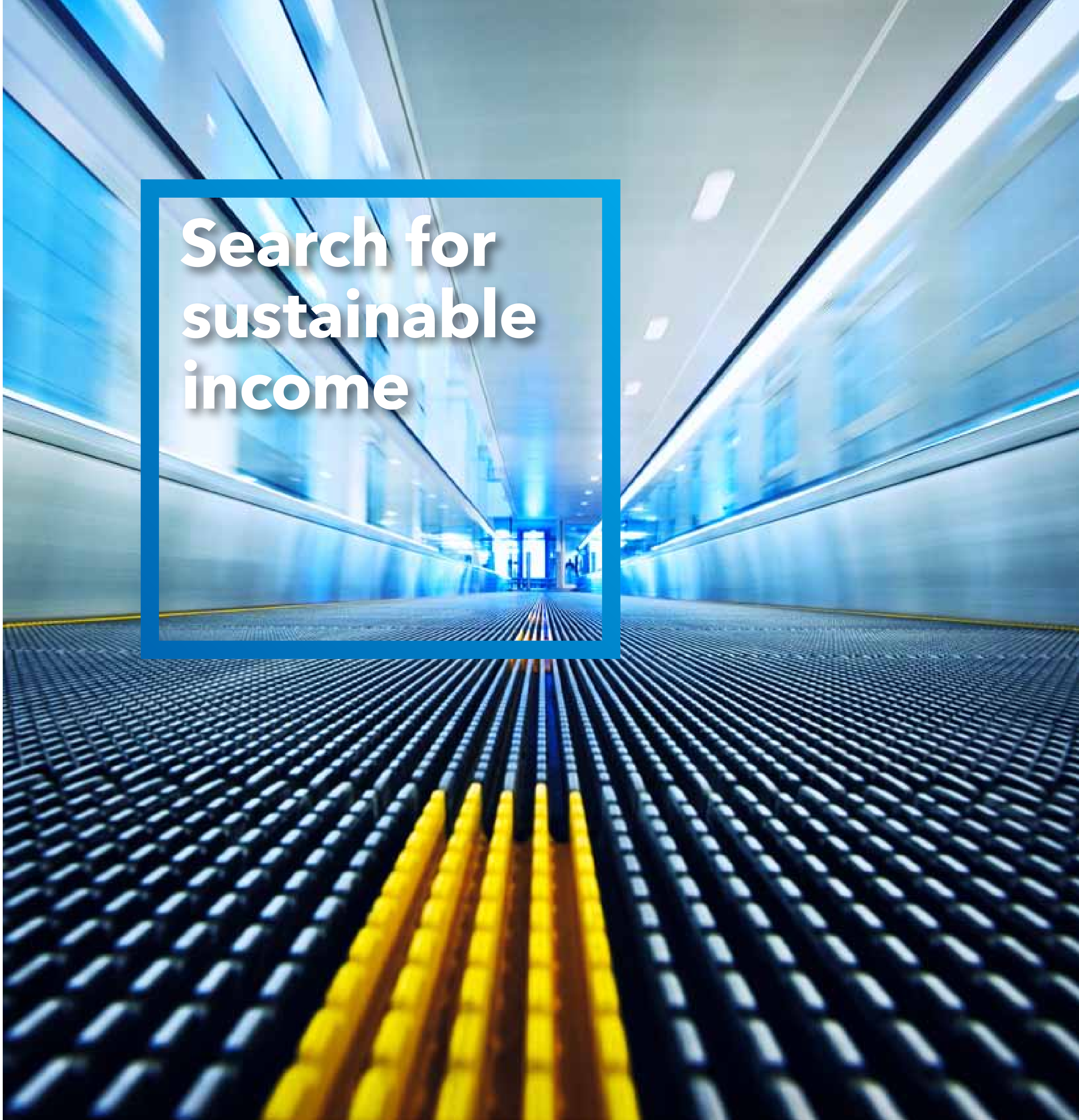
The Long View

Investment Insights

July 2014



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"The best investments are ones that just keep working for you."

Alan Berro, Portfolio Manager

Razors and blades. Talk about a business model with legs. More than a century ago, K.C. Gillette came up with a plan: Give customers the razor and sell them the blades. Of course, Gillette didn't exactly give away his safety razors. They retailed for the relatively substantial sum of $5 in 1903, or about $140 in 2014.

Still, the real money was in the blade, that thin, inexpensive, disposable piece of stamped steel that men around the world have been buying over and over in one form or another ever since, and Gillette was more than happy to sell them the blades.

That's called recurring revenue, and it's become the holy grail for many companies in industries ranging from technology to consumer products. The model can apply in some unexpected ways, from the ongoing maintenance of jet engines to subscriptions for software.

Investment analyst Thatcher Thompson says automatic teller machines have become a classic and surprising example of the razor and blade model.

"The company makes some money selling and installing the ATM, but once a bank buys an ATM, they want it serviced by the manufacturer," Thatcher says. "The service contract typically has a three-year term, and the renewal rate is about 90%. One ATM maker, Diebold, services about 400,000 ATMs around the world."

The model now seems to cut across sectors and industries, with a wide variety of goods and services being monetized on a recurring basis, ranging from Keurig and its K-Cups® to Rolls-Royce and the long-term maintenance of their jet engines.

The range of companies now using the model presents an opportunity for investors looking for a diversified income portfolio with sustainable dividends and the potential for growth. For example, there has been a marked increase in dividends paid by the information technology sector, where the model has become so prevalent that software is now referred to as the new razor for its ability to create an ongoing revenue stream.

In fact, Oracle, the largest enterprise software company, has about half of its revenues in recurrent mode, selling updates on software licenses it installs. NetSuite, which emerged in the 1990s as one of the first companies to sell business software as an online service, is another prime example of recurring revenue. The company also manages a high-tech double dip of sorts by installing software to help other companies manage their recurring revenue, from which it generates recurring revenue.

"Companies that adhere to a recurring revenue model can remain relatively stable in a challenging economic environment, which can mitigate volatility in portfolios during periods of turbulence," portfolio manager Alan Berro says. "Our fundamental research can lead to the best of those companies, and when we find them we like to partner with them for the long term. The best investments are the ones that just keep working for you."

Jody Jonsson
Portfolio Manager
25 years of investment experience

The income connection

Because it can be so difficult to predict the direction of markets and make judgments about the macroeconomic environment, I like to assemble a portfolio of companies that can march along regardless of the economy or whether the market is up or down.

I call them "global champions," companies that have such outstanding businesses that the economy isn't going to make a huge difference. They have defensive characteristics and deep moats around them, meaning there are very high barriers to entry.

The other thing that many of these companies have is a long-term source of income, or recurring revenue, from the maintenance contract that goes along with the sale of the original equipment. The aircraft engine business is a good example. The companies sell the engine, and they also service the engine for the next 20 years. It's possible sales may drop off, but the maintenance contract goes on forever, figuratively speaking.

That quality can make for a robust company that can survive in a lot of different business environments. I have a deep appreciation for very durable franchises and the role they can play for long-term income investors.

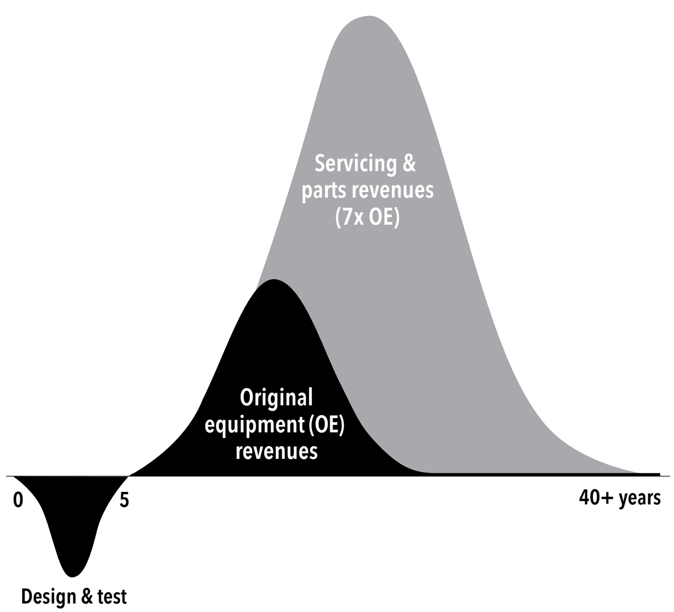
For jet engine makers, the real money isn't up in the air

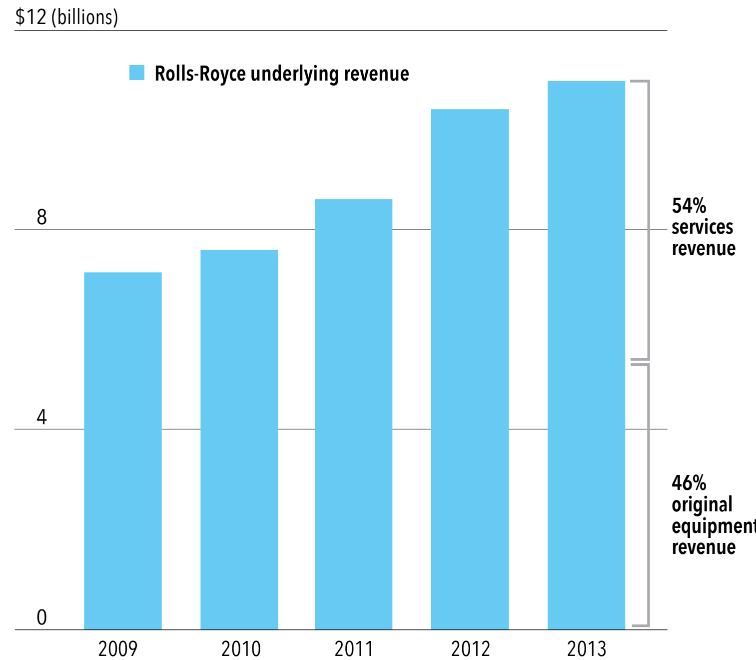
Maintenance can be worth seven times the engine, and provide decades of recurring revenue

"By the end of an engine's life, every part has been replaced, and some have been replaced numerous times."

Todd Saligman, Investment Analyst

Economic life cycle of an aircraft engine





Source: *Global Aero Engines*, September 11, 2012, Credit Suisse; Rolls-Royce Holdings plc annual report, 2013. Data for Rolls-Royce represent revenues for the civil aerospace segment, which is a major manufacturer of aero engines for the airline and corporate jet markets. The underlying revenue was converted from the British pound to the U.S. dollar as of December 31 for each year.

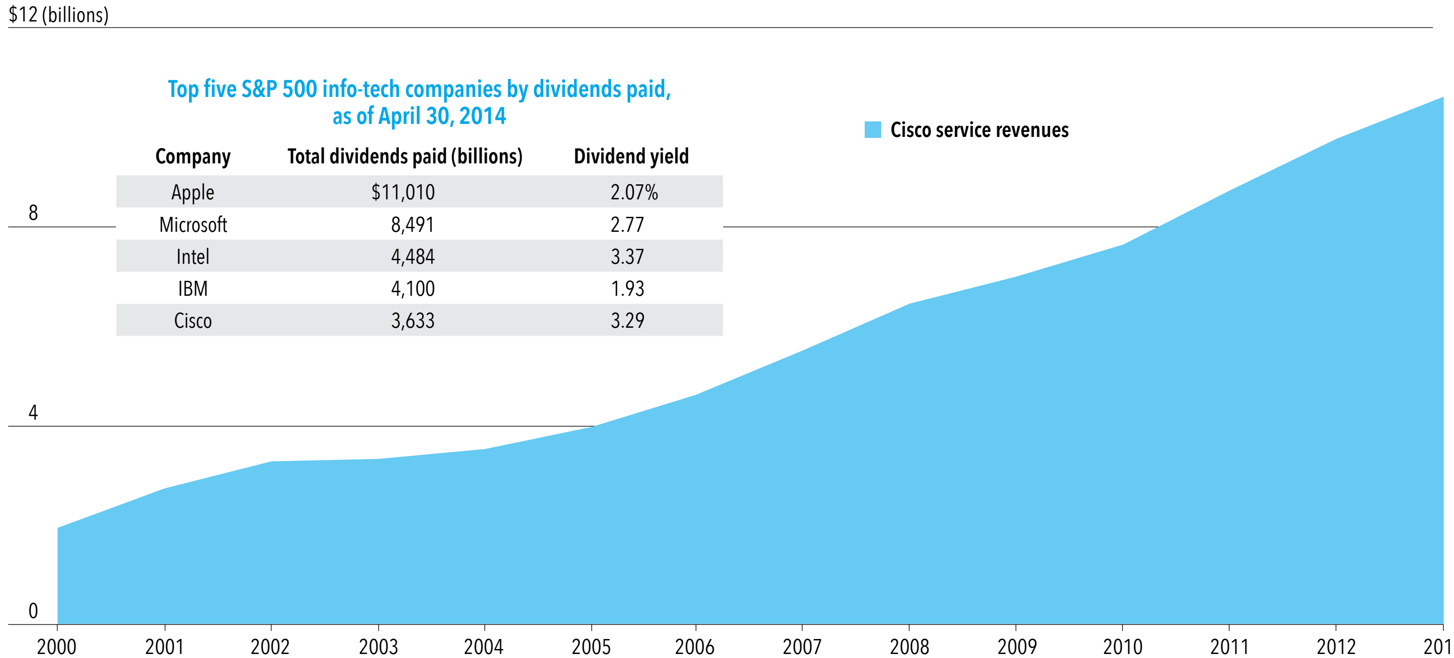
- Rolls-Royce Limited was founded in 1906 by Henry Royce and Charles Rolls at the Midland Hotel in Manchester, England. The company produced its first aircraft engine in 1914. A century later, the company's engines and turbines can be found on commercial jets, fighter planes, helicopters, ocean liners and in power plants. Rolls-Royce, along with General Electric and Pratt & Whitney, supply the vast majority of engines for the planes that connect the world.
- But selling engines is just the beginning, and it's not necessarily where makers of jet engines make their money. The companies sell the engines for relatively little gain. The maintenance, repair and overhaul of the engines, however, can keep engine makers busy for 20 to 30 years, and provides a recurring stream of revenue for the companies — and visibility into future cash flow. As the chart above shows, the aftermarket can be worth as much as seven times the original equipment value of an engine, spread out relatively consistently over several decades.
- In the case of Rolls-Royce, about 54% of the company's revenue is derived from service. The company has about 13,000 engines in service around the world.
- There could be more to come for engine makers. Boeing, the world's largest airplane maker, predicts that so many more people will be flying over the next 20 years that 35,280 new airplanes will be in the air by 2032.

Tech companies: Razors and blades for the 21st century

Shift to recurring revenue model part of reason for tech's increased dividends

"We continue to shift toward more recurring revenue models in this business. This is actually part of our strategic plan, to build more recurring revenue."

John Chambers, Chief Executive Officer of Cisco Systems, Inc.



Top five S&P 500 info-tech companies by dividends paid, as of April 30, 2014

Company	Total dividends paid (billions)	Dividend yield
Apple	$11,010	2.07%
Microsoft	8,491	2.77
Intel	4,484	3.37
IBM	4,100	1.93
Cisco	3,633	3.29

Source: Reuters Global Fundamentals and FactSet. Cisco service revenue data, a proxy for the company's recurring revenue, are as of July for each year. Total dividends paid are for the trailing 12 months ended April 30, 2014.

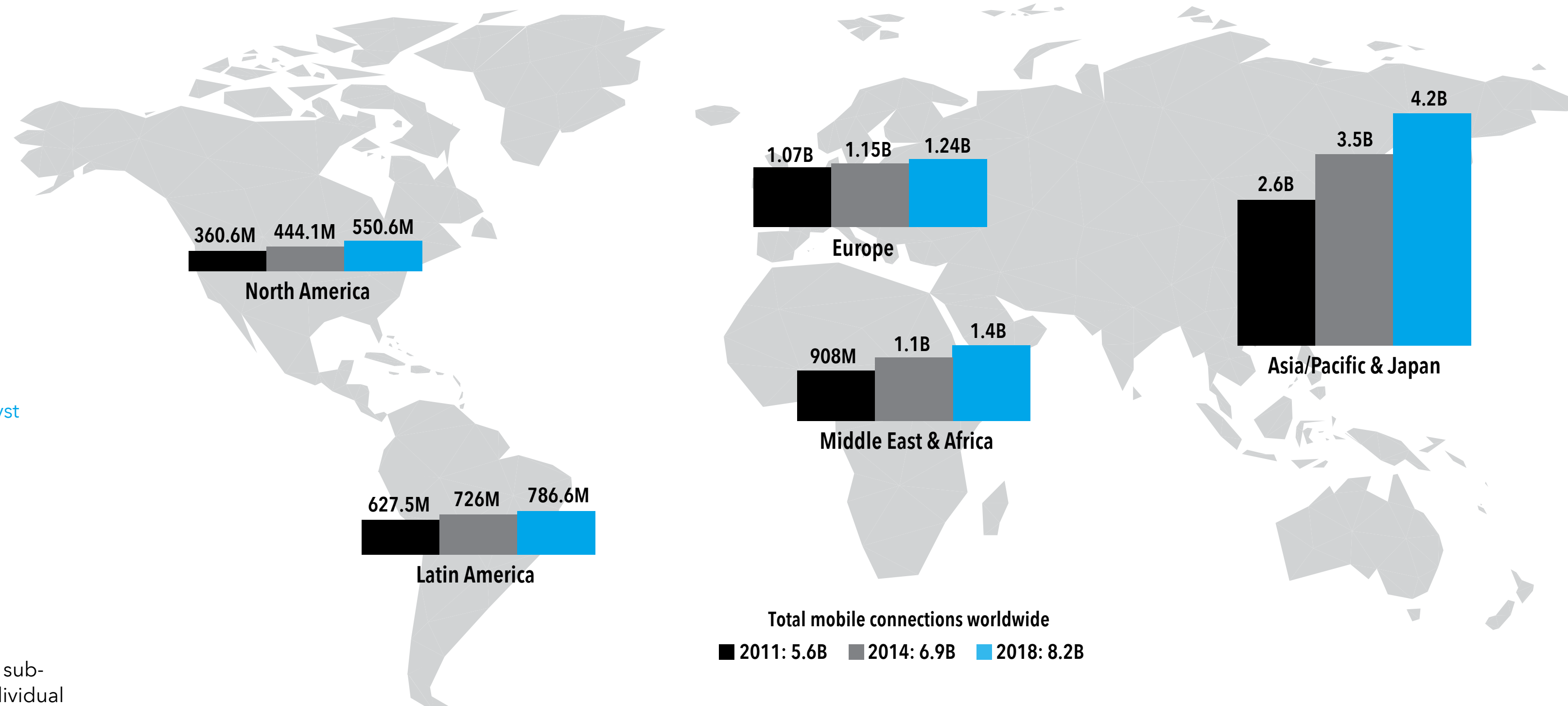
- The technology sector, once associated mostly with high-flying growth companies that disdained dividends, may be headed for a third year as the top dividend payer in the S&P 500.
- Tech's rise to the top in 2012 was partly attributable to decision by Apple to begin paying a dividend after more than 30 years as a public company. Apple puts something of a different twist on the razor and blade model. The company has tapped into a variety of recurring revenue streams by creating high tech razors, such as the iPhone and iPad, that can use a variety of applications and content. Once consumers have the device, or the platform for recurring revenue, they buy applications through the App Store, where Apple gets 30% of every sale, and content through an account at Apple's iTunes.
- More broadly, the sector's rise in the dividend column is partly due to a transition among some companies away from depending on sales to a subscription and service model that can generate significant recurring revenue.
- Because technology can rapidly become commoditized, some companies, including Cisco, have moved away from a reliance on the one-time sale of a product, often hardware, in favor of ongoing revenue from software and service.
- Some software companies now generate what's called sequential revenue. Microsoft, for example, creates an increasing stream of recurring income by encouraging customers to consistently upgrade to new products and service.

8.2 billion subscribers, $1.2 trillion in revenue. Can you hear me now?

In a connected world, the number of mobile devices exceeds global population

"The number of connected devices in your life will surprise you, and because most people need a phone, they aren't going to stop paying their wireless bill, which keeps everything connected. That makes for a very strong subscription business."

Andrei Muresianu, Investment Analyst



Source: Gartner, Inc. Connections, or subscribers, represent the number of individual network connections at the end of a given year. Multiple subscriber identity module (SIM) cards bearing one number count as a single connection. Two numbers associated with a single SIM card count as two connections. Prepaid SIM cards count as single connections, provided they are in operation at the end of the year in question. The connection forecast includes cellular modem connections and mobile connections to connected devices, including media tablet devices, e-readers, portable navigation devices, media players, imaging devices and mobile gaming devices; it excludes non-cellular wireless technologies, such as Wi-Fi, WiMAX and ultrawideband (UWB) connections. Data for 2014 and 2018 are projections, as published in a forecast report (by Gartner) dated March 2014.

- By the end of 2018, there will be an estimated 8.2 billion wireless subscriptions in the world. Many of those subscribers will be writing a check every month to a telecom company. Those subscriptions are expected to generate an estimated $1.2 trillion in total mobile service revenue in 2018.
- Phone companies may be one of the classic examples of recurring revenue, with many telecoms providing plans that combine voice, text and data services into a single price point on a monthly recurring basis. That's probably not going to change, but what people do with phones is undergoing a dramatic shift, one that's driving revenue for companies. When it comes to phones, it's not all about talking anymore.
- At the close of 2012, mobile voice revenue was about $636 billion, while mobile data revenue was $374 billion. Voice revenue represented about 63% of overall revenue. By 2018, the percent will shift dramatically as voice revenue will be only 40% of revenue.
- That shift is being driven by the seemingly insatiable demand for data, relatively fast and reliable data networks and soaring sales of smartphones and tablets that can access the information.
- Indeed, about 65% of the subscribers at the major carriers owned a smartphone at the end of the first quarter of 2013. Smartphone sales globally in 2013 exceeded a billion, and tablet shipments reached 184 million units, or more than three times the number shipped in 2011.

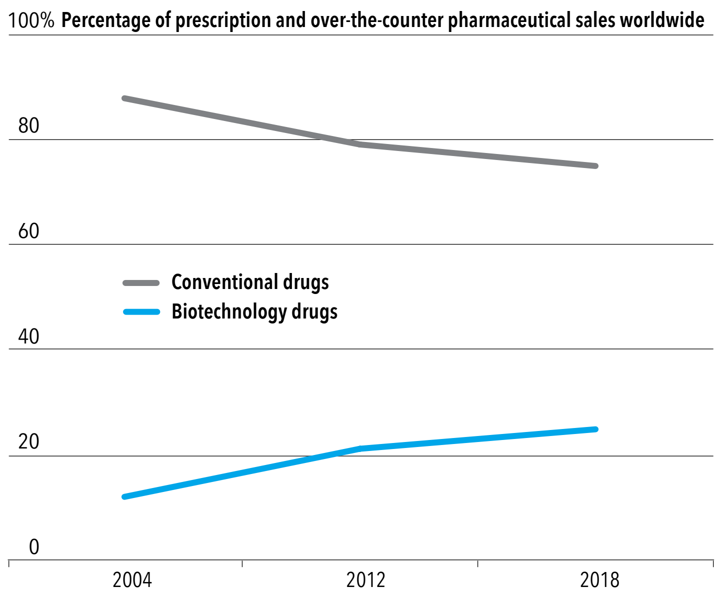
Biologics: Fast-acting medicine, long-lasting revenue

First developed in the late 1970s, biologics now offer hope for victims of many diseases

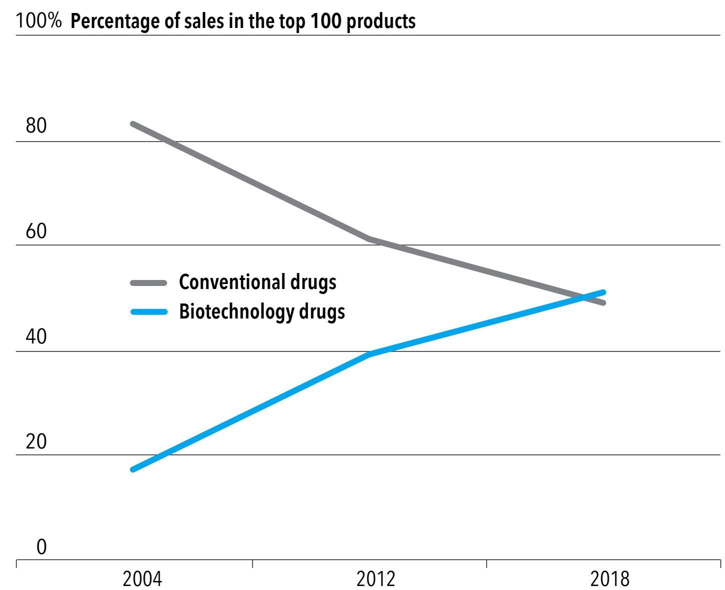
"The attractiveness of biologic drugs is their capability to command premium pricing and their longevity, which allows the companies to generate significant revenues and cash flows."

Craig Gordon, M.D., Investment Analyst

Biologics represent a rising share of all drug sales ...



... and 51% of the world's top-selling drugs by 2018



Source: *World Preview 2013, Outlook to 2018: Returning to Growth,* EvaluatePharma, June 2013.

- Biotechnology drugs, or biologics, are incredibly complex. They can be composed of sugars, proteins or nucleic acids, or a combination of those substances. Some are living entities, cells and tissues. They can come from humans, animals or microorganisms. Biologics are used to treat maladies ranging from rheumatoid arthritis to breast cancer.
- For those afflicted with such ailments, the only thing that matters is that biotechnology has resulted in a treatment that can slow the progression of a disease or, in some cases, cure a condition outright.
- That outcome has resulted in a remarkable track record for biologics. Among the top-selling prescription drugs in 2013, seven of the top eight were biologics. Humira®, an injectable drug made by AbbVie that's used to treat rheumatoid arthritis, topped the list with $10.7 billion in sales. Combined, the seven biologics had sales of about $62 billion.
- Research is crucial for investors in any industry, but biotechnology is among the most complex. Biologics have a long, risky and expensive development cycle, sometimes taking a decade or more from discovery to approval. Once approved, though, some biologics can command premium pricing. Because the barriers to entry are so high in this arena, a successful biologic represents a long-term and unusually secure source of recurring revenue for the manufacturer. And that cash flow, in some cases, is being used to reward investors with dividends.

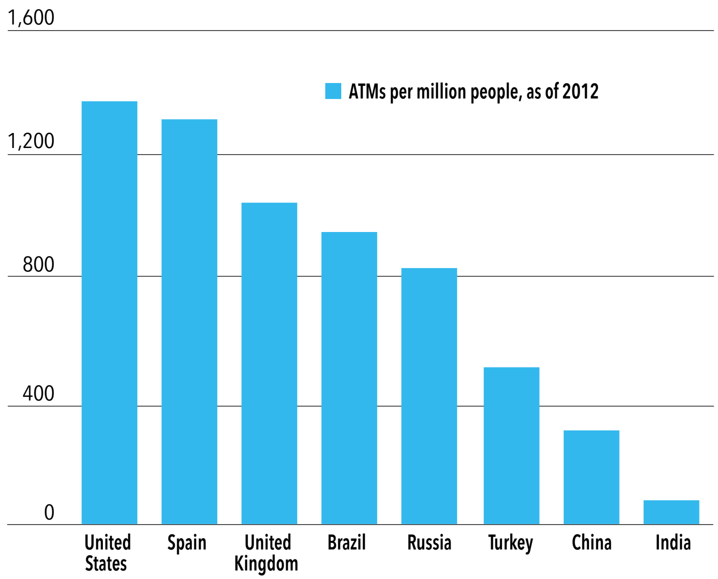
Cash machines can be a cash machine for ATM makers

Demand for cash, changes in banking business driving growth of "mini banks"

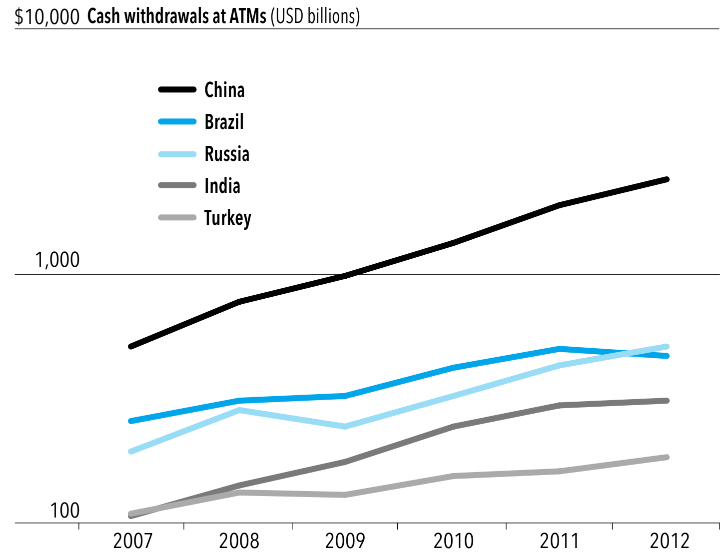
"The ATM business and the elevator business are similar. You make a little on the equipment sale and a lot (for a long time) on the service contract."

Thatcher Thompson, Investment Analyst

The number of ATMs in emerging markets is low …



… but more are on the way to meet rising level of cash withdrawals



Sources: (for ATM penetration) ATM Industry Association (ATMIA), ATM Marketplace, Bank of Spain, NCR Corporation, Retail Banking Research (RBR), and Susquehanna Financial Group, LLP/SFG Research and Susquehanna International Group, LLP (SIG); (for ATM cash withdrawals) Bank for International Settlements (BIS), *Statistics on Payment, Clearing and Settlement Systems in the CPSS Countries*, January and December 2013 reports. Cash withdrawals at ATMs represent transactions at ATMs located in the country, with cards issued in the country.

- Is cash history, or the future? Many card-carrying people around the world lead a nearly cashless existence, paying for things with plastic or making electronic payments from computers or phones.
- But in developing countries, many transactions are still in cash. The evolution of a middle class, and increasing wealth among some, has increased the demand for cash. Despite that, there aren't that many automatic teller machines (ATMs) relative to the population in emerging markets.
- That may be about to change. Globally, the number of ATMs in operation is expected to grow about 20% from 2012 levels to 3.2 million units in 2015, according to London-based consultant, Retail Banking Research. India has the fastest projected growth rate of 33%, followed by China, Indonesia and Russia. The Middle East, Africa and Eastern Europe are also adding ATMs.
- That's a market for not only new ATMs, but the infrastructure that supports the machine. Because banks are sensitive to ATM "uptime" and reliability, they typically buy a multiyear service contract that provides the maker of the original equipment with an ongoing stream of revenue from the machine.
- Even where cash use is decreasing, customers want convenience and choice, and ATMs provide a cost-effective way of adding capacity. Indeed, some ATMs are now activated by smartphones, offer check-cashing services, allow customers to pay bills or send money to other accounts. That's changing the banking landscape in a way that could boost ATMs.

The statements in *The Long View* are the opinions and beliefs of the speaker expressed when the commentary was made and are not intended to represent that person's opinions and beliefs at any other time.

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