

the Jensen Investment Brief

"Enduring wealth comes from owning great companies for a long time."

Volume 4 Number 2

A Jensen Investment Management Publication

June 16, 2009

Oracle: Ready to Absorb Sun's Energy

As we at Jensen Investment Management scour our investable universe of companies for new ideas, there are common themes that run throughout the companies that are ultimately included in our investment portfolio. One of those themes is the potential for market leadership. When a company has achieved market leadership, it has the ability to influence innovation, pricing and other market dynamics that can enhance value creation. As we have discussed in past articles, value creation within the business ultimately leads to wealth creation for the business and its owners – the shareholders of a public company.

Recently we invested in Oracle Corporation, a company that has long been a market leader but has refused to stand still nor rest upon its laurels. In fact, Oracle has sought to consistently increase its market leadership through its aggressive acquisition strategy, including its recently announced acquisition of Sun Microsystems. But more about this later.

We believe Oracle is a good fit for the portfolio of companies in which Jensen Investment Management invests. It has solid and sustainable competitive advantages, it is a financially strong company with consistent earnings and growth, and it is a market leader in the markets in which it competes – a remarkable journey from its beginnings over thirty years ago.

Oracle is a Redwood Shores, Calif.-based software company which develops and sells database, middleware, and application software worldwide to medium to large businesses. The goal of the company is to be the leading enterprise software company in the world. It is the leading vendor of relational database manage-

ment systems (RDMS) which enable customers to create a database without the need of a large mainframe. In addition to its infrastructure software, the company sells business software for managing finance, manufacturing, human resources, sales and marketing, and other functions.

Because of its strong market performance, Oracle is a large and highly profitable company which realized in excess of \$22 billion in revenues in 2008 with a 43% operating margin. The company's free cash flow growth exceeded, on average, 25% per year the last 10 years. It ended 2008 with \$11 billion in cash, more than enough to satisfy company needs and spur Oracle to start paying a dividend.

Not only does Oracle generate generous revenue, but the nature of the revenue is valuable. Roughly half of Oracle's revenue is so-called maintenance revenue. Maintenance revenues are annual license renewals that allow the customer to get full support and upgrades for any software they have purchased from Oracle. These revenues to Oracle do not cost much to support and are annuity-like in nature. Additionally, almost half of Oracle's revenue is from overseas. This has the effect of stabilizing Oracle's earnings and supports the company's performance in good times as well as bad.

Oracle's Beginnings on the Grid

Oracle got its start in 1977 with the development of its RDMS. Larry Ellison and two coworkers founded the company that would become Oracle. The corporate name was taken from a CIA project they had collaboratively worked on at the beginning of their association, according to the company's website. The technology for a relational database management system had not been commercialized yet. This would become the foundation of Oracle's remarkable success.

The basis of RDMS is grid computing which allows one to use multiple lower power, processor-based servers to create a database network. The advantage of the grid system is that a company can add incremental capacity as needed. Additionally, if a server goes down, the database network can still function. The main disadvantage to this type of system is that process speeds can be slightly slower. Customers, however, see this is as a fair trade-off for operational flexibility.

Oracle commands roughly 42% of the database soft-

Index of Articles

Oracle: Ready To Absorb Sun's Energy	1
<i>by Eric Schoenstein, Portfolio Manager, and Kevin Walkush, Business Analyst of Jensen Investment Management</i>	
Dividends: A Silver Lining	3
<i>By Dave Mertens, Principal and Director of Sales and Marketing of Jensen Investment Management</i>	
Inside Jensen	4
<i>by Jensen Investment Management</i>	

- Continued from page 1

ware market, according to technology research company Gartner. Microsoft and IBM sell database management software as well. Microsoft's SQL Server tends to support small businesses and departments within large organizations. IBM's database management software initially only ran on its mainframes, but over time it evolved to other server types and competes with Oracle for medium- to large-sized customers. Both IBM and Microsoft have approximately half as much revenue from database management software as Oracle.

Moreover, Oracle is today one of four large companies that sell integrated software "stacks" comprising a hierarchy of technology infrastructure and applications.

At the base of the hierarchy is the hardware. The operating system is the next layer and it allows software to run on the hardware. On top of the operating system is the database management software which stores and manages data. Application software sits on top of all the supporting hardware and software and is what enables a company's operations to function; i.e. finance, sales, and human resources. Middleware sits between database management software and applications software and allows them to work together. Competitors in Oracle's space include IBM, Microsoft and SAP. But Oracle has the largest offering of any competitor and is the only one to offer a full suite of software from database management to applications.

Building the Software "Stack"

By the late 1990s Oracle came to dominate the database software market. Larry Ellison, Oracle's longtime CEO, is often quoted as saying, "It is cheaper to buy than build." Faced with limited growth opportunities in database management software, Oracle embarked on an acquisition spree. It used the large amount of cash generated from the database business to purchase PeopleSoft in 2005 for \$10.3 billion. It has gone on to purchase 46 more companies to build out its product suite.

Oracle's initial strategy was to buy big, market-leading companies in their respective markets. It quickly became evident that Oracle was seeking to build out a software stack. The advantage of a stack is that one vendor can supply more of the software that a company needs, and it has much better interoperability. Customers can be more efficient in spending information technology dollars and trust that the various software packages will work together seamlessly.

Oracle's string of acquisitions focused first on application software, which is software that enables companies to operate and execute daily business functions. Application software includes enterprise resource planning (ERP) and customer relationship management (CRM) software. Acquisitions then shifted to middleware software that enables enterprise software to work together.

With Oracle's stack largely complete, the company shifted its acquisition strategy to smaller companies with software focused within specific sectors such as banking, retail or manufacturing. This strategy's aim has been to semi-customize Oracle's software stack to specific business verticals with great success.

Key Competitive Advantages

We believe Oracle has many sustainable competitive advantages. Key among them is its broad product portfolio which allows Oracle to address a greater percentage of a client's software needs. While there are significant competitors, we believe that Oracle can best deliver the breadth of database, middleware and applications software for the medium to largest enterprise market.

Additionally, Oracle has the advantage of both economies of scale and scope. The company can take an acquisition, plug it into its business operations and quickly scale it up. Oracle can also almost effortlessly take a technology developed or acquired for one vertical market and leverage its sale into another market. It achieves economies of scope by eliminating overhead and efficiently utilizing Oracle's sales and support resources to sell newly developed or acquired technologies quickly.

Furthering its competitive position through technological leadership, Oracle spends roughly 12% of its revenue on research and development. Ongoing product development and integration is vital to Oracle's continued dominance in its markets. The company is investing heavily to maintain its leadership position.

Another key barrier to competitors is the traditional high switching costs associated with software systems and, consequently, the "stickiness" of clients. It is expensive to switch software vendors, especially for large enterprise systems. Once a customer has purchased a significant portion of its software from a vendor such as Oracle, the tendency is to stick with that vendor.

New Avenues for Growth

Oracle has continued to look for new avenues for growth. Having already acquired many of its likely targets the company has been looking at opportunities that, at first glance, may not seem like typical Oracle acquisitions. The recently announced Sun Microsystems acquisition is just such a transaction. While there are potential growth prospects, it is a very different type of acquisition for Oracle for a few reasons.

First, Sun is both a hardware and software company. Secondly, Sun's software is not a perfectly clean fit within Oracle's software portfolio. Lastly, Sun is a distant third at best in its markets.

These challenges aside, we believe Oracle will acquire Sun for a decent price. Historically, Oracle has paid four times annual sales of the company for each of its

- Continued from page 3

acquisitions. With Sun, it is paying three times sales for just Sun's software. The hardware and support revenue are essentially free.

Strategically, this is an interesting acquisition. Oracle can expand its software stack upstream through the acquisition of Sun's Solaris operating system. That will provide it with an even fuller software stack than its competitors. Furthermore, by acquiring and retaining Sun's hardware products, servers, workstations and storage, Oracle will have the opportunity to create a whole solution for customers. In addition, it will control Java, the software language for which Oracle's software is written. Had Java fallen into competitors' hands Oracle would have been beholden to a new owner and support for the computer language would have been uncertain.

Finally, we believe the acquisition is an opportunity for Oracle to experiment with new product offerings without too much risk.

Dividends: A Silver Lining for Long-Term Investors

We thought it timely to reflect on the thoughts of renowned economist John Maynard Keynes. In 1936 Keynes noted,

"It is rare, one is told, for an American to invest, as many Englishmen still do, 'for income'; and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, i.e., that he is a speculator."¹

We will leave it to our readers as to whether they agree with Keynes beliefs or not.

We at Jensen Investment Management firmly believe in purchasing the stocks of quality growth companies with an eye toward capital appreciation. A positive attribute that most of our holdings possess is the financial strength to pay dividends and in many cases, a long track record of paying and growing these dividends.

The Importance of Dividends to Investors

Commenting on the importance of dividends 10 years ago would have drawn yawns from investors as they searched for more exciting content in the rapidly growing Internet age. The common view of that period was that no business worthy of an investor's dollars would utilize its cash to pay out dividends. Savvy company

¹ John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace & World, 1936)

management should instead, they reasoned, have exciting plans for funding internal growth and acquisitions. Considering the market's spectacular returns for the decade of the '90s and the miserly dividend yield during the period for equities, it is little wonder that investors held this opinion.

Now fast forward to 2009. We see that because of the market's decline during this period, much of the returns "taken home" by investors so far this decade have come from dividend payments (much as they did back in Mr. Keynes' decade of the 1930s). And "taken home" is entirely accurate, as dividends represent cash in hand for the shareholders.

What Could Be Better Than Dividends?

Not all dividend-paying stocks should be considered equal in the eyes of prudent investors. Those with a history of growing dividends are all the more attractive as potential wealth generating investments. In normal economic times, more companies are apt to increase dividends than resort to cuts. But in today's difficult market, cuts have been headline material and increases have waned. In contrast, companies within The Jensen Portfolio have largely maintained their record of increases. Moreover, as of June 10, 2009, eight of the Fund's holdings have announced dividend increases this year.

Many quality growth companies have exhibited histories of persistently high business performance thereby allowing them to grow their dividends year after year. Examples of such companies within The Jensen Portfolio include Johnson & Johnson with 47 consecutive years of dividend growth, Coca-Cola with increasing dividend payments for 47 years, Emerson Electric which can boast 52 years of dividend growth, and Procter & Gamble showing 53 years of dividend increases!

Dividend growth most greatly benefits the long-term investor. Consider that the stock of a company that yields a 2% dividend when purchased will equate to a yield of more than 5% on the investor's cost of shares if the dividend payout increases at 10% per year for 10 years. Assuming the growth in dividends continues at that rate for another 10 years, the patient investor will enjoy a yield of more than 13% on the original cost of his/her shares.*

What Consistent Payment of Dividends Tells Us

The focus of Jensen Investment Management is on

* This is a hypothetical example for illustration purposes only and does not reflect the investment advisory fees and other expenses incurred by the Fund, or the realized and unrealized gains and losses incurred by the Fund on its portfolio securities holdings. These figures are not representative of the Fund's historical or future dividend yield or total returns.

quality growth companies. These are businesses with strong and growing free cash flows and earnings streams that enable management to fund the growth of their companies, make strategic acquisitions, buy back shares and, in many instances, still have excess cash to return to shareholders in the form of dividends.

A company's track record on the payment of dividends, particularly growing dividends, is one more indicator to us that we are viewing a financially sound business with recurring revenues and strong cash flows. It also gives us a sense that management shares our conviction in the outlook for their business.

INSIDE JENSEN: Oh Baby! Our Extended Family Is Growing

We at Jensen Investment Management are thrilled to tell you of two new additions to Jensen's extended family.

Congratulations to Allen and Ana Bond on the birth of their baby girl, Bianca Carmen Bond. This is their first child. Bianca was born on March 16, 2009, weighing in at 6lbs., 13ozs. and measuring 19 inches long. Allen, a Business Analyst, has been with Jensen since 2007.



Bianca Carmen Bond

Jensen would also like to congratulate Linsey Owens and Ken Gerts on the birth of their little girl, Milena Irene Gerts. This is also their first child. Milena was born on March 2, 2009, weighing in at 7lbs., 2ozs. and measuring 21 inches in length. Linsey, the Manager of Marketing Services, has been with Jensen since 2004.



Milena Irene Gerts

Everyone on the Jensen team extends their best wishes to both families.



JENSEN
INVESTMENT
MANAGEMENT®

Have a comment? Want More Information?
Visit our Website at WWW.JENSENINVESTMENT.COM
OR Call Toll-Free 1-800-992-4144

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1.800.992.4144, or by visiting www.jenseninvestment.com. Read it carefully before investing.

Past performance is no guarantee of future results. Mutual fund investing involves risk. Principal loss is possible. The Fund is non-diversified, meaning that it may concentrate its assets in fewer individual holdings than a diversified fund, and is therefore more exposed to individual stock volatility than a diversified fund.

As of September 30, 2009, the Fund held the following positions (as a percentage of net assets) in the companies mentioned in these articles: Johnson & Johnson - 4.50%; Emerson Electric -3.74 %; Abbott Laboratories - 4.00%; Coca-Cola - 3.59%; and Oracle - 3.46%. Fund holdings are subject to change and are not recommendations to buy or sell any security.

Free Cash Flow: (FCF) Is equal to the after-tax net income of a company plus depreciation and amortization less capital expenditures.

Opinions expressed are those of Dave Mertens and the Jensen Investment Team and are subject to change, are not guaranteed and should not be considered investment advice.

The Jensen Portfolio, which is advised by Jensen Investment Management, Inc., is distributed by Quasar Distributors, LLC.