IN FOCUS

# CHEAP IS NOT VALUE

CAMBIAR INVESTORS

The Cambiar International Equity strategy currently has a meaningful allocation to technology stocks. We are often asked about this portion of the portfolio, given that we are relative value investors and technology companies don't appear to be "cheap" after a strong multi-year run. We've maintained that cheap does not equate to value, and that part of being a relative value investor is recognizing that value is a function of both price and quality – with the latter dictating the former. One important (yet not the only) metric Cambiar uses to define quality is a company's Return on Invested Capital (ROIC), evaluated over a reasonably long timeframe. Why does ROIC matter? Let's explore this question using a real company domiciled in Asia - we'll label this Company A.

Company A was founded in the late 1980s as a semiconductor foundry that makes state-of-the-art semiconductors on behalf of its clients, which include a number of the leading global technology companies. As a foundry, Company A has a significant global market share for chip making and for the most advanced chips used in products such as smartphones, cloud data centers, artificial intelligence processors, autonomous driving, etc… The barriers to entry – in terms of capital, but more importantly technology – are immense. As such, we believe Company A will have a commanding lead over its competitors for the foreseeable future. Suffice it to say, the moats are very wide for this company. Like many leading-edge companies, Company A invests a certain amount each year to produce more chips for clients and in order to grow its future sales and profits. Over the past five years, Company A has generated an incremental $0.24 for every $1.00 invested in the business, thus an ROIC of 24%. This is an excellent return, and exemplifies what we at Cambiar consider a great business. Put another way, Company A has 24% more capital every year with which it can then use to either reinvest back in the business to grow future earnings, distribute to shareholders through dividends or buybacks, or engage in accretive M&A. As investors, we place a higher multiple on higher ROIC companies because these companies can either compound earnings faster without having to borrow or issue equity, or have more distributable free cash flow after reinvesting in the business to give back to shareholders. In the case of Company A, it distributes about 30% of its excess free cash flow after capex to shareholders in the form of dividends, which at its current price amounts to nearly a 3% yield.

So how does the above example equate to what we believe is Relative Value? One way to illustrate this is by comparing Company A to two other real-life International companies and their stocks. For simplicity's sake, we'll label these two other companies Company B, and Company C. Company B is a fast-growing challenger payment processor. As payments move from cash to electronic, and as consumers use different means to pay (Apple Pay, Alipay, Paypal, Square, etc…), this company's processing technology has become more valuable (and more disruptive) to the established incumbent players that don't have the capability to meet the needs of its merchants in the new digital era. Company B generates strong operating and free cash flow margins with Returns on Invested Capital also in the high 20s/ low 30s. To be clear, this is an exciting company that we admire; however, this company currently trades on a 12-month forward P/E multiple of 126x.

Company C is a legacy IT services provider with very little to no top-line growth, as parts of its business is being eroded away by the cloud, with new challenger companies competing away at the more leading edge areas of IT services. The company generates a relatively low Return on Invested Capital of ~7%, but also trades at a low P/E multiple of just 10x.

If we assume each of these companies generates $1.00 of earnings per share and we compound these earnings at their respective Returns on Invested Capital (after taking into account a certain level at which these companies have to reinvest back in the business to grow), we can get a sense of how fast these companies' earnings can compound over a forward five or ten year arc. By applying a reasonable multiple to those earnings into the future, we can then assess what kind of IRR

| | Company A | Company B | Company C |
|---|---|---|---|
| **ROIC** (%) | 24.0 | 29.0 | 6.5 |
| **Reinvestment Rate** (%) | 50.0 | 103.4 | 66.0 |
| **Compounding Rate of Growth** (%) | 12.0 | 30.0 | 4.3 |
| | | | |
| **EPS - Year 1** ($) | 1.00 | 1.00 | 1.00 |
| **EPS - Year 5** ($) | 1.57 | 2.86 | 1.18 |
| **EPS - Year 10** ($) | 2.77 | 10.60 | 1.46 |
| | | | |
| **P/E - Current** | 22.0 | 126.0 | 10.0 |
| **P/E - In 10 Years** | 20.0 | 25.0 | 12.5 |
| **Implied Forward Price** ($) | 55.00 | 265.00 | 18.00 |
| **10 Year IRR** (%) | 15.2 | 11.0 | 8.2 |
| **Dividend Yield** (%) | 3.0 | 0.0 | 2.0 |
| **Total Shareholder Return** (%) | 18.2 | 11.0 | 10.2 |

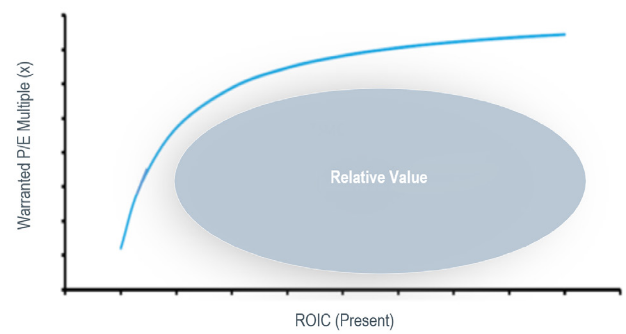
Source: Bloomberg, Company Annual Reports, Earnings per share (EPS) Year 1 is an assumed rate for comparative purposes. ROIC %, Reinvestment Rate %, P/E - Current Multiple and Dividend Yield is actual data obtained from third-party sources as of 9.30.20. The remaining metrics are hypothetical, forecasted numbers and subject to change.

(Internal Rate of Return on our investment) these stocks could potentially generate for us as investors if we purchased shares today. The table below shows all three companies and their forecasted earnings over five and ten years, using the same assumed current earnings per share.

In the previous chart, Company A generates the far superior investment IRR, despite the fact that the company does not grow as fast as Company B and is not as cheap as Company C. This IRR also neglects the nearly 3% dividend yield that we would theoretically collect each year from Company A. We see that Company B, the fast-growing payment processor, should compound earnings at a much faster rate than Company A, but does not provide much margin of safety at its current multiple; in essence, the current stock price already embeds much of its future prospects. If Company B falls short of these lofty expectations, then the IRR to investors collapses quickly. Company C also generates an IRR lower than Company A despite its much cheaper valuation. That's because we believe, despite its optically low valuation, its ROIC and sustainable rate of growth is too low to meaningfully compound earnings into the future. Furthermore, the risk here is that if earnings growth stalls - or even worse, were it to decline - given the lack of structural competitive advantages and excessive competition, the investment IRR turns negative fairly quickly as earnings power erodes over time. Therefore, the low multiple properly reflects what is deemed to be an inferior business model. To be fair, this is a very basic analysis and fails to take into account changes in end markets and product and service opportunities over time. As investors, we have to constantly monitor for changes in these opportunities or threats to these companies' competitive position in order to frequently reassess what we believe is appropriate fair value.

As relative value investors, Cambiar is striving to find a combination of reasonable valuations for above-average quality businesses. We don't believe there are many that exist, hence our more concentrated approach to investing. The chart below, borrowed from Morgan Stanley, shows companies that can generate a high sustainable Return on Invested Capital tend to warrant a higher P/E multiple vs. those that generate poor Returns on Capital.

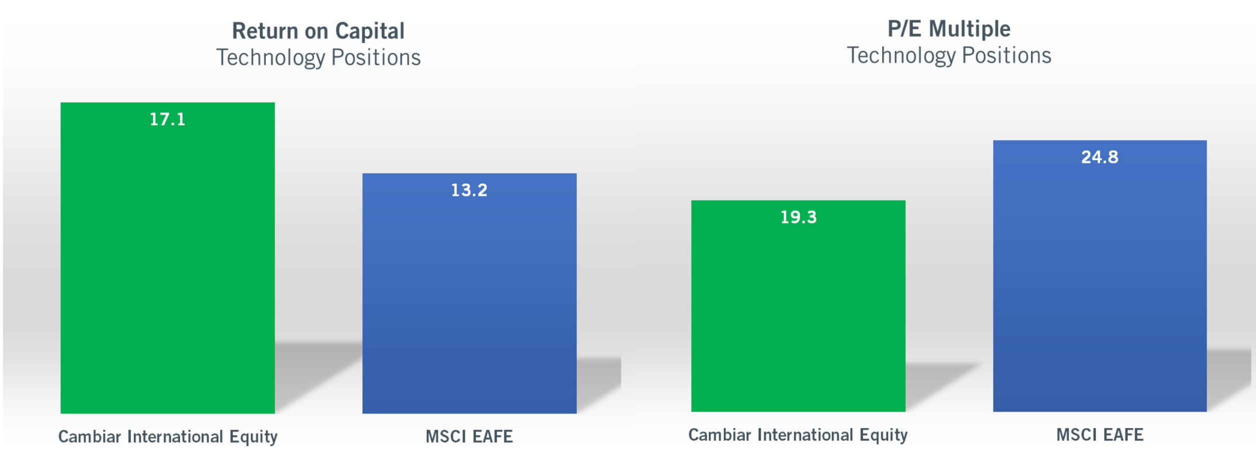
**WARRANTED P/E MULTIPLES WITH DIFFERENT ROICs**




Source: Morgan Stanley

In other words, investors pay up for quality, and therefore higher quality companies get rewarded with a higher multiple by the market. What's important for us as relative value investors is to be disciplined about what we pay so as to maximize the return on our investment and minimize the risk of a permanent loss of client capital. The "Land of Relative Value" sits below this efficient frontier where quality is not appropriately reflected in current valuations. That's where we believe there are arbitrage opportunities to exploit market inefficiencies and deliver superior long term returns with a decent margin of safety.

At the moment, our technology companies across the Cambiar International Equity strategy generate ROICs that




As of 9.30.20. Source: MSCI

are well in excess of the average company within the overall benchmark itself. We've achieved this while paying a multiple that is below that of the average technology company in the benchmark. So we own businesses that have superior ROICs, while paying a below-average multiple. We believe technology companies, given their high barriers to entry - whether it be from specialized IP and/or network effects - offer investors the potential for high Returns on Capital in addition to secular tailwinds that allow for these businesses to compound for many years. Cambiar will continue to watch valuations, changes in competitive landscape, and new opportunities that may arise that would alter our current view around future returns for clients, but for the time being, we remain comfortable with our overweight stance towards this space.