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Poplar Forest Analyst Insights

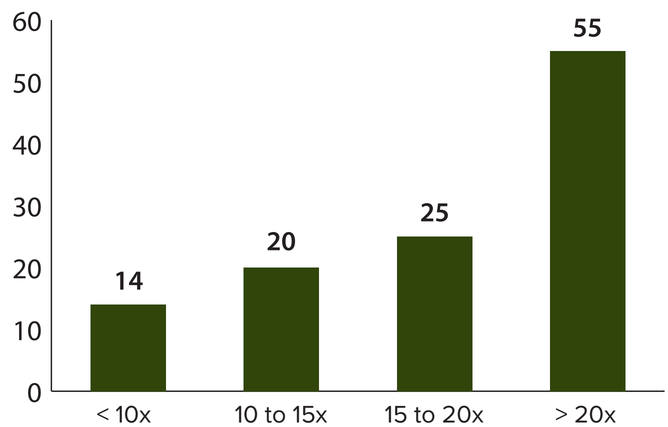
In this edition of Analyst Insights, Cathy Lloyd talks about what she looks for when evaluating opportunities in Technology and Communication Services, how the COVID-19 pandemic has impacted the industry, and discusses growth opportunities for tech companies beyond 2020.

Q The technology sector is probably the poster child for highlighting the differences between growth investing and value investing. What's the framework that you use when evaluating potential technology investments as a fundamental bottom up value investor?

That's a great question. The tech sector is incredibly diverse. It covers everything from semiconductors to software. Some of these companies are very well loved by the market, meaning, the stocks tend to trade at very healthy valuations. And then there are those that are less loved.

As value investors, we employ a benchmark agnostic investment approach here at Poplar Forest. That being said, if you look at the technology constituents within the S&P 500 Index and the Russell 1000 Value Index, the dichotomy between growth companies and value companies, at least from a valuation perspective, is really obvious. While many of the "tech darlings" trade at comparatively higher valuations, there are still many stocks that trade at less than 15x based on calendar year '21 earnings estimates. So, I'm able to identify attractive opportunities without having to compromise our value-sensitive process.

Chart:
Technology Constituents *by CY'21 P/E*



Source: S&P Global Capital IQ, technology constituents of the S&P 500 and Russell 1000 Value Indices.

In terms of the framework that we employ at Poplar Forest, obviously we look for companies in which our valuation estimate is well above the current stock price, but in Technology, in particular, it's incredibly important to distinguish between value stocks and value traps. Value traps are really cheap stocks in which underlying fundamentals may be in secular decline. The stock prices are cheap, but they're cheap for a reason, and we're going to avoid investing in those companies. That said, I pay close attention to product cycles and technical moats that lead to sustainable competitive advantages. It's also important to differentiate between what is secular and what is cyclical. One example of this might be our investment in IBM, which we've owned for some time now.

IBM is a software and services company that is also in the business of selling mainframes. Many investors believe that the company's mainframe and some of their old legacy software businesses are in secular decline. Instead, what we see is a portfolio mixing towards higher growth businesses. For instance, we believe IBM's acquisition of Red Hat is improving the company's ability to facilitate modern, next-generation IT architectures for their client base. Today, IBM is trading at just 10x calendar year '21 estimates with a mid single-digit dividend yield. So, in our view, IBM is not just a cheap stock. We believe that the combination of IBM's core business with Red Hat's portfolio is going to drive better-than-expected revenue growth with attractive levels of profitability, and that's a company that's currently trading at just half the multiple of other competing tech companies.

Q How has the pandemic impacted technology and communications services companies?

In the Technology sector, both supply and demand have been impacted. In the first quarter of this year, as the pandemic started to take hold, many of the supply chains were disrupted because a lot of tech manufacturing is done in the Asia-Pacific region. However, when the quarantine started to hit the US and other developed markets, we saw the work-from-home environment emerge. That required a lot of businesses to quickly gear up their employees. Companies had to send their employees home with laptops and PCs, and additionally, they needed to make sure their networks were secure. That means a lot of businesses have redirected and redeployed assets as well as conserved cash.

At the same time, there are other businesses, such as those involved with semiconductor chips for 5G devices, that have done remarkably well. In fact, in China, the industry had a very nice recovery, and 5G smartphone devices represented over 60% of smartphone sales.

The Communications Services sector is more diverse. In fact, there are certain pockets within Communication Services, such as advertising, that are cyclically exposed. This has made the fundamentals for those companies a little bit tougher. However, if you look elsewhere in the sector, areas such as Telecom Services have fared better. The investments we have within the wired and wireless services arena showed fundamentals that were more resilient because the value of reliable high-speed service has become more critical in this pandemic environment.

This is the second recession that I've been through at Poplar Forest, and it's the fourth in my career. Each recession has been different, and while there has been commonality in terms of pressures on overall IT spending, the COVID-19 recession has presented unique opportunities for technology, media and telecom companies, particularly for tech companies who can facilitate secure remote networking solutions for employees working from home, or for telecom services companies who can provide remote voice and data communications, for both wired and wireless access.

Q It seems as though the Communication Services sector now includes more companies than what we would think of as traditional telecom stocks. Can you comment on the increasing breadth of the sector and what type of communication services investments you look for?

Since the Communication Services sector was reconstituted, it covers everything from advertising, media and entertainment companies to telecommunications services companies. It's a wide variety of companies. The framework that I use is similar to what I use in the tech sector, but here, I look for competitive moats, and a lot of the competitive moats manifest themselves in high levels of recurring revenue and free cash flow. Many of these businesses are capital intensive and that capital intensity serves not only to preserve but also to expand the competitive moats that these companies possess. A good example is AT&T.

We invested in AT&T after the Time Warner acquisition, and during the pandemic investors have been increasingly concerned about cord-cutting. However, we believe the content being offered by virtue of the Time Warner acquisition can be levered not only across the Direct TV subscriber base, but also across the wireless subscriber base. That means AT&T can not only reduce churn and turnover among those subscribers, but at the same time, motivate subscribers to gravitate towards higher value plans. The company has generated over 25 billion dollars in free cash flow over the last 12 months, and they are using that free cash flow to pay down debt. They have also returned capital to shareholders in the form of a dividend. In our view, AT&T presents a timely opportunity while trading at an attractive valuation.

Q What strategies are technology and communication companies using to facilitate growth and what areas present opportunities for growth in 2020-2021?

Many companies are using the pandemic as an opportunity to rightsize their cost structures and increase investments behind growth initiatives such as 5G, hybrid cloud/on-premises networking, and "as-a-service" IT consumption. "As-a-service" consumption models enable clients to shift IT spend from capex to opex which may facilitate greater budget flexibility in this environment, while allowing both hardware and software vendors to create a more stable, recurring revenue base with incrementally higher margins over time. Similar to past cycles, technology companies, in particular, are using both organic investments, through research and development and capital investments, as well as inorganic investments, from acquisitions to strategic partnerships, to stimulate growth beyond 2020.

Let's Discuss

We'd love to continue the conversation. Please contact Patty Shields (**pshields@poplarforestllc.com** or **(626) 304-6045**) if you're interested in scheduling a call to discuss this or any other topic of interest.

The S&P 500 Index is a market-value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. The Russell 1000 Value Index measures the performance of the Russell 1000's value segment, which is defined to include firms whose share prices have lower price/book ratios and lower expected long/term mean earnings growth rates. One cannot invest directly in an index. Price/Earnings (P/E) Ratio is a common tool for comparing the prices of different common stocks and is calculated by dividing the earnings per share into the current market price of a stock. Free cash flow is equal to the after-tax net income of a company plus depreciation and amortization less capital expenditures. Dividends are not guaranteed and a company's future ability to pay dividends may be limited. Dividend yield represents the trailing 12-month dividend yield aggregating all income distributions per share over the past year, divided by the period ending fund or stock share price. It does not reflect capital gains distributions.

The Partners Fund top ten equity holdings and their percentage weights as of 6/30/20: Advance Auto Parts 5.1, CVS Health 4.9, AmerisourceBergen 4.9, Kroger 4.4, International Business Machines 4.3, Equitable Holdings 4.2, Conagra Brands 4.1, E*Trade Financial 4.0, Eli Lilly 4.0, AT&T 4.0. Composition of sector weightings and fund holdings are subject to change and are not recommendations to buy or sell any securities.

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