Newsletter
Taking Stock

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Fundamental Value Equities

High Conviction You Can Count On

STATE STREET GLOBAL ADVISORS

The Big Picture: Is That It?

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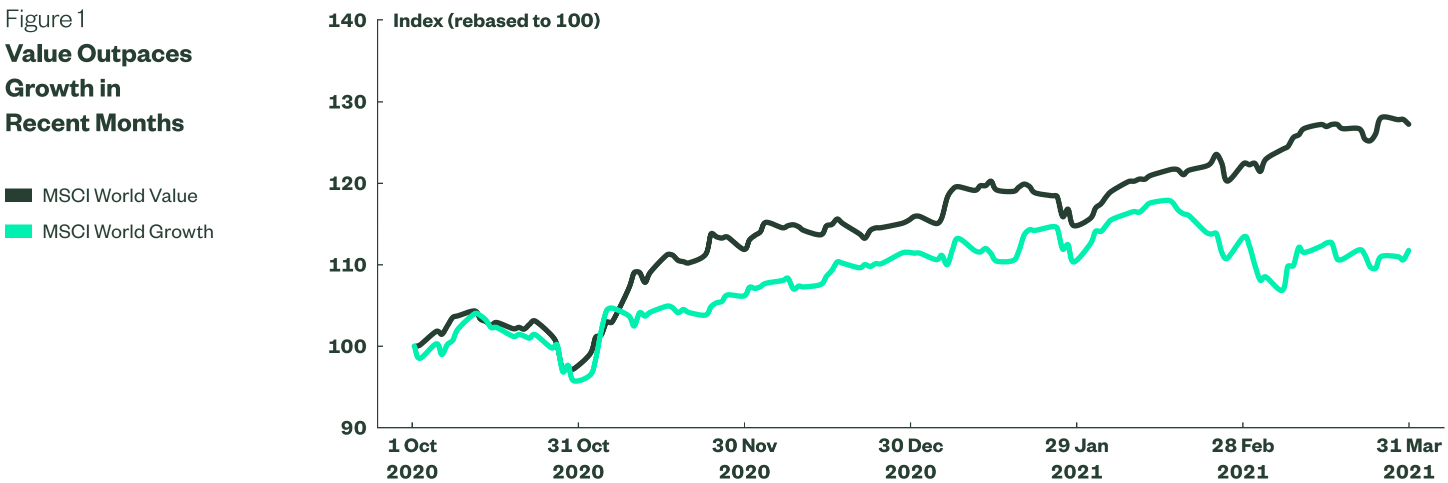
Events and news over the last few months seem to have pushed the market towards the provisional conclusion that economic growth will likely be less scarce over the coming years. As a result, the fundamentals of value stocks are looking much improved, and the premium ascribed to growth has diminished slightly. This move has been reinforced by a sense that it may be time to monitor inflationary expectations again, with the attendant consequences for rising interest rates. Both tend to weigh heavily on the net present value of future earnings.

The resulting rotation within equity markets has seen value enjoy a rare moment in the sun — outperforming growth significantly over the last few months (Figure 1). The key question is whether this will come to represent any more than a brief respite, as has been the case for most of the last decade. Or might this be the beginning of something more enduring?

Figure 1
Value Outpaces Growth in Recent Months



Source: State Street Global Advisors, MSCI, Refinitiv as at 31 March, 2021. **Past performance is not a guarantee of future results. Index** returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The Time for Value?

In trying to figure out whether we are on the cusp of a sustained value rally, we consider the potential for reversal of some well-established forces that underpinned the growth regime. That potential is real when set aside the extreme valuation position the equity market finds itself in.

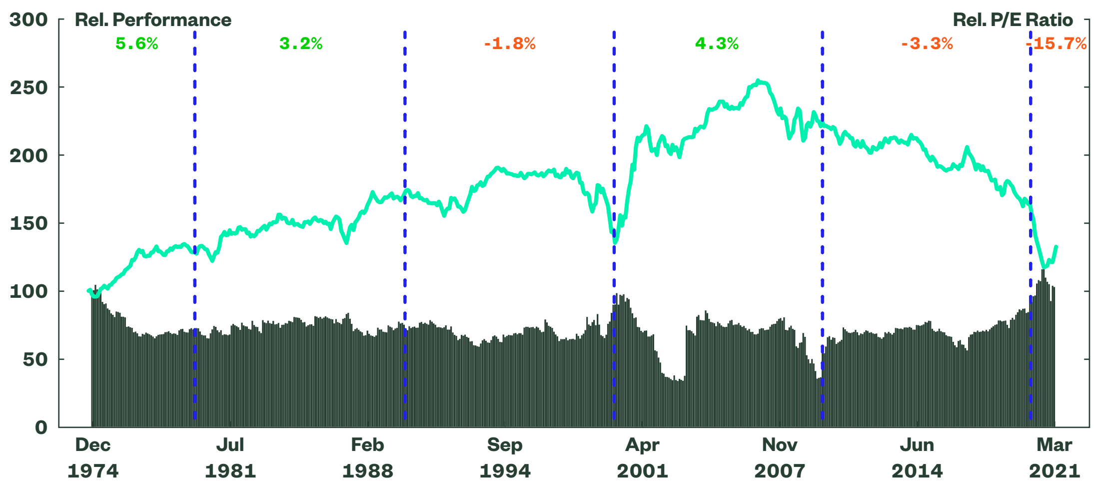
Figure 2 was originally included in our September 2020 edition of Taking Stock,* and was conceived to highlight the extreme polarisation within equities at the time of writing. The dark green shaded area represents the evolution of the growth premium since 1974, i.e. the difference between the price-to-earnings (PE) multiple the market pays for growth stocks relative to the PE multiple the market pays for value stocks. The sage line traces the relative performance of value over growth. When the sage line is rising, value is outperforming and vice-versa. Finally, the numbers represent the annualised out-performance of value over growth for each decade (or part thereof).

Figure 2
Turning Point for Value?

Ratio of MSCI World Growth & Value P/E Multiple

Relative Perf. of MSCI World Value Vs. Growth

End of Decade



Relative Performance of Value Vs Growth by Decade (per Annum)

Source: State Street Global Advisors Economics, MSCI, Refinitiv as at 31 March, 2021. **Past performance is not a guarantee of future results. Index** returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

We observed the following: the underperformance of value since the Great Financial Crisis is the longest and deepest on record. The relative PE ratio narrates this period quite well. For much of the time (until about 2017) growth was outperforming, and the relative PE multiple was quite stable. In other words, the performance was driven by the denominator — earnings.

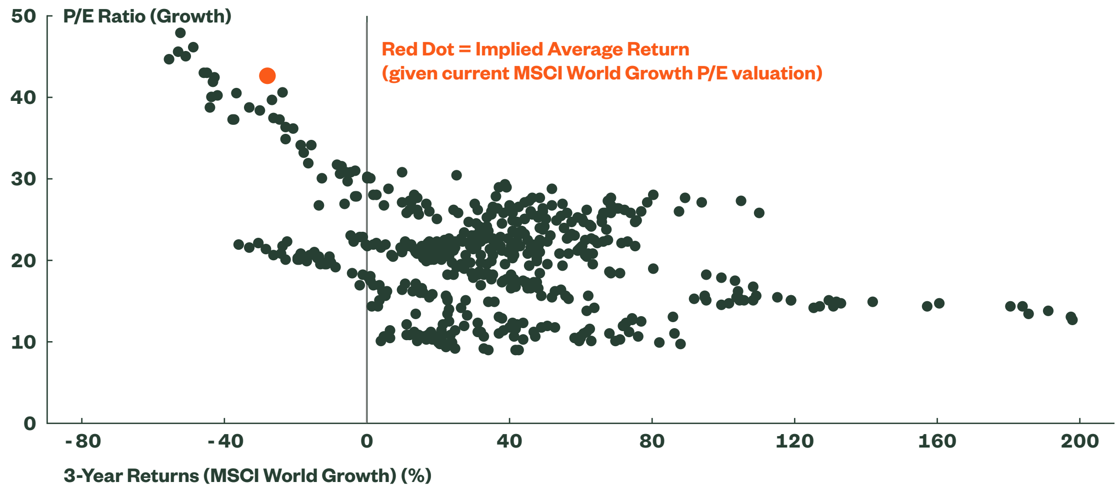
The value part of the market was increasingly populated by cyclicals and financials, whose fundamentals were struggling due to the flattish economic trajectory and the capital and regulatory hangover from the GFC. The growth indices were stacked with companies that were delivering earnings growth. As these trends became more apparent, investor appetite for the latter increased and prices of growth stocks rose. However, since 2017 the increasing prices were driven not by earnings or fundamentals but by multiple expansion. The momentum behind these trends drove markets to valuation extremes.

By the end of August 2020, the PE of the growth index was more than two times that of the value index, a level that exceeds the two most notorious periods of speculative excess in the last 50 years: the Nifty Fifty bull market that peaked in March 1973 and the DotCom Bubble that peaked in March 2000.

* What Were You Thinking? September 2020.

The current market appears to us as a fusion of those two episodes: we have echoes of the Nifty Fifty — great companies whose share prices are simply too high; we have a re-run of the DotCom bubble — companies at the cutting edge of disruptive technologies, making no profits and valued at astonishing multiples of sales (Zoom and Shopify). The result is an MSCI World Growth index trading at 40 times earnings, a starting point, as evident in Figure 3, that has never led to a positive return over the subsequent three years.

Figure 3
Price/Earnings Starting Point Analysis for MSCI World Growth Index



Source: State Street Global Advisors, FactSet, Refinitiv as of 31 March 2021. **Past performance is not a guarantee of future results. Index** returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Opportunities for Stock Pickers

We've written before that one of the benefits of value investing is that it keeps investors away from speculative excess. Growth equities are one example, but even while the market has rotated slightly into value of late, the valuation premium remains very extreme. Other examples include the recent spate of initial public offerings (IPOs), where the pattern is reminiscent of the DotCom bubble, the SPAC phenomenon, the price action around so-called "meme" stocks, bitcoin and cryptocurrencies, and of course the fact that there is still more than $13 trillion of bonds offering negative yields at the end of March 2021[1], even after the bond market sell-off of recent months.

The market's voracious appetite for such investments has resulted in huge swathes of the market being overlooked. As a results, stock pickers have had a very interesting opportunity set. While we write market commentaries of this sort from time to time, our day job is to identify, analyse and invest in the shares of companies that offer an attractive valuation relative to their long-term earnings power. Over one year has now passed since the pandemic wreaked havoc on capital markets. The first few months of the period favoured growth stocks, but more recently the regime has swung in favour of value. Through it all, we remained focused on the simple (but not easy) task of investing in stocks that offered good value. We found many opportunities, and I asked my colleagues — one from each of our six global sector teams — to share details on the most interesting stocks they invested in over the last 12 months.

Finding Value: Uncovering Opportunities

The Fundamental Value Equity team seeks opportunities where the market's valuation of a company is disconnected from our view of the quality of that business. In making this assessment, we focus on both sustainable earnings power and capital efficiency, or the manner in which management deploys shareholder capital. In the short run, share prices are driven by sentiment and the mood of the market — the starting valuation has relatively little impact on the investment return. But in the long run, valuation is a critical factor in the outcome of our investment decisions.

Financial markets were thrown off-kilter with the onset of the COVID crisis, bringing some quality stocks on to our investment radar that would previously have been too expensively valued.

The following examples provide insight into what our analysts seek when researching stocks for inclusion in our equity portfolios.

Global Resources: Owen Dwyer, Research Analyst

The Company: CCL

CCL is a Canada-listed, specialty packaging company. The business is run as four separate but related segments: CCL, the historic core of the group, manufactures labels and pressure sensitive films; Checkpoint has a leading position in RFID labels and technology; Innovia produces films for various consumer products; and Avery manufactures office supplies and consumables.

The Investment Case CCL had been on our investment radar for some time as a company with a high return on invested capital (ROIC), growing at a low- to mid-single digit rate and with strong cash generation capabilities. It typically competes in fragmented end markets with a long runway for growth through new products and geographic expansion. In the Checkpoint business, the value proposition of RFID ("radio frequency identification" that is used to tag and track inventory) is compelling in supply chain management with a 12–24 month payback — and yet penetration until relatively recently has been limited. Finally, management has a strong track record of value creation and the balance sheet was and is robust.

In early 2020, market concern was largely centred on the exposure of CCL to China — which accounted for about 15% of sales — and the potential impact of the pandemic on the RFID business, which has significant exposure to textiles/clothing. With the spread of COVID globally, the effect of lockdowns on the Avery office supplies and consumable business heightened concern and the shares sold off heavily. Our assessment at the time was that market reaction appeared overdone. While apparel-related sales were down 50% and some parts of the Avery business were down 90–100%, the company also had large exposure to consumer goods including cleaning/hygiene products, a natural hedge from lower raw materials and a first rate management team who were very pro-active in cutting costs and managing cashflow. Remarkably, despite the challenges, CCL finished 2020 with sales essentially flat, profitability up and free cashflow up significantly.

From a valuation perspective, at the time of our investment, the shares were trading at 1.7x EV/IC (enterprise value/invested capital) compared to a 2.5x to 3x historically — this was discounting a COVID-disrupted return on invested capital into perpetuity of circa 11% and a trough free cash flow yield of c.9%. The share price has increased considerably from the lows amid increasing earnings, while the rating of the business has also risen. The value proposition from here centres on increased penetration of RFID and CCL's ability to capture its share of that growing market, allied to cyclical recovery in the Avery business. The value of RFID in enabling real time inventory monitoring in supply chain management was amply demonstrated in 2020 and we see increased intensity of use for the technology going forward. In addition, the flexibility offered by the company's balance sheet to make value-accretive bolt-on acquisitions offers upside optionality.

Global Financials: Oliver McClure, Head of Research

The Company: Bank Mandiri

Bank Mandiri is the second-largest bank in Indonesia by assets and is 60%-owned by the Government of Indonesia. The Indonesian banking market is one of the most attractive globally due to the low penetration of banking services and a large population with favourable demographics.

The Investment Case Given the positive market fundamentals, it is rare to find Indonesian banking stocks that trade materially below their intrinsic value. Over the last 20 years, Bank Mandiri has traded at an average valuation of 1.8x book value, which is warranted by return on equity (ROE) in the high teens and strong long-term growth prospects.

In March 2020, its valuation had declined to just 1.0x book value, a level not seen since the global financial crisis (GFC). March 2020 was of course the peak of pandemic-related market concerns, so there was a high degree of uncertainty generally. Concerns that the Indonesian financial system, which is highly reliant on external funding, would come under pressure weighed on sentiment towards Bank Mandiri at the time. Compounding this was concern that Bank Mandiri, along with other large state-owned banks, would be forced to bail out smaller banks.

None of these concerns were realised — although there was a material increase in credit losses, the earnings power of Bank Mandiri has been largely unaffected. One year on, in March 2021, the bank's valuation has recovered to 1.7x book value and remains modestly cheap within our framework. Like a lot of banks held in our portfolios, uncertainty around the extent of credit losses that will materialise once forbearance programmes end has lingered. We capture this risk by including an assumption of relatively high credit losses in 2021 and even after accounting for this we believe there remains further upside potential for Bank Mandiri.

Global Consumer: William Killeen, Portfolio Manager

The Company: Gree Electric

Gree is a China-based domestic appliance manufacturer and is the leading maker of air conditioning and climate control appliances in the world. Gree has 37% market share of the air conditioning market in China. The government of the City of Zhuhai recently sold down a 15% stake in Gree Electric to Hill House Capital, a private equity firm, essentially taking the company out of government ownership.

The Investment Case About 85% of Gree Electric's sales are in China and 78% of sales are driven by air conditioners (AirCon). The secular drivers of demand for air conditioning and climate control technologies are very strong in China; very high summer temperatures in big cities (exacerbated by global warming), increasing particle pollution and an increasing desire for climate-controlled homes, have bolstered demand over the last decade. We believe this trend is set to continue, driven by a number of factors.

The Chinese government has introduced successively more stringent minimum energy performance standards (MEPS) in home appliances to promote more efficient usage of electricity. These MEPS are accompanied by subsidies to allow households to upgrade from older more energy-consumptive units, resulting in significant replacement demand and innovation/premiumisation in the sector.

Though growing, penetration of AirCon units in Chinese homes remains far below that of cities elsewhere that experience high summer temperatures — about 40% of households in China do not have an AirCon unit. Also, with the increase in mass affluence in China, more complex integrated climate control systems are becoming more commonplace.

The COVID-19 crisis had the effect of creating a lull in demand and temporarily disrupting Gree's distribution model. The accompanying drop in market valuation delivered a relatively attractive price point at which to invest in this growing company. As demand begins to pick up and the wider market recognizes the opportunity, we expect the valuation to recover over time. Gree Electric trades on a PE of 14.4x at the end of March, which is very low given that its balance sheet has net cash equal to 50% of its market capitalization. It currently presents a dividend yield of 3.6%.

Global TMT: Mark Prentice, Research Analyst

The Company: Tokyo Broadcasting System Holdings

Tokyo Broadcasting System Holdings (TBS) is a comprehensive media group with involvement in broadcast and satellite television, video production, content streaming, cultural events, real estate and shopping businesses.

The Investment Case TBS is ranked number three in prime time TV viewer ratings, number one in radio and with major theatrical productions, it is expected to continue to play a major role in Tokyo's vibrant entertainment life in the post-COVID environment.

TBS trades at a deep discount to the net asset value of the cash, financial assets and real estate on the company balance sheet. On its year-end balance sheet at 31 March 2020, TBS recorded net cash of 83 billion yen; investment securities of 380bn yen (comprised of over 160bn yen of investment grade bonds together with a portfolio of holdings in listed Japanese equities); and real estate assets with a book value of 96bn yen. TBS disclosed that the independently-appraised market value of the real estate assets was over 300bn yen. By contrast, the market capitalisation of TBS at the time was approximately 270bn yen.

But TBS is not just a financial holding company; it is also a profitable, cash generative, operating business which, at current valuation, can be purchased at a considerable discount to what we believe is its intrinsic value — the balance sheet provides a considerable 'margin of safety'. However, a concern for market participants would be that 'non-operating' assets are at risk of becoming 'stranded'. But the company has undertaken shareholder-friendly actions including board reform, asset sales and engaged in a share buyback, while a wider backdrop of corporate governance reform in Japan offers further comfort. These first signs of the company addressing its over-capitalisation are welcome to us as shareholders, and we would like to see an acceleration of the process.

Global Industrials: James Savage, Research Analyst

The Company: Dassault Aviation

Dassault Aviation designs and manufactures military (Rafale) and business (Falcon) jets. It also owns 25% of aerospace and defence company Thales S.A.

The Investment Case We began our due diligence on this stock after it entered the top decile of our screen. At first glance, the set-up appeared similar to Tokyo Broadcasting Systems, with the stock reflecting a negative enterprise value (EV). Dassault's market capitalisation of €9.8bn was less than the value of non-operating assets i.e. cash of €2bn, marketable securities of €3bn, and a stake in Thales worth €5.3bn. Our accounting framework led to adjustments to these numbers following an assessment of customer advances and tax leakage, but the stock still looked attractively valued on an adjusted EV/EBIT (earnings before interest and tax) ratio of 3.8.

Low valuation multiples do not always correspond to good value, and so our due diligence focused on the robustness of the denominator: was the current level of EBIT (operating profit) sustainable? Our research concluded that not only was the prevailing level sustainable, but that it would likely grow over the coming years. In both businesses, profitability is underpinned by replacement demand and aftermarket revenues. The market for large business jets has been a challenging one over the past decade, and sentiment soured further as a result of the pandemic. However, the company has a healthy order book and the prospect of new orders with the launch of the new Falcon 6X aircraft in 2022. On the military side, the company's reported backlog provides visibility over the next 2–3 years. As the sole provider of combat aircraft to the French State, we believe the outlook for additional orders is constructive, while we also note several opportunities in the export market and Rafale's past success in these competitions.

Global Healthcare: Paul Carthy, Research Analyst

The Company: Ipsen

Ipsen is a French specialty pharmaceutical company which operates in Europe, the Americas and in select emerging markets.

The Investment Case The bulk of Ipsen's revenues are generated from a range of oncology products, a botulinum toxin called Dysport and a small number of primary care products. Ipsen sold off aggressively in the early months of 2020 due to: a) fears that revenue from its biggest product Somatuline would collapse due to generic competition, and b) a clinical hold due to a safety signal on a recently-acquired compound called Palovarotene. In our view, these risks were overstated and Ipsen was thus attractively priced at less than 40% of the net present value (NPV) of its marketed products. In the first instance, Somatuline, which is used in the treatment of symptoms caused by neoendocrine tumours and acromegaly, is complex to manufacture and so the number of generic filers will likely be limited — consequently, the pace of erosion will likely be gradual. Secondly, the clinical hold on Palovaratene has been lifted and the drug is likely to be filed and approved for the treatment of a rare orphan bone disease — we don't believe it will ever achieve its most optimistic financial targets, but it should nonetheless contribute meaningfully to Ipsen's bottom line. Lastly, the company's in-licensed oncology product, Cabometyx had excellent results in a clinical trial in combination with Bristol-Myers Squibb drug Opdivo for late-stage kidney cancer. This gave rise to an increase in peak sales estimates for that drug.

Ipsen's shares more than doubled from the early-2020 lows, before falling back amid some confusion on medium-term targets from the new CEO. At current levels, it trades on just under 70% of the NPV of the cash flows from its marketed products and risk-adjusted pipeline. For a company with relatively little debt, we believe this represents an attractive proposition given that earnings will likely organically grow at a low single digit compound annual growth rate over the medium term and will generate significant free cash flow to finance business development.

Endnote

1 Source: Bloomberg Finance LP as at 31 March 2021.

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* This figure is presented as of March 31, 2021 and includes approximately $60.33 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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