ValueInvestor INSIGHT
May 31, 2024
The Leading Authority on Value Investing

Great Expectations

George Davis and Scott McBride of Hotchkis & Wiley compare and contrast today's market environment with the 1990s' Internet bubble, highlight industry sectors they believe are offering ample opportunity, detail a recent error of omission, and explain what they think the market is missing today in valuing APA Corp., Ericsson and U.S. Bancorp.

INVESTOR INSIGHT



Hotchkis & Wiley
George Davis, Scott McBride

Plenty has changed in markets since Hotchkis & Wiley's George Davis started in the investment business nearly 40 years ago, but the key source of opportunity remains much the same: "Share prices are volatile in the short term, while good businesses grow their value per share over time," he says. "Investors' overemphasis on the present is what creates the value opportunity."

Capitalizing on that dynamic, the firm's $17 billion (assets) Diversified Value strategy since 2000 has earned a net annualized 9.1%, vs. 7.2% for the Russell 1000 Value Index. Today, Davis and co-portfolio manager Scott McBride (also Hotchkis & Wiley's CEO) are finding mispriced value in such areas as oil and gas, telecom equipment and U.S. banking.

Hotchkis & Wiley has a long history in contrarian value investing. Would you say any basic tenets of your approach have been challenged by the market environment of the last 10 to 15 years?

Scott McBride: Our value approach is based on looking at situations where expectations are low. Value stocks with low expectations tend over time to do better than expected. Growth stocks with high expectations tend over time not to live up to those expectations. That's a primary reason value over long periods of time wins over growth.

In most markets and sectors that premise has remained true even in the last 10 to 15 years. One prominent exception is in the U.S. large-cap space where a number of the well-known technology stocks have fully lived up to or exceeded expectations. But those expectations have also gone up a lot. We've owned Microsoft over that period at 8x our estimate of its normal earnings and we value it today at 32x normal earnings. That part of the outperformance will be hard to replicate.

George Davis: The essence of what we do hasn't changed. Market inefficiencies – often resulting from the investment community's short-term focus on the trends in place at the moment – can create the opportunity to buy businesses that are undervalued relative to their long-term earnings potential. In looking to take advantage of that it's important that we come at it with a level of humility balanced with the conviction that comes from doing the hard work necessary to understand what companies are worth.

We always need to learn how to do that better, say by more fully recognizing the value of intangible assets, but I believe the opportunities are as prevalent as ever. If anything, short-term volatility for a variety of reasons seems to have increased, resulting in more potential for dislocation and inefficiency.

When we last spoke [*VII*, April 30, 2019] you made what was then the rather lonely investment case for General Electric, which despite fits and starts has turned out to be a significant winner. In what ways was it representative of the types of situations that attract you?

GD: We had multiple analysts weighing in on this because it was a very complex company with different lines of business. We felt that Larry Culp, who had taken over as CEO in October 2018, was focused on all the right things, delevering the balance sheet through asset sales and refocusing the company on its core strengths in commercial aviation, healthcare equipment and power and renewables.

That was playing out when the shock of the pandemic turned everything upside down, particularly the jet-engine business when the travel industry came to a halt. As can often happen, we had to be patient but we never lost the resolve that the company overall was worth a lot more than the enterprise value the market was placing on it. As the economy and individual businesses recovered, the company successfully spun off both the healthcare and power businesses. The thesis played out extremely well. Kudos to the management team – we're pleased we stuck with them.

SM: How well this turned out was somewhat atypical, but this is a good example of what we emphasize in our research and analysis. The company was out of favor due to mismanagement under prior leadership and there were also some cyclical industry issues, but the quality of the core underlying businesses was very good. Some 50% of the large commercial jets in the world fly GE engines – when you have 50% of any growing market with few competitors and high returns on equity, that's a valuable long-term asset. We didn't think the market was sufficiently recognizing that in the engine business and elsewhere.

We also put considerable focus on the balance sheet, in particular that it would allow the company to withstand big shocks that might derail a recovery. The debt profile at GE had been a chronic concern, but we got comfortable that the asset sales already done or underway would significantly lower the risks related to leverage. That turned out to be the case when the pandemic hit.

Especially in a turnaround situation like this we had to have confidence that management was up to the task. From both his record and his articulation of what he planned to do, we were confident Larry Culp was the person to right what had been a pretty badly listing ship and create shareholder value.

That setup with respect to the business, the balance sheet and management is generally what we look for in ideas. Combine all that with a cheap stock valuation because the market is worried about what's going on today and not focused on the long-term opportunity, that's exactly what we want to own.

We also spoke five years ago about Discovery, now Warner Bros. Discovery [WBD], an out-of-favor stock then as well as now. Is patience still in order here?

GD: This has been disappointing, no question, but we don't think the story is over yet. We were – and still are – aware of the uncertainty in outcomes as the industry transforms broadly speaking from linear to digital. The company compounded that uncertainty in merging with Warner Bros., adding a lot of debt when interest rates were going up. The market has not looked kindly on that.

SM: The stock today [at around $8 per share] trades at only 6x consensus forward EBITDA. It's true that a lot of that EBITDA comes from the traditional TV business that is declining, but we believe there's a lot of potential upside from the current valuation if the company is able to execute on its plan to grow the streaming business, better monetize its content in other ways, and use cash flow to pay down debt.

ON RISK ASSESSMENT:

We've always been focused on risk, but we've found there to be value in ascribing actual scores to the risk levels.

I might talk briefly here about how we assess investment risk, which we've formalized somewhat recently. For each of our ideas we'll assign a risk score from one to five (best to worst) on the three attributes we've already discussed, business quality, balance sheet and governance. We've always been focused on risk in these areas, but we've found there to be value in ascribing actual scores to the risk levels. It helps clarify our thinking, makes it easier to document, and allows us to better compare investments to each other.

If the risk scores are high, that usually means there's more uncertainty around what the company is worth. So for the same estimate of fair value relative to the share price, companies with higher risk scores will likely have smaller positions in the portfolio. With Warner Bros. Discovery the risk score on the business, because of the uncertain industry transition and changing competitive environment, is fairly high. The balance sheet score, because of all the debt taken on in the merger, is fairly high. We see fewer issues around governance, as management appears to us to be doing the right things and is well aligned with our interests as shareholders. Overall we consider the risk level relatively high, so it's a small position in the portfolio despite our seeing a lot of upside in the stock.

With the market hitting all-time highs, some have likened the current equity environment – with its concentrated set of big winners, large valuation disparities and enthusiasm about revolutionary technology – to the Internet bubble. Do you think those comparisons are apt?

SM: The S&P 500 trades at 23x next year's consensus earnings estimates, well above the median of 18x over the last 30 years. It has traded at a higher multiple only 20% of the time since the early 1990s. In general, we would say the impressive growth, profitability and free cash flow generation of the market's largest stocks make today's valuations more rational than they were 25 years ago. The sustainability of all that, in some instances, would be our primary concern. We would also say that outside of the technology-oriented mega caps, large-cap valuations are rather ordinary. Our Large Cap Diversified Value portfolio trades at only 10.5x forward earnings, just a bit above historical averages and at an unusually large relative discount to the broad index.

You've written recently about finding opportunity in the healthcare sector. What's going on at a company like Medtronic [MDT], for example, that makes it interesting to you today?

SM: Medtronic is the world's largest medical-device company, selling a wide range of products including pacemakers, surgical tools and insulin pumps. In most of their markets they are the #1 or #2 player, with only a few competitors and significant barriers to competitive entry. The result is a very steady business with a high return on equity and consistent cash flow generation.

The reason for the opportunity is that the company has disappointed on revenue growth in recent years. When we look at the product cycles and product pipeline in many key segments, however, we believe they can get back to the more normal mid-single-digit annual revenue growth of the past. The Street, based on more recent experience, is expecting less than that and the stock [at a recent $80.60] trades at 15x our estimate of normal earnings power. A 7% free-cash-flow yield on a free-cash-flow stream growing at least 5% per year, in a company with a 3.4% dividend yield and that is buying back stock, is quite attractive in this market.

Your large-cap portfolio is quite underweight technology. Why does something like F5 Inc. [FFIV] make the cut?

SM: The company sells software products to corporate IT departments, which use the software to improve the efficiency and ensure the security of mission-critical enterprise software applications. An example would be for a large financial institution operating a mobile-banking application where millions of end users generate heavy, unpredictable traffic volume on the bank's network, which can lead to downtime and other performance challenges. F5's software directs traffic from end users to available servers and also implements security protocols to safeguard the network and the sensitive bank-account information running through it against outside attack.

F5 originally stood out to us because it had characteristics of a higher-quality software company – 80% gross margins, sticky customer relationships and a high share of recurring revenue – but because its legacy product also includes hardware, the market and the analysts following it seemed to be treating it more as a commoditized IT hardware provider. We think that's a misunderstanding – the value it delivers has always been in the underlying software.

At the same time, recent quarterly earnings have been depressed by investment spending on R&D and marketing along with some industry-wide delays in IT spending that has impacted new sales. We expect the industry trends to normalize in due course and for the investment spending to help drive top-line growth at a high-single-digit rate as operating margins return to the mid-30s level of the past. If we're right, we believe EPS can grow at a double-digit rate for many years.

The shares [recently just over $167] trade at only 12x our estimate of normal earnings. Given the quality of the business, the net cash on the balance sheet and the potential for organic growth in an attractive market, we consider that a real bargain. This is a top-five holding in the portfolio.

You have been active in traditional energy. Explain your broader investment case today for U.S. oil and gas company APA Corp. [APA].

GD: Speaking first about the industry backdrop, we are among those reconsidering the speed with which global energy markets can transition to clean energy and cause a decline in demand for traditional oil and gas. Such demand will eventually peak as this transformation happens, but

INVESTMENT SNAPSHOT

APA Corp.
(Nasdaq: APA)

Business: Exploration, production and development of oil and natural gas, with key operations in the U.S., U.K., Egypt and off the coast of South America's Suriname.

Share Information (@5/30/24):

Price	**29.73**
52-Week Range	28.73 – 46.14
Dividend Yield	3.4%
Market Cap	$10.83 billion

Financials (TTM):

Revenue	$8.08 billion
Operating Profit Margin	31.0%
Net Profit Margin	34.0%

Valuation Metrics
(@5/30/24):

	APA	S&P 500
P/E (TTM)	3.2	23.2
Forward P/E (Est.)	6.1	21.5

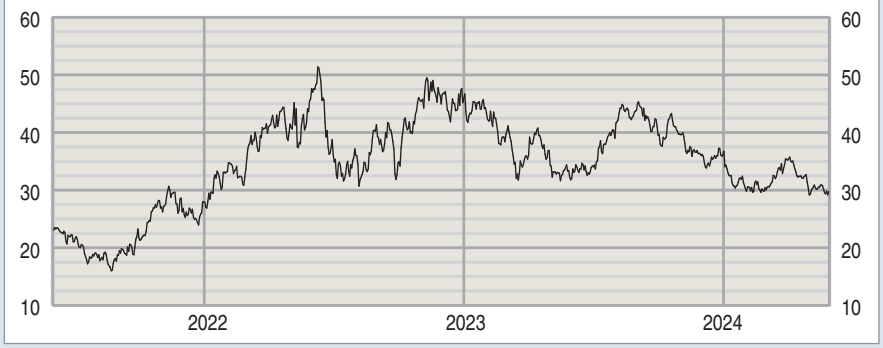
Largest Institutional Owners
(@3/31/24 or latest filing):

Company	% Owned
Vanguard Group	12.0%
BlackRock	7.3%
Hotchkis & Wiley	6.6%
State Street	5.9%
Harris Assoc	5.2%

Short Interest (as of 5/15/24):

Shares Short/Float	5.6%

APA PRICE HISTORY



THE BOTTOM LINE

Given his more positive view on medium-term oil prices, George Davis believes the market is erring in valuing the company's shares at a 17% earnings yield and 3.4% dividend yield. That in his view appears to assign zero value to large, in-development assets in coastal Suriname that he estimates are worth close to half the company's current market value.

Sources: S&P Capital IQ, company reports, other publicly available information

we continue to see demand growing for some time.

On the other hand we don't see the same supply response as we've had in the past. Big new projects take seven to ten years and billions of dollars to get underway, so managements have been understandably reluctant to commit such long-term capital and are instead returning excess cash to shareholders. We think that means we'll see continued underinvestment in the industry, which if demand still grows will provide support to equilibrium oil prices. We're using what we consider a conservative $75 per WTI (West Texas Intermediate) barrel price as normal, just below the current price of around $80.

At today's oil prices, exploration and production companies like APA, formerly known as Apache, generate significant earnings and free cash flow that the market isn't valuing very highly. APA's shares trade at 6x consensus forward earnings and the current free-cash-flow yield is in the mid-teens.

Are there also unique aspects to the story for APA, whose stock currently trades at around $29.70?

GD: The primary one is the company's asset off the coast of Suriname in the northern part of South America. The reserves discovered there are very significant, similar to what Exxon Mobil and Hess have found in neighboring Guyana. APA has a production-sharing agreement for the reserves with the large French multinational oil company TotalEnergies which we think is quite advantageous. It will take three or four more years until production comes on at material levels, but the great bulk of the capital spending to develop the resource is being paid by Total, making the incremental returns on APA's piece of the project extremely high.

Current earnings are generated by operating assets located primarily in the North Sea, in Egypt, and in the Midland and Delaware basins in the U.S. Permian. The market is valuing that earnings stream at a 17% earnings yield and a 3.4% dividend yield. We would argue that means the assets not producing earnings or free cash flow, namely in Suriname but also including a liquefied natural gas contract with Cheniere Energy, are essentially free. The Suriname project alone we think is worth close to half APA's current stock price.

You've written that telecom-equipment company Ericsson [ERIC] has been "left for dead" by the market, a contention with which you disagree. Describe the opportunity you think that creates.

SM: In efficient capital markets, struggling companies often sell at low valuation multiples while leading companies – say, those with technology that is critical for the modern economy – often sell at high valuation multiples. The future is the enemy of the struggling business and current results are likely as good as it's going to get. But time is the ally of the strong business, which will grow and become far more valuable with the passage of time.

There is generally considerable uncertainty about how the fortunes of most businesses will change over time, but you might imagine that a company that leads an industry essential to modern life, where increasingly sophisticated technology in-

INVESTMENT SNAPSHOT

Ericsson
(Nasdaq: ERIC)

Business: Based in Sweden, develops, manufactures and sells network hardware and software used by carriers deliver telecommunications services worldwide.

Share Information (@5/30/24):

Price	**6.05**
52-Week Range	4.33 – 6.36
Dividend Yield	2.7%
Market Cap	$19.72 billion

Financials (TTM):

Revenue	SEK 254.12 billion
Operating Profit Margin	6.8%
Net Profit Margin	(-10.0%)

Valuation Metrics
(@5/30/24):

	ERIC	S&P 500
P/E (TTM)	n/a	23.2
Forward P/E (Est.)	13.0	21.5

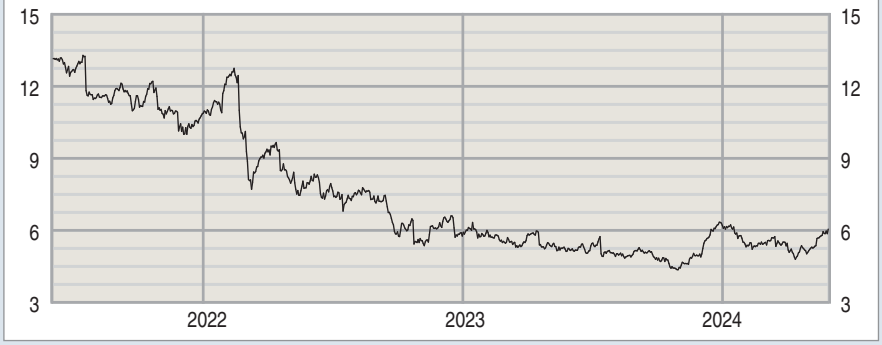
Largest Institutional Owners
(@3/31/24 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	13.0%
Investor AB	8.7%
Cevian Capital	4.6%
Hotchkis & Wiley	4.5%
BlackRock	4.1%

Short Interest (as of 5/15/24):

Shares Short/Float	1.1%

ERIC PRICE HISTORY



THE BOTTOM LINE

Based on underlying demand, the potential for a better pricing environment and for a favorable product mix shift as 5G technology rolls out, Scott McBride believes the company's normalized margins will far exceed current levels. At what he considers a reasonable 12x his estimate of normal EPS, the shares would double from today's level.

Sources: S&P Capital IQ, company reports, other publicly available information

creases its value-add and builds a higher barrier to competitive entry, and where a key competitor may face problems that threaten its relevance, would be considered to have the future on its side. That doesn't sound like a business that should be valued as if it has a dim future, but we think that's exactly the situation today with Ericsson.

The company is the leader, with nearly 40% share, in a three-player global market for the hardware and software needed to run wireless networks. The industry has gone through a very long period of consolidation and at this point is mature, with modest but persistent growth over time as increasing demand for data will require added investment in new and more technologically sophisticated capacity by wireless network providers. That doesn't happen in a straight line, and service providers go through spending cycles that can depress earnings for Ericsson when they're pulling back. We're in such a cycle now, which has driven the company's operating margins below 10% and is the biggest reason the stock trades at half the price it did at the beginning of 2022.

The key question then to answer is what normalized operating margins look like, which is where we spent much of our time in due diligence. We believe over time based on underlying demand, the potential for a healthier pricing environment and for a favorable product mix shift driven by the ongoing rollout of 5G technology, that normalized margins can reach 18%, at the top end of management's 15% to 18% guidance.

Talk more about the various problems that threaten top-competitor Huawai's relevance.

SM: Huawei has outstanding engineering and a large captive domestic Chinese market, but as politics bleeds into commerce its equipment is banned in a number of countries – including the U.S., Canada, Australia, the U.K., Japan and India – and sanctions block it in some cases from obtaining cutting-edge components it needs to compete. We believe it will be difficult for Huawei in such an environment to maintain its current 35% global share of the market. Its challenges are opportunities for Ericsson.

The company has paid significant fines in recent years for violating the Foreign Corrupt Practices Act. Broadly speaking, how do you rate the corporate-governance risk here today?

SM: The fines paid were primarily for infractions prior to 2016, when management turned over and has since put considerable emphasis on better compliance.

ON MARKET EFFICIENCY:

If anything, short-term volatility seems to have increased, resulting in more potential for dislocation and inefficiency.

We generally score the company well on governance. We've spent a great deal of time with the CEO, Börje Ekholm, and have also discussed this with the new Chairman of the Board, Jan Carlson. We believe they're focused on the right things operationally and on creating shareholder value. The company hasn't yet been buying back shares, but it would not surprise us to see that.

How neglected do you consider the ADRs, now trading at just over $6?

SM: The stock trades at around 12.5x earnings, so it's not expensive on current results, especially for a company with a net cash balance sheet. If they get to 15% operating margins, the stock on our normalized estimate of earnings trades at a 7x P/E multiple. If they get to 18% margins we estimate close to $1 in EPS, so the multiple on that today is only 6x. If the business operates at the level we believe it can, something closer to 12x earnings would be reasonable. That would result in 100% upside from today's price.

From telecom equipment to banks, why are you high on the investment prospects for U.S. Bancorp [USB]?

GD: Banks remain a large exposure in our large-cap value portfolios. We're invested in companies that we believe have meaningful franchise value with significant scale and deposit-share advantages. That should enable them to earn returns well above their cost of capital, but we don't believe the share prices reflect that. We'd also argue that the industry has managed through various regulatory and interest-rate environments more effectively and with greater flexibility than is generally recognized. Select banks may be at risk during times of financial stress – as we saw last year with Silicon Valley Bank and others – but we view obsolescence risk as quite remote for the industry overall and for our positions specifically.

SM: U.S. Bancorp is the fifth-largest bank in the U.S. by assets, with strong market positions mostly in midwestern and western markets. It has traditionally delivered above-average core profitability with a somewhat unique operating mix, with roughly 40% of its business coming from providing capital-light, fee-generating services in areas such as payments, corporate trust and wealth management. It has high deposit share in the markets in which it competes, which translates into good cost efficiency and high normalized returns on equity, which we consider to be in the mid to high teens.

The core of our thesis is that we believe USB is underearning relative to its potential. It has been going through an investment period in operating expense, upgrading systems and capabilities in digital banking and other areas, which is now largely over and starting to show benefits. Rising interest rates have pressured net interest margins as deposit costs increase more quickly than longer-dated loans can reprice, a dynamic that lessens over time. We also think the ongoing integration of the company's late-2022 acquisition of Mitsubishi UFJ Financial's Union Bank will pay dividends from increasing

INVESTMENT SNAPSHOT

U.S. Bancorp
(NYSE: USB)

Business: Fifth-largest U.S. bank by assets, providing a wide range of banking, lending and administrative products and services for both commercial and retail customers.

Share Information (@5/30/24):

Price	**39.38**
52-Week Range	29.33 – 45.85
Dividend Yield	5.0%
Market Cap	$60.92 billion

Financials (TTM):

Revenue	$25.16 billion
Operating Profit Margin	32.2%
Net Profit Margin	20.1%

Valuation Metrics
(@5/30/24):

	USB	S&P 500
P/E (TTM)	13.0	23.2
Forward P/E (Est.)	9.9	21.5

Largest Institutional Owners
(@3/31/24 or latest filing):

Company	% Owned
Vanguard Group	8.7%
BlackRock	7.1%
MUFG Bank Ltd	4.4%
State Street	4.2%
J.P. Morgan Asset Mgmt	3.7%

Short Interest (as of 5/15/24):

Shares Short/Float	1.3%

USB PRICE HISTORY



THE BOTTOM LINE
The bank due to the end of a period of investment spending, normalizing net interest margins and ongoing benefits of a large acquisition should see an increase in normalized earnings that the market doesn't appear to expect, says Scott McBride. The stock trades at 8x his normal estimate of EPS, while he would consider 13-14x to be more appropriate.

Sources: S&P Capital IQ, company reports, other publicly available information

market share in core western-U.S. markets and ongoing cost savings. While current earnings per share is a bit below $4, we estimate normal earnings at closer to $5.

If you're right, what upside do you see from today's share price of around $39.40?

SM: For a high-quality bank with strong market positions and above-average core profitability, we would argue that fair value is closer to 13-14x normal earnings. On our $5 normal EPS estimate the stock today trades at only 8x.

GD: It might be instructive to look back at the big market concerns when regional bank stocks sold off last year. One was that deposits were going to flee as people sought higher interest rates elsewhere. Another was around banks having to mark to market their held-to-maturity investment portfolios and the negative impact that would have on capital ratios. The latter concern was even higher for USB given it had reduced much of its surplus capital with the recently completed acquisition.

Clearly these were problems for some select banks, but they certainly weren't widespread. USB's deposits over the past year have grown by 4%. The mark-to-market concerns for it haven't come close to being an issue. We didn't think the issues then warranted the stock falling as much as 40%, which gave us the opportunity to increase our position meaningfully at the time.

Describe something you got wrong fairly recently and why.

SM: My biggest mistake in the last year or two was not buying Meta Platforms [META] in the second half of 2022 when it was trading at less than 10x our estimate of normal earnings with a strong balance sheet. Like a lot of other investors I didn't like the control of the business Mark Zuckerberg had, thought he was spending way too much on the "metaverse," and was starting to increasingly question the sustainability of the core business. But in retrospect when Zuckerberg started talking about shifting emphasis to a "year of efficiency," we should have adjusted our thinking. Because the stock went up 20-30% on that news – which was real news – it didn't mean it wasn't still undervalued.

As dyed-in-the-wool value investors, how have you processed the market's behavior over the last few years?

GD: No one wishes for a down market, but in some respects we were happy to see the role a value style can play in your mix of asset allocation validated in 2022. The S&P 500 was down 18%, the Russell 1000 Growth Index was down 28-29%, and the Russell 1000 Value Index was down 7%. As the market roared back in 2023 and again started capturing a lot of momentum, over the two years the returns of value and growth were almost exactly on top of each other.

We believe momentum markets can't last indefinitely and that there will come a time when the market broadens out and value has a tailwind behind it again. Trying to time that is impossible, but I have to believe we're relatively close to that point, if for no other reason than the fact that

valuation spreads between growth and value are so wide right now. That spread over the last 45 years has been wider only 7% of the time, all of which was during the late-1990s tech bubble. It's an interesting time. We haven't at all lost the faith – we believe the strategy still makes a lot of sense and we're just trying to execute it as best we can. VII

VALUE INVESTOR INSIGHT
MAY 31, 2024
"INVESTOR INSIGHT: GREAT EXPECTATIONS"

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COMPOSITE PERFORMANCE (%) ANNUALIZED as of September 30, 2026

	QTR	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception
H&W Disciplined Value (gross)	5.01	11.38	16.41	18.18	12.71	13.01	9.89
H&W Disciplined Value (net)	4.84	10.85	15.81	17.89	12.49	12.83	9.65
Russell 1000 Value Index	2.61	19.27	23.81	20.07	11.92	11.43	8.23
Russell 1000 Growth Index	0.92	6.30	7.50	24.26	13.66	18.16	8.00
S&P 500 Index	2.30	12.75	15.74	22.89	13.79	15.33	8.31

Commencement of Large Cap Disciplined Value Composite: 4/1/00. Past performance is no guarantee of future performance.

Investment returns include reinvestment of dividends, interest and capital gains. Valuation is based on trade-date information and stated in U.S. dollars. Net performance results are presented after actual management fees and all trading expenses but before custodial fees. The Large Cap Disciplined Value strategy's returns for different time periods and market cycles can result in significantly different performance results. An account's investment guidelines, timing of transactions, market conditions at the time of investment and other factors may lead to different performance results. The Composite includes all Large Cap Disciplined Value discretionary accounts. The Large Cap Disciplined Value strategy seeks capital appreciation primarily through investments in equity securities of large capitalization companies and may invest in foreign (non-U.S.) securities. Additional performance disclosures are included in the strategy's GIPS Report.

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Investing in equity securities have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry, and market factors. Investing in foreign as well as emerging markets involves additional risk such as greater volatility, political, economic, and currency risks and differences in accounting methods. A value-oriented investment approach involves the risk that value stocks may remain undervalued or may not appreciate in value as anticipated. Value stocks can perform differently from the market as a whole or from other types of stocks and may be out of favor with investors and underperform growth stocks for varying periods of time.

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