ClearBridge Investments

Podcast: Growth Opportunities in Digital Transformation

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With Select Strategy Portfolio Manager Aram Green (AG), Technology Software Analyst Hilary Frisch (HF) and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello, and welcome to the latest ClearBridge podcast. This is Jeff Schulze, CFA, Investment Strategist at ClearBridge Investments. ClearBridge is a global equity manager with $146 billion in assets under management committed to delivering long-term results through authentic active management. ClearBridge tailors our strategies to meet three primary client objectives in our areas of proven expertise: high active share, income solutions and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

So growth strategies make up a significant portion of our high active share offerings at ClearBridge and have been the dominant investment style among U.S. and global equities for most of the current bull market. That positive momentum had a hiccup, however, in the third quarter as investors began to question the growth rates and long-term profitability of smaller and newly public growth companies. To help us examine the about-face in sentiment towards growth stocks and where they continue to see promise in this area of the market, I'm excited to be joined on the podcast by Hilary Frisch, a Senior Technology Software Analyst at ClearBridge, and Aram Green, Portfolio Manager for the ClearBridge Select Strategy and Co-Portfolio Manager for our Small Cap Growth and Mid Cap Growth Strategies. Hilary joined us last year to discuss cloud computing. So welcome back, Hilary, and Aram, I believe this is your first visit to the ClearBridge Podcast booth.

AG: Yes, thanks for having me, Jeff.

HF: Thanks, Jeff, we're happy to be here.

JS: And the topic of today's podcast is Growth Opportunities in the Digital Enterprise. So we'd love to get your feedback about the topics we cover and how we can make our podcast better, so you can contact us with questions, comments, and suggestions by emailing us at podcast@ClearBridge.com.

So it's been an interesting three months. I think the question that's on everybody's mind right now is whether value has the ability to have some sustained leadership after leading the last three months. It's really been a growth world for the last ten years, but I think in trying to be able to determine whether or not this leadership can persist, let's talk about the events that led to this sudden shift in market dynamics. So Aram, maybe I'll start with you. What do you think really started this move over to the value cycle that we've seen in the last quarter?

AG: Thanks, Jeff. Well, I think you have to take a step back and understand why we had such asset inflation on the growth side of the market. We really had valuations expanding in more secular growth companies whose products or services address large market opportunities as investors were enamored by this growth in a number of different industries and sectors, but particularly within technology. And at the same time, investor interest in holding exposure to cyclical companies started to wane over the last couple of years due to fears over where we were in the cycle, that we were late in the cycle and

there wasn't much left, issues over global trade with China, as well as a series of weakening global manufacturing data.

And so valuations with growth expanded for the last couple of years. There was a brief selloff in the end of 2018 and then we saw valuations start to roar back again in the beginning of this year. And what worked, continued to work, so we saw really strong performance out of IPOs. The growthier companies were outperforming the lower growth companies and people were really piling into the growth companies and IPOs.

And by late August, the premium valuation that investors were willing to pay for secular growers versus cyclical businesses was really reaching historic levels. And coincidentally, we started to see some signs that value stocks might be more attractive, not only due to valuation, but some signals and some data points on the macro economy. And I know, Jeff, you spent a lot of time looking at that. Maybe you can talk about sort of what we were seeing at that period of time in the end of summer.

JS: Yes, certainly valuation plays a point, but valuation is a notoriously bad timing tool, but the further stretch that rubber band gets, the more of a violent rebound you will have when things tend to normalize. But when you think about what was happening over the summer, the administration continued to move forward on tariffs with China in July of this year, the markets were pricing in a recession, you actually saw the 10-Year treasury go down by 52 basis points in the month of August, but not coincidentally the day that the administration said that trade talks were being resumed and there was a thawing of negotiations, the 10-Year treasury bottomed, started to move up, and it never really looked back. But if you take that one factor and you had a couple of other positive catalysts that kind of went into value's corner, if you will, for this outperformance.

You also saw an oil price spike due to Saudi Arabian production going offline in mid-September. The ECB, in Draghi's final farewell, he basically threw all of his monetary policy bullets out there, cut rates again into more negative territory, but they also instituted QE of $20 billion for the foreseeable future essentially until inflation converges with where the ECB wants that to be. So we're talking three or four years out from now.

And then also to your point, Aram, you saw a couple of better data points here in the US that took recession fears off the table. Specifically, a better retail sales number and then also a firming up of inflation. So I really think that is being driven by overly pessimistic fears that trade wars were going to cause a near-term recession, and also the realization that a soft landing may be a better probability than an outright recession.

Now I'm kind of thinking about this selloff from growth and it hasn't been that robust of a selloff overall. If you look at the quarter to date numbers, the Russell 1000 Growth Index is actually outperforming the Russell 1000 Value by two percent and IT specifically has outperformed on a relative basis versus the market since this value rotation. So it hasn't been IT that's been kind of the slow patch, it's really been consumer discretionary that has been leading to this breakdown. But overall as a sector, Hilary, do you view this selloff as healthy? And given the selloff that we've seen, where are you focusing your efforts and what looks attractive to you today?

HF: Thanks, Jeff. Yes, well, we have seen growth selloffs in what feels like each of the past four or five years. We had early '14, early '16. We had late '16, although that was broader based, we had late '18, that was also more indiscriminate and broader based, but it really hit growth relatively hard.

JS: It's not the first time.

HF: Not the first time in this rodeo. (Laughs) And typically, each of those has represented a pretty good opportunity to accumulate dislocated growth names. However, as you point out, this selloff represented about half the selloff among growth names that we've seen in those prior downdrafts, particularly '14 and '16, and actually '18 as well. So meaning growth names, certain ones are down a lot, but on average they're down about half the amount we saw peak to trough.

For that and certain other reasons, we're focusing the majority of our time and finding the majority of the opportunities within names we consider key franchise names with proven out business models.

Those are typically what we consider cloud based or subscription-based business models that leverage the key trends of digital transformation and names that also have strong free cash flow support. There are quite a number of them trading below their historical averages. And particularly, we look for names that are industry leading in sustainability measures because we think they're going to weather the long term much better. And there are a number of those, at least increasing pockets of those, that we're focused on.

JS: Now you mentioned that you're investing in companies that are benefitting from the digitization of the enterprise. Try saying digitization three times quickly. It's impossible to do so.

HF: I tried already. (Laughter) I failed miserably, yes. (Laughs)

JS: What exactly is it? Why is it happening? And what companies and sectors are enabling this initiative?

HF: Sure. Well, basically, the world made a lot of technology investments in the late 1990s, all of which have to be upgraded. A lot of those were focused on the sort of run the back office of the business, but they're old and they're in need of tender loving care and change. The cloud and modern cloud-based architectures are allowing organizations to conduct business digitally and flexibly, and also to harness the power of data in ways that corporations never could. That's a huge subtheme across all of our industries. And companies like Amazon have just really raised the bar on what constitutes an effective business. One that's able to serve customers in a fast, personalized, and responsive way. So all that combined means that companies have to invest and keep up and the preferred and really the one weapon of choice is technology in that regard. So that's basically digital transformation.

It's the modernization of IT systems and the addition of new systems which enable companies to do things in relation to their customers, partners, and employees that they've never done before or they tried to do and now they can do better, and they can do all sorts of new things. In that regard, we're finding opportunities in technology kind of across the board that manages the key functions that cut across an organization from IT to the human resources systems that manage employees, to the systems that handle financial transactions, and those certainly that manage customer interactions. It's a key area of focus for every organization.

And once you have all these systems in place there's a tremendous amount of data that's generated from them. We're seeing companies able to draw intelligence from that data and we're investing in companies, among others, data analytics vendors, that allow those companies to pull that data and drive that intelligence to be able to operate their businesses better, to be able to better address the customer. And then we're also focusing on all the glue that makes it work. One example is security. With all that data out there on the businesses, on customers, that resides both within the four walls as well as in the cloud, that data has to be protected and kept safe. And there are a lot of examples of that, but that's enabling infrastructure.

JS: Target, obviously, from a couple of years ago. I mean, this is going to be a secular theme for …

HF: A long time.

JS: Decades. Maybe even centuries.

HF: Yes, yes.

JS: Absolutely.

HF: It's sort of the necessary evil and also a key enabling technology. So security is still an exciting area.

JS: I know the team spends a considerable amount of time meeting and evaluating private companies which is unique. Why is that useful to your investment process? Maybe I'll kick it over to you, Aram, to give a little bit of perspective on that.

AG: We're mostly public investors, but it's important to remember that most of the economy isn't public, it's private. And so having a finger on the pulse in terms of what's going on in the private marketplace is very important to us really for three chief reasons. Firstly, these companies, if they're rapidly growing and have some innovative products or solutions there's a good chance that they're going to end up

being independent public companies. So getting to know those company management teams and understand the business models before they go public gives us an information advantage.

Secondly, we do invest in private companies. It's a minority of what we do, but in a number of our funds we have the ability to invest in late stage companies and so we've made a number of successful investments in those companies. So always looking with one eye on the private market to understand where there might be opportunities to deploy some capital in the private marketplace. And the last reason …

JS: Can I cut you off there?

AG: Sure.

JS: Can you maybe give me an example of one that you've done that has been private that's come public that you were able to get in early on?

AG: Yes, sure. So one example of that is a company called DocuSign. DocuSign, many of you might be familiar with. You maybe used it to open up a bank account or start a mortgage.

JS: I'm literally selling a house right now, so DocuSign is what we use. So I'm supporting our franchise here.

AG: It really speaks to what Hilary was talking about earlier about finding these companies that cut across so many different industries and organizations to improve the efficiency within their business and DocuSign really fits in well there. It was a company that we invested in when they were private, and we made a substantially larger investment when they were public.

Another example is a company called AppDynamics. Again, speaks to some of the trends that Hilary touched upon earlier. AppDynamics is a company that helps monitor applications, infrastructure, really a number of different areas of your technology stack to jump in front of problems before they occur. And so really to understand how your applications in technology are running. And that's something that was a much more manual process and is now very automated with harnessing the power in data analytics that are being fed off of those applications in areas of your tech stack. So that was a company that we invested in when they were private. We thought that they would actually go public and on the doorstep of the IPO Cisco (Systems) swooped in and made a very large premium offer to acquire the company before it ended up going public.

But I think it also speaks to why investing and spending time with private companies is so important. Because in that investment and understanding that market opportunity it led us to a company called New Relic which ended up going public a couple of years later, which was a peer company to AppDynamics, but they were originally playing more on the small/medium business side versus AppDynamics was going after the Global 2000 companies. That also led us to a company called Dynatrace in doing our competitive intelligence and we made an investment in Dynatrace when they ended up going to public. And then most recently, Datadog ended up going public and we invested in them on the initial public offering.

JS: And this was all from your initial work five companies ago. (Laughter)

AG: Yes, yes. So investors often ask us, "How do you find ideas?" And we find ideas in a number of different ways. I think that's a good example of sort of how one idea can lead to another idea. And Datadog is actually a company that we wanted to invest in when they were private. They were actually headquartered in our headquarters here in New York. They're a couple of floors below us.

JS: (Overlap) Is that right? They're in our building?

AG: Yes.

HF: A few floors down.

AG: A few floors below us. So we had been spending time with them understanding the business and had been really begging them to let us come in as investors when they were private, but the business model is so efficient that they really didn't need access to a lot of capital. And so even though we

wanted to invest when they were private and every time we saw them in the elevator going up and down we were begging to let us in.

JS: (Overlap) It's not stalking, right? It's begging, right? (Laughter)

HF: It's really begging.

AG: Poking and prodding. So we had to wait until the initial public offering which happened just a couple of months ago and we finally made our investment in Datadog. So I think it speaks to why it's so important for us to be spending time with these private companies and how the work that we're doing can lead us to new opportunities. The last reason that I just want to emphasize in terms of why we spend time with private companies is a lot of these well-funded private companies are or could be competing in the future with our public companies.

JS: Okay.

AG: And so understanding how these companies' products and solutions could challenge our incumbent position in the investments we have in our public investments is very important to make sure that we're staying on top of the risks that are bubbling up.

JS: Make sure the disruptors that you have in your portfolio that you think are disruptors don't get disrupted by the new, better technology coming out there.

AG: (Overlap) Absolutely.

HF: (Overlap) That's right. Increasingly in the cloud era there are few, either fewer barriers to entry or the barriers are different than they used to be historically. So often key disruption comes from the early stage, very early stage smaller companies which is different from what had been the case historically.

JS: So it really sounds like the IPO window is a real means for idea generation. Obviously, one idea led to five later that ended up in the portfolio. What specifically are you looking for in these companies? Is there like a certain profile that you want to see?

AG: It's not too different than what we're doing in an existing public company. We're looking for companies that have an innovative product and solution that's coming into a marketplace that either is well established and they're going to take a lot of market share or this might be the category leader in a rapidly developing market which didn't exist before. And so that's the cornerstone, the first nugget of what we're looking for in terms of the criteria, but from there we want to see an innovative, forward-looking management team. Oftentimes on the IPO these companies are taken public by a visionary CEO founder who is the person that really dreamed up this idea and has taken it from an idea to a business to now scaling to $100-200 million dollars in revenue and really has this vision of where things are going and understands the marketplace very well. We tend to favor recurring revenue streams, so this gives us the wherewithal to see that there's a sustainable business, that there's a constant draw of customers or the end user of the products and solutions that these companies provide.

JS: A stickiness, if you will.

AG: Absolutely, a stickiness. And so those are some of the things that we're looking for. We also want to know that the company from this point is a funded company so that they don't need to access additional capital in the marketplace to continue to build this company over time.

JS: Now that's an important point that you bring up because if you look at WeWork, right, I mean, they needed to access capital and when they tried to come public, we all know how that turned out. So I think that's an underrated quality that I think a lot of investment managers probably overlook.

AG: Going back to your first question in terms of what caused this bubble to burst in late summer, that was the time that WeWork hit the road and started to meet with investors and I think that was the biggest posterchild for a company that was growing very rapidly on the topline, but when you peeled back the onion and looked at the unit economics, the capital intensity of the business, the eventual margin

structure, it really was not as attractive as what people thought and that was because we didn't have all the details until they hit the road and filed with the SEC.

So that was a realization that investors were sort of looking at growth broadly with a broad brush and that all growth is not created equal. That you need to look at the unit economics of the business or the capital intensity or the margin structure to understand when things mature what is the cash generation of this business? At the end of the day as investors that's what matters to us is not just the growth, but the cash generation and the earnings power of the company.

JS: Or in WeWork's case, the ability to actually make a profit down the road. What are your thoughts on the fact that the public markets have taken a pretty objective eye to WeWork and these questionable business models? I mean, I think this is probably a healthy development at this point in the cycle, right? And if you think about private equity, a lot of money has been flowing into that space and it's just really been about ideas, not quite akin to the late '90s, but the fact the market is putting some discipline there I think is an encouraging sign for the longevity of this cycle. I mean, would you agree, Hilary?

HF: Absolutely. I think investors in general are becoming more discerning and the areas where we're focused are areas where those battlegrounds or battle lines have generally already been drawn a long time ago or for the most part. And what's interesting is that not only are these business models recurring revenue models and highly predictable, but one of the facets of these models that's increasingly appreciated by investors, certainly us for a long period of time, is that they're generating a lot of cash. In fact, some of our target names have free cash flow margins that are five, ten points above where they were historically. They're converting from revenue to free cash flow at 20 to 40 percent margins, headed higher.

JS: Pretty healthy. (Laughs)

HF: They're okay, they're okay. I mean, it's interesting, especially because they're in this land grab mode of garnering new customers and trying to expand rapidly within their customers in this rapidly growing space. So the fact that they're doing that now is highly encouraging for the future. So we think that leaves a lot of optionality on the table.

JS: And that's kind of your outlook for the growth picture for the next year or so? You're looking for these disruptors, that baby being thrown out with the bathwater right now at attractive valuations?

HF: Yes.

JS: How about you, Aram? What are your views on the outlook for 2020?

AG: Yes, so very much in line with what Hillary was just talking about. I think that we saw this rapid rise of valuations in growth and usually when a bubble bursts and people sort of get burned from the last person entering, they realize that they were the greater fool that it takes time for that sort of to calm down. And so I think we're in an environment where valuations have come back a very reasonable level. We're seeing attractive valuations. They're not giving these businesses away because of a lot of the attributes that Hilary talked about are very recognized. These are innovative growth businesses growing quite rapidly with expanding cash earnings in free cash flow yields.

The other aspect is that these companies have a great degree of visibility into what the future looks like. So if we do go into a downturn these companies that have 80 to 100 percent of their revenue recurring, they understand and have visibility into what the revenue is going to look like in the future years. You contrast that with a company that is an auto manufacturer or an industrial company, they really need to go out there and hustle and create those sales, whereas these companies already have a good chunk of their revenue contracted.

JS: The proverbial hamster wheel, if you will.

AG: Absolutely. So they're different attributes there, but we feel that these companies from a revenue perspective are going to have good stability. And clearly what will slow is closing new business. So while new business might be harder to come by, they have a lot of visibility into the revenue coming in

the door which gives them the fortitude to continue to invest for the future which paves the way for future year revenue growth.

JS: So they don't have to be beholden to the financial markets. They can continue to find and expand into the verticals where they see opportunities. One thing I'll mention from just a broader economic perspective is that software capex has increased from two percent of total capex in 1980 all the way up to 15 percent in 2019. A lot of that has obviously been driven by cloud computing. So for the first time in history, software is now a bigger share of capex than tech equipment.

HF: Wow.

JS: So I think I think that is obviously the beginning of a secular trend and this is going to be a dynamic that goes on for the next couple of decades.

HF: (Overlap) Indeed.

JS: As we mentioned earlier.

HF: We think it's headed higher.

AG: That's what we're investing in.

HF: Hilary, Aram, thank you so much for joining me in the booth here today, and thank you, listeners, for joining into the podcast here. And we hope to have you on the next ClearBridge Podcast next month.

HF: Thanks, Jeff.

AG: Thanks, Jeff. Nice talking to you.

JS: Take care.

JS: Please note the following. Past performance is no guarantee of future results. The opinions and views expressed in today's podcast are the individual speakers' as of November 15th, 2019 and may differ from other managers or the firm as a whole and are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics referenced have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Investments or its information providers are responsible for any damages or losses arising from any use of this information.

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