International Perspectives

DIAMOND HILL | CAPITAL MANAGEMENT

The Power of Disruption...and Sound Fundamentals

June 2020

Grady Burkett, CFA
Portfolio Manager

In 2006, the research organization CableLabs released its third generation of DOCSIS, a set of technology standards allowing cable companies, including Comcast, to carry internet traffic over their coaxial cable networks since the late 1990s. This latest iteration (DOCSIS 3.0) facilitated data rates that were far higher than what telecom operators could deliver over their fixed-line copper networks. The following year, Netflix launched its streaming video service, and household bandwidth consumption exploded.

In retrospect, telecom companies were facing a long, uphill battle. Their copper fixed-line networks were poised to become increasingly uncompetitive, but the high cost of rebuilding their networks would be extremely difficult to justify to shareholders. As internet traffic grew, the inferiority of copper-based internet services became more obvious—customers defected, revenue declined and network reinvestment became more difficult. The fixed-line telecom industry found itself in a long-term, vicious cycle.

Simply having the foresight to realize that Comcast would exploit its structural network advantage with sustained market share gains and steady price increases would have served investors well. From 2006 through 2019, Comcast's shares generated twice the total return of the S&P 500® Index. Of course, time travel isn't an investment option, and the investment case for Comcast is somewhat different today than it was nearly 15 years ago.

One thing that hasn't changed, however, is the importance of the internet. As we reflect on the potential lasting impacts of COVID-19, the increased influence of the internet on our daily lives is arguably among the most important.

Digital advertising, video streaming, remote workforces, online gaming, shopping, banking and ubiquitous connectivity have steadily gained adoption over the past decade. These long-term trends have received a boost from social-distancing policies. Companies such as Alphabet, Shopify, Netflix, Zoom and Tencent are experiencing demand spikes for their services. These companies may also disproportionately benefit longer term if they can capitalize on behavioral changes that persist after the pandemic ends.

So, as value investors, what can we do with this observation?

First, we can evaluate opportunities we believed were attractive investments entering the pandemic, including Alphabet, Tencent and Taiwan Semiconductor Manufacturing. If the pandemic does accelerate trends toward digital advertising, online gaming, cloud computing and connected devices, these companies should stand to benefit. However, if these trends don't accelerate, these businesses are already undervalued and high quality. In either scenario, we believe these companies are positioned to do well over time.

Additionally, we can evaluate how effectively our holdings incorporate digitally focused processes into their operations. Many well-run companies with structural advantages could emerge stronger from the pandemic. Strong firms operating in industries that are

enduring temporary demand weakness can expand their digital offerings to gain an additional edge over weaker competitors as customers return. For example, before the pandemic, U.K.-based kitchen remodeling supplier Howden Joinery had been steadily increasing market share due in part to its competitive cost structure and singular focus on home kitchen contractors. The company maintains an extremely strong balance sheet and has loyal customers—attributes that should benefit Howden Joinery as the U.K. economy recovers. Moreover, the company provides its customers with online kitchen design tools, e-commerce services and timely distribution. These capabilities may become increasingly important if contractors and homeowners place greater emphasis on streamlining and accelerating the kitchen remodeling process due to the pandemic. If so, Howden Joinery's existing market share may continue to increase because of the firm's digitally-focused processes.

Monitoring business threats that could emerge as a result of new competition or changing consumer behavior is also key. For example, we're wary of the negative impact that low-cost eyeglass providers like Warby Parker might have on EssilorLuxottica's retail operations, as Warby's online ordering tools are compelling. If eyeglass customers increasingly shop online, then EssilorLuxottica's physical retail stores could eventually become less relevant over time. Today, EssilorLuxottica is the largest manufacturer of eyeglass lenses and frames and has a very strong market position—an enviable position as change tends to be slow in the eyeglass industry because of regulation and inertia. Moreover, EssilorLuxottica has its own existing online presence, so it can almost certainly adapt to change and new competition.

Still, we need to stay alert to emerging threats posed by the steady rise in digitally focused business models. Even strong companies can experience long-term fundamental weakness as a result of what initially appears as a small threat. While we highlight EssilorLuxottica specifically, we are monitoring for similar potential risks throughout our holdings. These threats vary in severity and can be seen across industries, including banking, retail, wealth management, health care and media.

Without question, this pandemic is changing consumer behaviors. Some of these changes will likely have lasting impacts to businesses we own in our portfolios. Clearly, digital services have risen in prominence during this crisis, and the internet will continue to be a disruptive force.

We always consider the potential impact of technological change when estimating intrinsic value and evaluating business risk. However, this is just one of many inputs that goes into our decision-making process. We wouldn't necessarily sell a business because of an emerging technological threat, and we certainly wouldn't buy a business just because it was benefiting from a technological shift. Valuation always guides our decisions, and thorough business analysis underpins our intrinsic value process.

Circling back to Comcast - its network advantage, which had once been a source of future outperformance, was not the sole driver. The company's sound capital structure, quality management team and steady free cash generation were equally important attributes. Comcast's cable peer, Charter Communications, had a similar network advantage in 2006. However, Charter buckled under an overleveraged balance sheet just three years later, and equity holders were wiped out.

The divergent outcomes for these two companies' shareholders emphasize the point that while understanding technology shifts is important, staying grounded in fundamental business analysis is absolutely critical.

As of May 31, 2020, Diamond Hill owned Comcast Corp. (equity), Alphabet, Inc. (Cl A) (equity), Tencent Holdings Ltd. (equity), Taiwan Semiconductor Manufacturing (equity), Howden Joinery Group PLC (equity), EssilorLuxottica (equity) and Charter Communications, Inc. (equity). As of March 31, 2020, Diamond Hill owned Comcast Corp. (debt) and Netflix, Inc. (debt) .

The views expressed are those of the portfolio manager as of June 2020, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.