DIAMOND HILL

INVESTED IN THE LONG RUN

Market Drawdown Creates Opportunities in Smaller Companies

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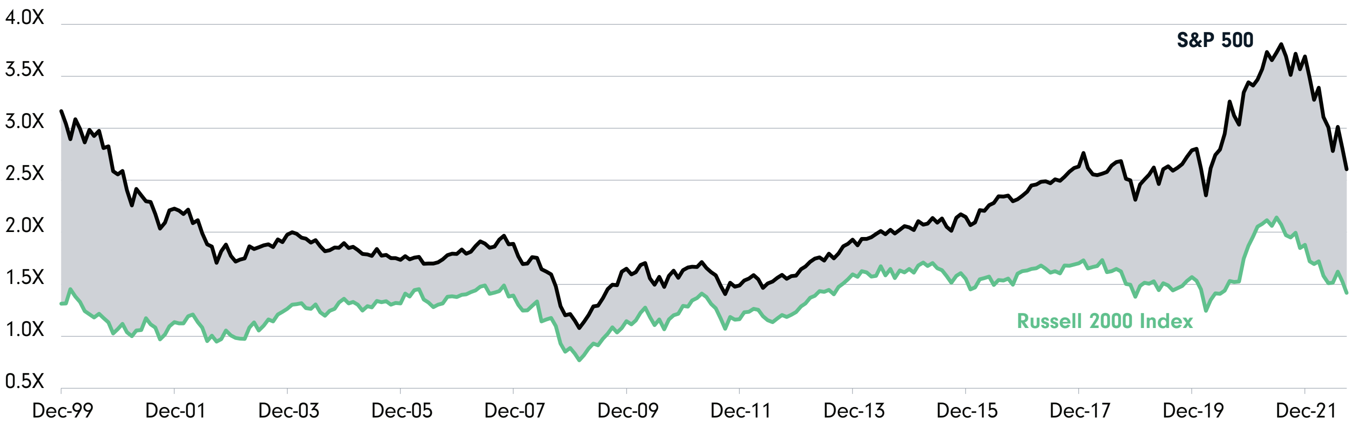
The 2022 market selloff has been broad, impacting various size and style segments as well as individual businesses. For most investors, down markets are not fun. But those who are valuation disciplined can appreciate the opportunity a market drawdown presents. In our opinion, the pullback this year has been favorable for finding attractive investment opportunities, especially among small- and mid-cap stocks.

Whether you're looking at an enterprise value to sales ratio or a price-to-earnings ratio, small-cap stocks are trading at some of the largest discounts in terms of valuation relative to large cap stocks that we have seen in the last 50 years (Exhibit 1). The only other periods that compare in terms of the types of discounts we see today are the 1970s and the late 1990s in the build-up to the peak of the tech bubble. Those historical periods where we saw deep discounts also corresponded to attractive relative returns over the next 10 years. Today, we are confident that over the longer term, this type of valuation environment has great potential to lead to attractive results for small- and mid-cap companies.

Two investment opportunities that we've capitalized on in our [All Cap Select strategy] during this time period include small business lending services company Live Oak Bancshares ($1.5 billion market cap) and plant-based food and beverage producer SunOpta ($1.1 billion market cap).

Exhibit 1 — Enterprise to Sales (Last 12 Months)



Source: FactSet.

Live Oak Bancshares

This year, investors have become increasingly concerned about the possibility of a recession, which has led to a selloff in more cyclical companies, including banks. Whether the US economy goes into recession in the next six months or we're in a recession now, we think the market is far too concerned about the short-term risks for banks. When we look at those risks, we see that consumer balance sheets are still strong today. And while the extraordinarily positive credit environment we've had over the last couple years has shown some weakness, we don't think it's going to get dramatically worse like what we saw during the global financial crisis. Bank balance sheets are in fantastic shape — if you look at the riskiest loans on bank balance sheets, they are much lower than they were coming into the financial crisis. And if you look at the capital levels that banks hold against their risky assets, they're in excellent shape as well as evidenced by the Federal Reserve's stress tests.

When we look at banks today, we focus on the normalized earnings power of the business over the next several years. And we don't think anything has changed about that long-term earnings power. Some things have shifted at the margin. For instance, we think net interest income is slightly improved from a few quarters ago because interest rates have moved higher. But that's largely offset by some weaker non-interest income and some inflationary pressure on expenses. Overall, we think the market is excessively focused on some near-term risks that look extreme and not as focused on what we care about most, which is the long-term earnings power of those banks. As a result, we see very attractive valuations.

Live Oak is particularly interesting because we believe it has an even higher return potential than many other banks because it is positioned as a small business bank that is also a technology leader. Live Oak is a digital, cloud-based bank serving small business owners in all 50 states with a focus on service and technology to redefine banking. As an investor at today's prices, we think the long run benefits of the company's investments in financial technology offer nothing but upside. Investors get the double benefit of a pessimistic market in terms of financial companies in general, but also a company that continues to build out cutting edge technology that can broadly disrupt the industry.

SunOpta

SunOpta is the largest co-manufacturer of non-dairy milks, e.g., soy, almond, oat. The company also has a small fruit business, which it's turning around and will likely sell once it's fully spruced up given that it's not a core capability.

Milks are interesting because it's a heavy product and therefore difficult to ship. If you think about a traditional milk business, there are dairy farms all over the country and the radius from which they can deliver is relatively short. SunOpta is the only manufacturer of non-dairy milks that has a national footprint here in the US. In fact, it's the only manufacturer that has anything even resembling a national footprint. All other competitors are ultra-regional or resemble a more traditional mom-and-pop shop. This advantage gives SunOpta a shipping benefit and a scaling benefit. Its buyers are national and prefer to have a small number of relationships, and SunOpta fits that bill perfectly.

Demand for non-dairy milk is growing quickly given its taste, health benefits and environmental advantages. The number of individuals with dietary restrictions or lactose intolerance has grown over the years — in fact, it is estimated that over 50% of the world's population has some degree of lactose intolerance. Demand for oat milk, in particular, is growing the most among non-dairy alternatives. In terms of overall volume, oat milk currently enjoys the number two spot behind almond milk, but we expect it to eclipse almond milk in the near future. Perhaps some of the growing interest in oat milk stems from the fact that it is better from an environmental standpoint in that it takes very little water to grow oats compared to the amount of water it takes to grow almonds.

The non-dairy milk industry is also capacity constrained. SunOpta can add capacity more rapidly than others because of its national footprint and it currently sells out of that capacity quickly. Another attractive element of SunOpta's business is that milk margins are much higher than fruit margins. So as the non-dairy milk outgrows the fruit business, margins are going to improve from a mix shift.

As of 30 September 2022, Diamond Hill owned equity shares of Live Oak Bancshares and SunOpta, Inc.

Enterprise value-to-sales (EV/sales) is a financial ratio that measures how much it would cost to purchase a company's value in terms of its sales.

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