DIAMOND HILL

INVESTED IN THE LONG RUN

Uncovering Value Amid a Turbulent Market

August 2022

Scott Williams, CFA
Research Analyst

Markets over the last two years have been memorable to say the least. The period has tested investors' mettle, especially those evaluating software and software-related businesses, and reinforced some foundational principles for us. We are optimistic about the software space today — we've been finding investment ideas during the sector's selloff this year and believe the current opportunity set is promising.

Reflections on a Roller-Coaster Market

Market pain in spring 2020 swiftly turned to unabated euphoria over the next several months, a feeling acutely felt in the software corner of the market. From May 2020 to October 2021, a very short time by market standards, nearly 60% of the software companies we follow saw share prices grow by more than 50%. At the time, we viewed these returns as likely unsustainable, but they were casually normalized and extrapolated by many investors. Outsized gains became the rule rather than the exception, often supported by liberally defined addressable market opportunities, improbable growth projections and very distant profit dreams.

As business analysts, we admire the positive characteristics software firms possess — usually some combination of attractive growth prospects, recurring revenue, strong incremental margins and low capital needs — and like most investors, we'd always like to own more businesses like this. However, we've been more spectator than participant in the sector in recent years. Particularly in 2021, our view was that the prices of several software businesses projected low-probability outcomes, not possibly known for several years, as near certainties. This rosy outlook was present despite the pesky realities of capitalism, like competition and technological improvements, which could derail success. To quantify the point, take how many software companies we follow that traded at ominously high enterprise-value-to-revenue (EV/revenue) multiples during 2021. EV/revenue is a commonly cited valuation metric in the software sector because companies may not yet be profitable — the higher the multiple the better the expected future revenue and profit growth. We estimate that roughly 40% of firms we cover traded at EV/revenue multiples greater than 15x at some point in 2021, but only around 10% do currently, which is more consistent with recent history. It has also been quite rare for publicly traded software companies to be acquired for more than 15x revenue, which further suggests prices were quite stretched. We think it's appropriate for software companies to command premium multiples, on average, given their desirable attributes. However, in our assessment, a large number traded at unjustifiably high levels in 2021, with seemingly long-shot outcomes being priced as heavy favorites.

In late 2021, the sector's strong performance ended abruptly, as exuberance and credulity were ostensibly replaced with rationality and skepticism. From October 2021 to July 2022, roughly two-thirds of software businesses we follow lost more than 25% of their value, with approximately one-third declining more than 50%. There are several well-worn but justified reasons for some of the washout in the sector, including interest rate hikes, inflation and fears of an economic slowdown, but we also suspect that the party simply ended for many companies. Paraphrasing something said by Edwin Lefèvre, the famous financial author and journalist, easy money goes even more easily than it came.

Principles Reinforced

Despite having limited exposure to the software space in recent years, we've followed the sector closely. The period has indelibly cemented a few of our guiding investment principles.

- **Intrinsic value, a beacon amid volatility:** The foundation of our investing process is confidently estimating a business' worth using reasonable assumptions about future cash generation and/or what an informed buyer might pay — a business' intrinsic value. We hold our estimates of intrinsic value close, especially during periods of market volatility, to support sound decision making.
- **Heed high prices:** Lefèvre also said that "buying stocks of prosperous concerns may be good business — but only at a certain price," a sentiment we agree with. Rationalizing higher prices, even for the best software businesses, dramatically increases the odds of poor investment outcomes. We fear an uncomfortable amount of capital was permanently lost recently by those that failed to appreciate this concept.
- **Focus on the long term:** Large stepwise price changes, both positive and negative, seem to occur more regularly these days, usually based on information with fleeting importance. We do our best to avoid consuming short-term noise, instead focusing our efforts on data that's consequential over the long term.

Current Opportunity Set

We are optimistic about the current opportunity set in software — market declines have generally made prices much more approachable, and we believe many companies have the potential to generate solid growth and profits over the next several years, even with the specter of a recession near term.

Today, we estimate there are roughly 250 publicly traded software or software-related businesses, up from 180 or so in mid-2020 — the increase largely a result of significant IPO and special purpose acquisition company activity (read our recent insight to learn more about SPACs). Naturally, not all 250 will be actionable for us — many are younger businesses in dynamic niches or face unsettled competitive situations, making it difficult for us to reasonably estimate their future economics. Additionally, we are cautiously approaching companies transitioning from a growth-at-any-cost strategy to a more profitable growth model, a move seemingly influenced by more discerning investor bases. On balance though, we view the opportunity to evaluate more software businesses over time as a clear positive.

Recently, we're finding opportunities in smaller cap names within the space — many are important vendors for specific applications or end markets, have shown respectable profitability in the past and appear capable of expanding margins appreciably with the correct balance of sustained sales growth and prudent expense management. We estimate there are 50 to 75 of these companies, and our general thesis is that the market has incorrectly discarded some quality businesses from this cohort in recent months that likely meet our investment standards. We've been able to identify three new investments in 2022, and we believe there's a reasonably good chance of further success in the coming quarters.

- **ChannelAdvisor** sells software to the retail sector that helps manage online product listings and supports other e-commerce functions. The company has increasingly won larger customers with more robust needs the last few years, which we believe signals a strengthening value proposition.
- **First Advantage** is one of the largest background screening companies in the US. In our view, the company's usage of software and technology throughout their processes along with their scale positions them favorably.
- **Rimini Street** provides maintenance and support services for enterprise software products. The company is known for high-quality service at a value price point, leading to impressive client retention and solid fundamentals.

Looking Ahead

The last couple of years will likely be remembered by market participants for some time. We've aimed to dutifully learn from the tumultuous period, hopefully leading to better investment outcomes in the future. It's impossible to predict how prices in the software sector will evolve over time, but we're pleased with the investments we've made so far in 2022 and are hopeful the opportunity set will remain fertile well into the future.

As of 31 July 2022, Diamond Hill owned shares of Channel Advisor Corp., First Advantage Corp. and Rimini Street, Inc.