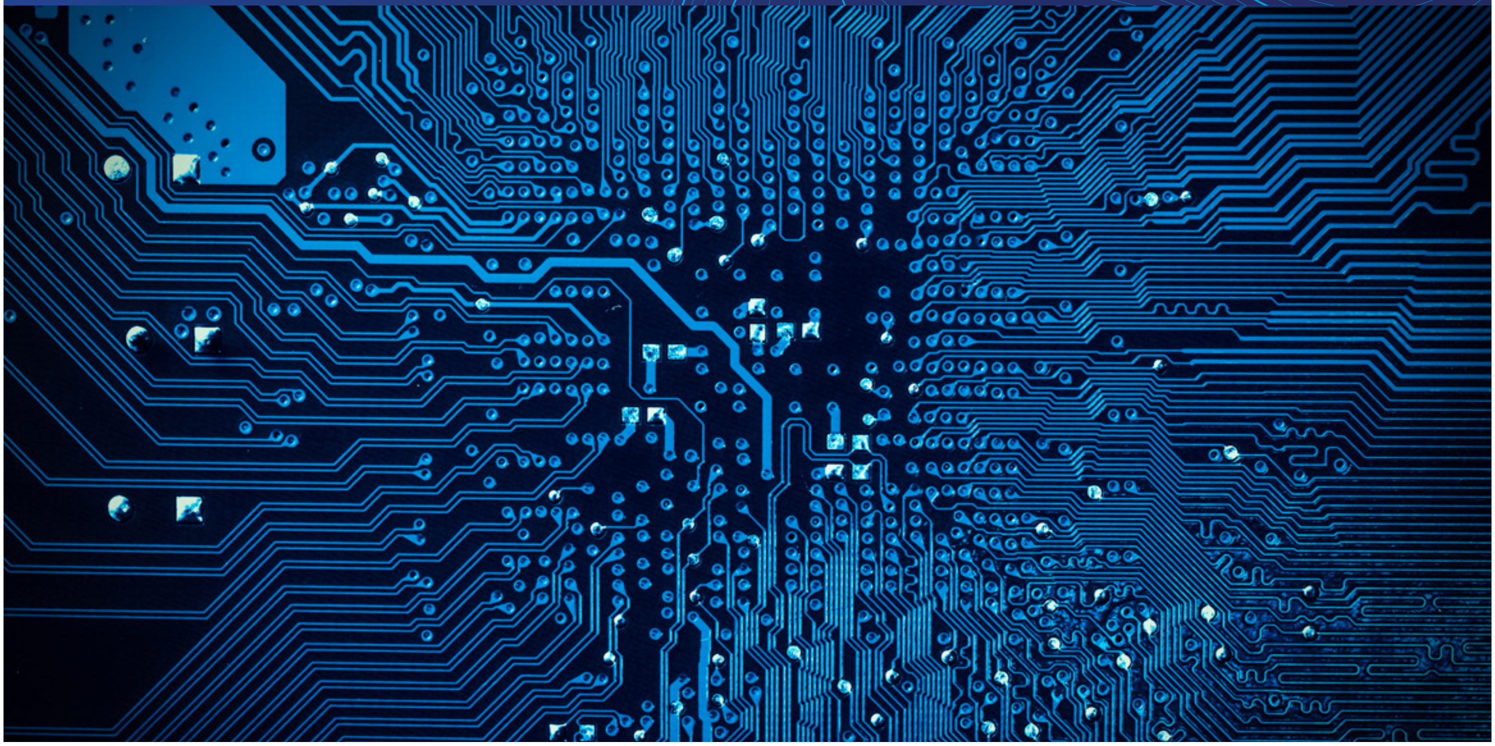

The Small Idea: Semiconductor Capital Equipment

First Eagle's Small Cap team believes small and microcap stocks represent a particularly volatile and inefficiently priced segment of the US equity market—and that these dynamics can create opportunities for disciplined active investment managers. In *The Small Idea* series, the team offers its perspective on some of the themes and trends impacting this large, diverse pool of domestic companies.

In his 1993 classic *Beating the Street,* famed value investor Peter Lynch listed "25 Golden Rules" that summarized what he believed to be the most important lessons learned in his career. One in particular stands out in our minds as we consider today's market environment: "Nobody can predict interest rates, the future direction of the economy or the stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you've invested."[1]

At a time when headlines are dominated by multi-decade-high inflation prints, shifting fiscal and monetary policy, rising interest rates, geopolitical tensions and global health concerns, this golden rule serves as a great reminder of an approach that historically has worked well in the small cap equity market. While we can think of more than a few industries that could benefit from greater investor focus on business execution and opportunity amid the many external distractions, one stands out: semiconductor capital equipment companies.

1. Peter Lynch, *Beating the Street,* Simon & Schuster (1993).

Our work in the capital goods sector has led us to invest in several companies that make equipment to support the production of semiconductor chips and integrated circuits (ICs), ranging from designers and builders of semiconductor manufacturing systems to providers of the equipment and services to test and inspect chips. As value managers, we seek to buy companies that we believe are trading with good value metrics—i.e., that appear cheap—but that also offer very good growth potential. In our view, a small handful of highly specialized semiconductor capital equipment companies are likely to benefit from the current buildout in semiconductor manufacturing capacity worldwide.

Semiconductor manufacturers have been ramping up production in the face of a global chip shortage. Despite new records for global chip sales and units shipped in 2021—$555 billion on 1.15 trillion units—demand continues to outstrip supply.[2] A recent report from the Commerce Department found that median demand for chips—driven in part by a shift to more semiconductor-intensive products in day-to-day consumer use, such as 5G cellphones and electric cars—was 17% higher in 2021 compared to 2019. Buyer inventories have fallen from 40 days to less than five days over that same period, and are even smaller in key industries like medical devices, broadband and autos. Insufficient fab capacity has been targeted as the key bottleneck, and while semiconductor companies in 2021 and 2022 have ramped up capital expenditures at a rate never before seen, ambitious projects take time to come online.[3]

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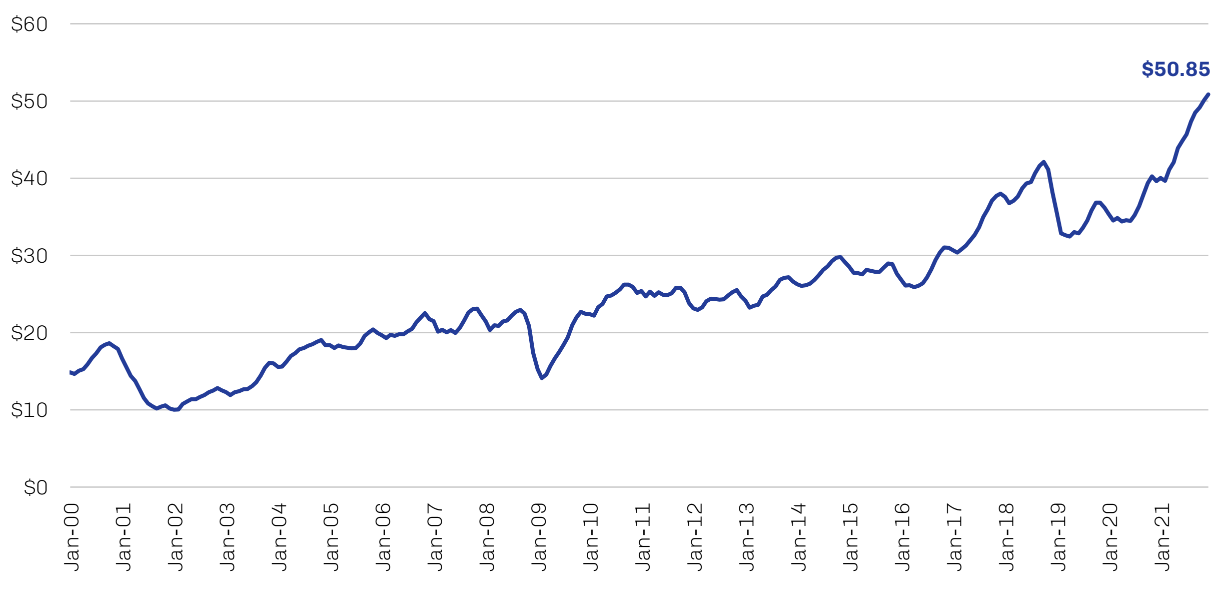
Fast-Growing Chip Demand Has Bolstered Semiconductor Capital Equipment Companies

Monthly Global Semiconductor Revenues in Billions of US Dollars, January 2000 through December 2021



Source: Semiconductor Industry Association; data as of December 31, 2021.

Buoyed by these dynamics, the semiconductor capital equipment companies we own have continued to produce strong earnings and cash flows, and have favorable outlooks well into the next year or so. However, their market values have remained muted, in our view, as the talking heads argue about where we are in the economic cycle or when the next recession will begin.

2. Source: Semiconductor Industry Association; data as of December 31, 2021.
3. Source: US Department of Commerce; as of January 25, 2022.

The US Small Cap team, applying Peter Lynch's wisdom, instead focuses on what is actually happening to the companies we are invested in. So, what *is* happening to the companies making the equipment that has enabled global chip makers to produce more than a trillion semiconductors a year? To put it quite simply, they are busy. Current projects include making equipment for:

- A new $20 billion plant in Ohio
- A $20 billion expansion in Arizona
- Two plants—$17 billion and $30 billion—in Texas
- A $30 billion plant in Europe[4]

The above are just part of the rush among semiconductor companies to adjust supply chains, diversify geographically and expand capacity to meet increasing global demand.

In our opinion, too much attention is paid to the historical cyclicality of the semiconductor industry and not enough on what is actually happening today. Looking back at the industry in the 1980s and 1990s, we can recall a much more "boom-and-bust" market dynamic populated by companies with less-than-stellar balance sheets and product portfolios beholden to the economic cycle more than any other factor.

In contrast, chip demand today is being driven not only by a strong economy but also the need for innovation among buyers seeking to keep pace with their ever-evolving competition. It is being driven by federal governments that believe it is in the national interest to maintain access to chip production and to avoid falling behind in the global chip industry. It is being driven by a vastly broader set of end users than existed before, and we would not be surprised to see demand continue to grow alongside the markets for such modern products and services as electronic vehicles, renewable energy and space travel.

Worrying Smart

Another of Lynch's golden rules states that "there is always something to worry about." By focusing our concerns on the performance and prospects of the semiconductor capital equipment businesses in our portfolio, however, we rest easier in the belief that these companies—which possess highly specialized technical expertise that represents a very higher barrier to entry for potential competitors—are well-positioned to provide the equipment, technology and services needed to meet the growing demand for chips.

4. Source: Company reports; as of February 22, 2022.

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