Two S&P 500 Companies with Valuation Adjusted for Net Cash and Debt on Balance Sheet

	DOW	Alphabet
Market Cap	31,118	975,325
Share Price	42	1,429
(Net Debt)/cash	(16,614)	100,425
Shares Outstanding	741	684
Next FY Estimated EPS	2.64	55.1
Vanilla PE	16x	26x
Adjusted PE	24x	23x

Source: Bloomberg. Financials as of 03.31.2020, prices as of 06.19.2020.

Warren Buffett has taken some hits in the popular press here of late, not putting his cash to work at the bottom of the market; but, at least he had the ability to put excess cash to work if he had so desired. According to Bloomberg, in the U.S., there have been 306 equity issuances totaling $99 billion this quarter, with many in the top 10, such as Softbank and Southwest Airlines, raising cash to shore up damaged balance sheets amidst the challenging economic environment brought on by COVID-19. As Warren Buffett notes, cash is not thought about when present, but becomes the only thing in mind when absent.

One area where our investment pillars blend with the potential benefit of our clients is when strong balance sheets and valuation can combine to create opportunity. While other investors may seek to have their return on equity boosted by a company taking on excessive debt, we look for companies that can generate attractive returns on capital without depending on excessive leverage. Moreover, in many cases we own companies that have attractive returns on equity while also having sizable stockpiles of cash (rather than debt) on their balance sheets. We believe the cash provides optionality for the company to increase returns for shareholders in the future, while also providing a margin of safety in the present. Cash rich companies can take the cash on the balance sheet and:

- Make an accretive acquisition
- Deploy or increase the dividend
- Repurchase shares and reduce the share count

How does one take into account this potential future firepower? One way is to adjust a company's valuation for the cash. Above is an example of two large cap stocks, one of which, Alphabet, is owned in a number of Sterling equity strategies. A price-to-earnings ratio is a typical valuation assessment for most stocks and is useful because it is so common. However, this valuation ratio may not take into account the strength of the balance sheet. As seen above, DOW stock appears less expensive on a "vanilla" price-to-earnings ratio relative to Alphabet. But, if one gives credit to Alphabet for its $100 billion in cash on the balance sheet and simply deducts the cash from the market capitalization (share price x shares outstanding) while doing the same for DOW, suddenly Alphabet appears less expensive than the chemical company.

S&P 500 Non-Financial Companies Ranked by Cash on Balance Sheet

1	Alphabet	$100
2	Apple	$74
3	Microsoft	$54
4	Facebook	$49
5	Cisco	$42
6	Humana	$9
7	Nvidia	$9
8	Regeneron	$7
9	Electronic Arts	$5
10	Paccar	$4

Source: Bloomberg, in billions

We believe the beauty of active management is the ability to create portfolios that concentrate on unique companies, such as those that possess high cash balances (versus debt) on their balance sheets. Perhaps it won't surprise you that companies with more cash than debt are a minority of stocks in the S&P 500 (16% as of March 2020, excluding financial service companies that can skew the data). While analyzing who has the most cash can be calculated by assessing cash relative to overall market capitalization or total assets, we've chosen simply to list those with the most cash on an absolute basis above. Here, Sterling equity strategies own the majority of the top five across its product suite. Through our holdings, we believe a strong cash position can offer value in good and challenging times, and seek to assess the value of strong cash positions in our work.

As always, thank you for your interest and trust managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is an equity portfolio manager. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation.

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