GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Investment Insight

Why GVA Focuses on Internally Financed Companies

GVA's investment approach focuses exclusively on cheap companies that have positive free cash flow[1] and positive Shareholder Yields.[2] FCF is a powerful metric in investing and it is the key metric within management's control. GVA looks for companies that generate enough FCF to maintain their assets, finance their growth, and return what is left to shareholders. GVA's research shows that companies that generate positive FCF and positive Shareholder Yield outperform the market.

FCF can be allocated in the following ways:

1. Reinvest in the business to maintain assets and finance growth
2. Pay a dividend
3. Repurchase shares
4. Pay down debt

$\left.\begin{array}{l}\text{2. Pay a dividend}\\ \text{3. Repurchase shares}\\ \text{4. Pay down debt}\end{array}\right\}$ Direct and indirect returns to shareholders

Capital allocation discipline is a key driver of stock price performance. Shareholder Yield is a calculation of how effectively management is allocating its FCF. Dividends are a direct measure of how much cash is being returned to shareholders. Share buy backs and debt reduction are indirect returns to shareholders. We include net change in debt to ensure that management teams are not returning cash to shareholders simply by raising debt.

Companies that have a high Shareholder Yield are often paying dividends, buying back shares, AND paying down debt. Sustainability of FCF and positive Shareholder Yield is a strong signal of a good business and management capital allocation skill – an essential driver of long-term outperformance.

Internally Financed vs Externally Financed:

If a company plans to growth their business, there are only 3 sources of funding at their disposal:

1. Cash flows
2. Debt financing
3. Equity issuance

Companies with high levels of FCF are often able to internally finance their own growth. Conversely, companies with low or negative FCF are forced to rely on external financing (debt financing or equity issuance) to drive growth. Our research shows that internally financed companies structurally outperform externally financed businesses.

The chart below summarizes the annualized excess returns of internally financed vs externally financed companies in the MSCI ACWI Ex-USA Small Cap Index (2003-20017). Companies are grouped into quintiles, based on the levels of external financing needed.[3] Quintile 1 is made up of companies who grow their businesses exclusively through internally generated FCF. This group produced the highest annualized excess returns over time at +4.5% vs the Index.

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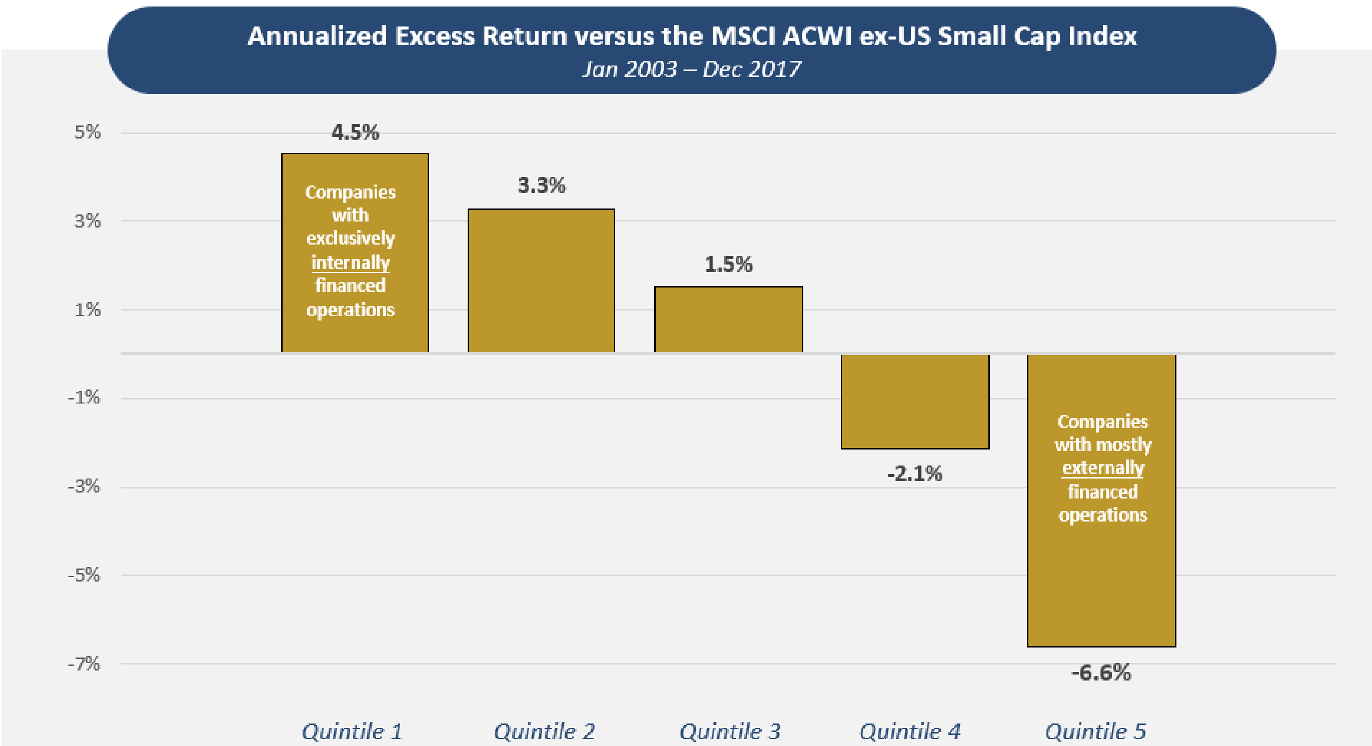
[1] FCF = Cash from Operations – Capital Expenditures
[2] Shareholder Yield = Dividends + Net Buy Backs + Change in Debt
[3] Quintiles are defined = (free cash flow + change in equity + change in debt)/sales

It is worth noting that the excess returns deteriorate in a linear fashion as we move from quintile 1 to quintile 5. Companies in quintile 5 are relying mostly on external financing to grow their businesses. Investing in these companies produced an annualized excess return of -6.6% vs the Index.

Internally financed companies structurally outperform externally financed businesses

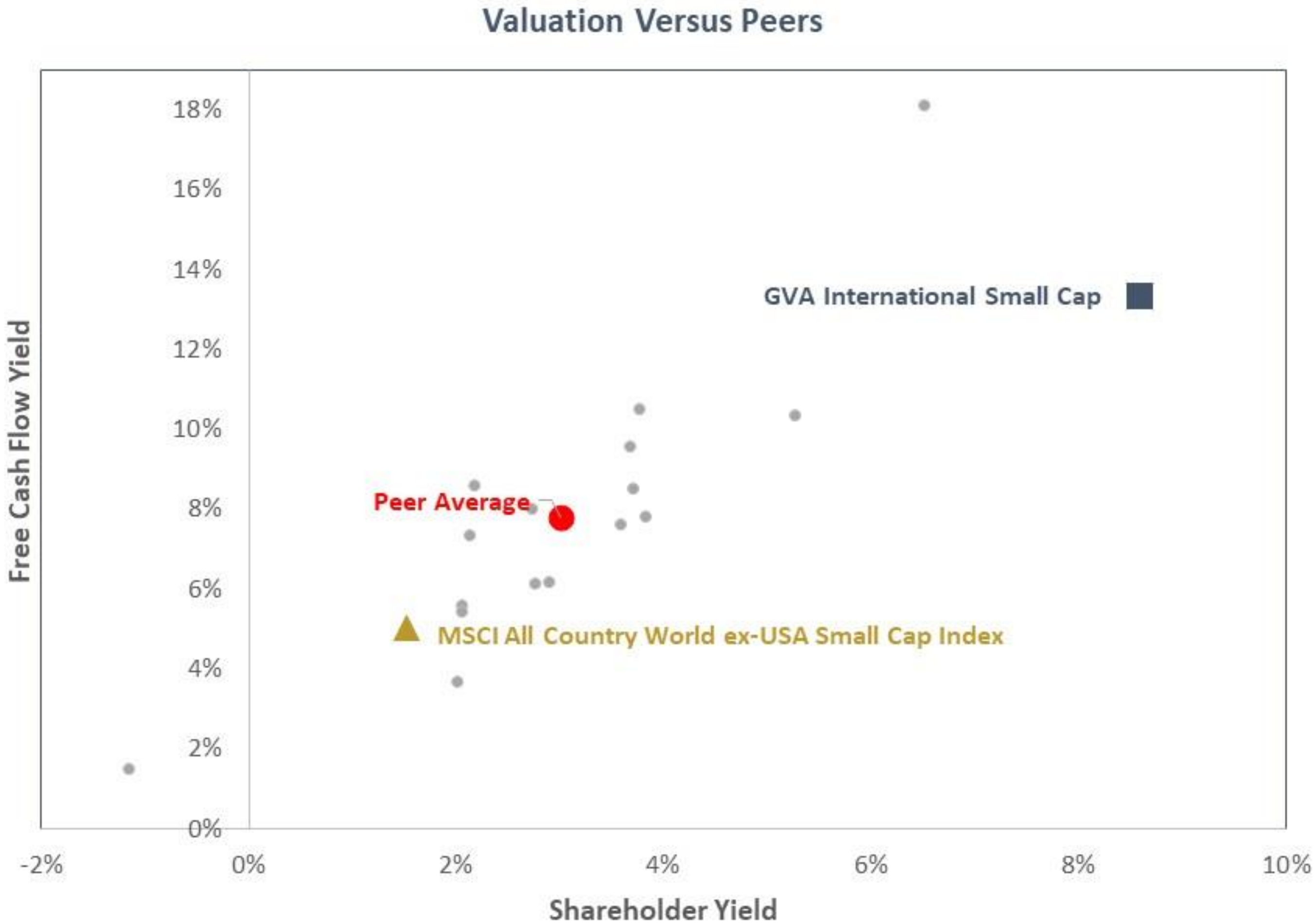


Source: FactSet. Quintiles were formed using the following ratio: (fee cash flow + change in equity + change in debt) / Sales applied independently to each industry. Returns are equally weighted and are industry group neutral.

GVA also applied this analysis to each industry independently and the results were consistent across business types (contact GVA for details).

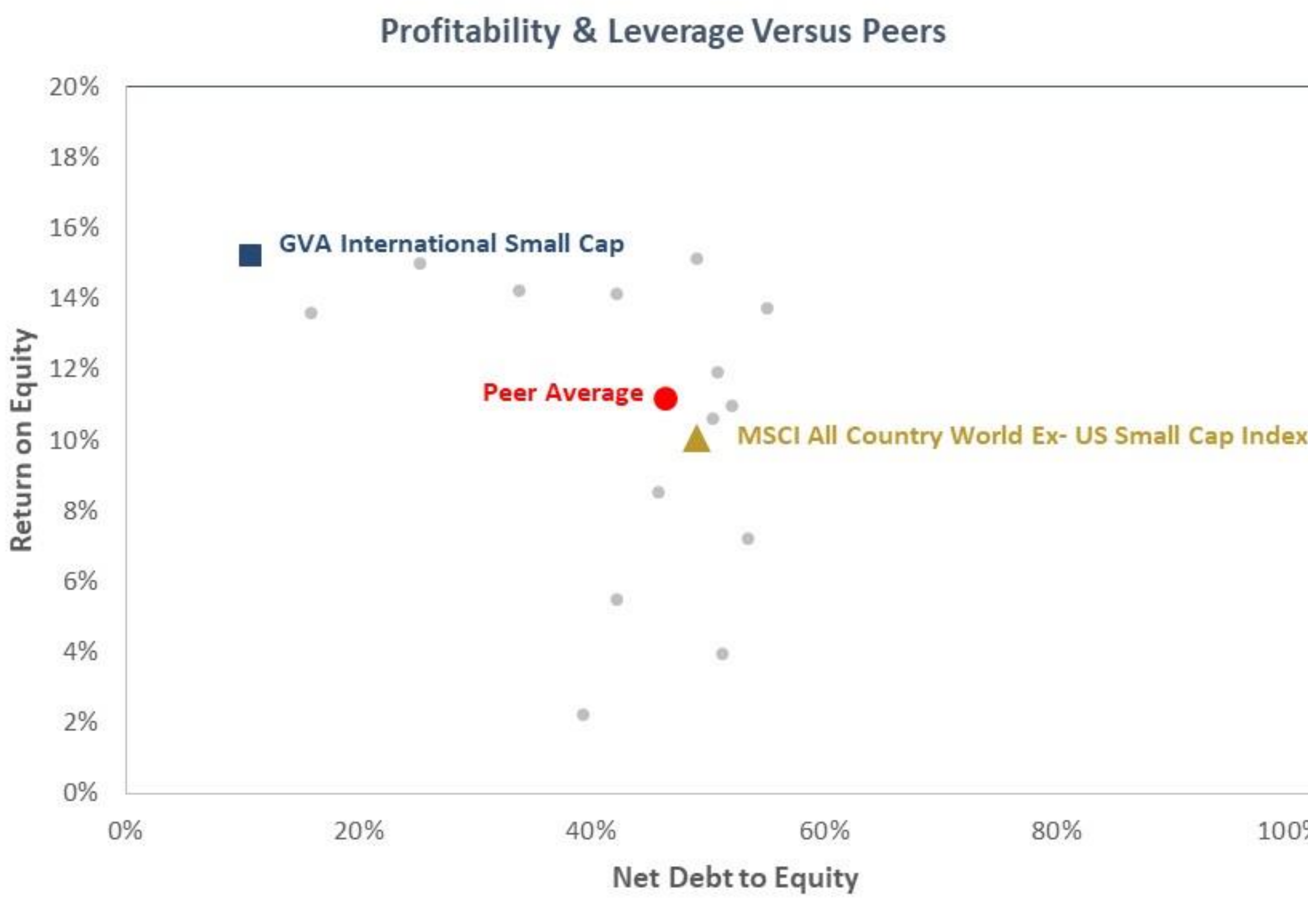
GVA has a high exposure to companies that internally finance their growth. Evidence of this can be seen at the portfolio level. GVA's portfolios hold companies with best-in-class free cash flow and very low levels of debt. Below is a snapshot of GVA's Small Cap International portfolio positioning vs the index and peers.

GVA's Disciplined Methodology Ensures Very Cheap Positioning Within a Structurally Advantaged Subset of the Universe



Source: Morningstar constituents in the Foreign Small Mid Value category and eVestment's universe is the MSCI All Country World Ex-US Small Cap Value (mutual funds constituents) as of June 30, 2020. Aggregate metrics are derived from the most recent quarterly reported holdings ex-financials and analyzed in Factset. Past performance is not indicative of future results.

GVA's Portfolios Are Very Cheap
While Delivering Superior Profitability And Balance Sheet Strength



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