

CUSP Managers Sell Skyworks and Hold Applied Materials

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We analyzed two companies in the Information Technology sector during April 2022. We proposed selling Skyworks from the CUSP and continuing to hold Applied Materials in the portfolio. The CUSP portfolio managers agreed with our recommendation. Our rationale for each recommendation follows.

Skyworks is involved in designing, manufacturing and selling a variety of semiconductor products, including intellectual property. The company's analog-related semiconductors have an array of applications within aerospace, automotive, broadband, cellular infrastructure, smartphones and other devices. Our analysis revealed Skyworks has valuation metrics similar to those of the other semiconductor companies in the CUSP, with a P/E ratio of 17.6 and an EV/EBITDA ratio of 13.7. They do not exhibit the elevated valuation metrics we often see within the IT sector, especially given Skyworks's 11% estimated revenue growth forecast for the coming year. While Skyworks has seen strong growth in past years, we believe they are susceptible to fairly large downside risk due to their significant reliance on Apple as a customer.

In fiscal year 2021, Apple was responsible for roughly 59% of Skyworks' total revenues. The next largest customer was Samsung at about 6% of total revenue. This is concerning given concerns about Apple's plans to further its vertical integration. According to a recent Bloomberg report, Apple is currently building out a team of engineers to develop its own wireless chips. Apple's efforts could eventually replace several of the components Skyworks produces for Apple. In July of 2021, Skyworks continued its efforts to diversify away from its reliance on Apple with a \$2.4 billion acquisition of the automotive and infrastructure businesses of Silicon Laboratories. This acquisition will give Skyworks further exposure into chips utilized in autonomous vehicles, 5G wireless infrastructures and several other innovative spaces. While we view this as a positive move, we believe the downside risk of losing Apple as a primary client is substantial. Given this risk and our belief the company is fairly valued, we recommended Skyworks be sold from the CUSP. The portfolio managers voted in favor, and the position was liquidated in April 2022.

Applied Materials (AMAT) is also a current part of the IT sector of the CUSP. AMAT provides manufacturing equipment, services and software to the semiconductor and display related industries. The company operates through three primary business segments: Semiconductor Systems, Applied Global Services and Display and Adjacent Markets.

At the time of our analysis, Applied Materials had a P/E ratio of 15.7 and an EV/EBITDA ratio of 16.8, valuation metrics that are generally in line with other semiconductor foundry equipment stocks. Given Applied's strong reputation and prospects within the industry, we believe the firm may actually be somewhat undervalued. Applied Materials has consistently generated strong and reliable cash flows in recent history, including a 46.5% growth in **Cash Flow** from Operations last year. Applied Materials pays a dividend (yield of 0.87%) and is participating in share buybacks (7.76% of shares over the past three years), which we expect will continue in the future. Lastly, Applied's management is projecting a 14% increase in sales this year coupled with a 17% increase in their EPS due to growing demand from their global customers.

Applied Materials has a diversified customer base with no single customer making up more than 15% of revenues. We like AMAT because of its conservative valuation, growth in revenues and cash flows and efficient use of cash flow for acquisitions, dividends and share repurchases. Add to that, the firm is forecasting continued strong operating margins and bottom-line earnings forecasts, and we believe Applied Materials remains a solid investment. The CUSP portfolio managers voted to retain AMAT in the portfolio.