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The Global Supply Chain Issue, Inventory and What it Means

Supply chain issues have been talked about ad nauseum. The Fed points to it as a reason we have inflation today, which is partially/largely true – at least in the near term. What I think is less understood, is that it's not getting better. Some of that is shipping and logistics. Other bottlenecks are because of semiconductor shortage. Labor is also an issue in some cases. That means inflation is likely to hang around longer, which means the Fed is likely to be more aggressive, and which increases the potential risk they get it wrong and hurt the recovery.

Understanding the inventory situation can be critical to understanding cyclical risk. Why? Because the inventory cycle plays out within a business cycle. Cyclical companies tend to begin a business cycle with low levels of inventory. Suddenly, demand begins to pick up for their products, and they start to produce more. Early on, demand continues to grow faster than they ramp production, and inventory remains low/in balance. Then demand growth slows, but production can remain elevated and inventory builds. Ultimately demand falls, and companies are typically slow to reduce production, which exacerbates the cyclical downturn. That leads to revenue falling more than demand, layoffs, losses, and big "one-time charges" as companies right-size their business.

Given increased uncertainty around global growth, and whether tightening monetary policy (especially in the US) will ultimately destroy demand, understanding the inventory situation and paradox can be important.

Let's look at two different companies that just reported and lowered revenue growth forecasts for 2022 – both largely due to supply chain issues. The first is F5 (Ticker: FFIV and represents a 2.0% position in MGMT as of 1/28/2022). The second is Lam Research a company we are not invested in (Ticker: LRCX and represents a 0% position in MGMT as of 1/28/2022). Both are selling to fundamentally strong demand – data growth/networking in the case of F5, and growth in the semiconductor fabs (i.e. production) for Lam.

Below is a quarterly look at F5's inventory, starting from Q4 '19, right before the pandemic started. The chart that follows is their Revenue during that same period. This is a very abnormal relationship. When companies see sales rise, they start building more product. Almost always. In the case of FFIV, they haven't done that –due to supply chain constraints. And thus, **inventory turnover has doubled**.

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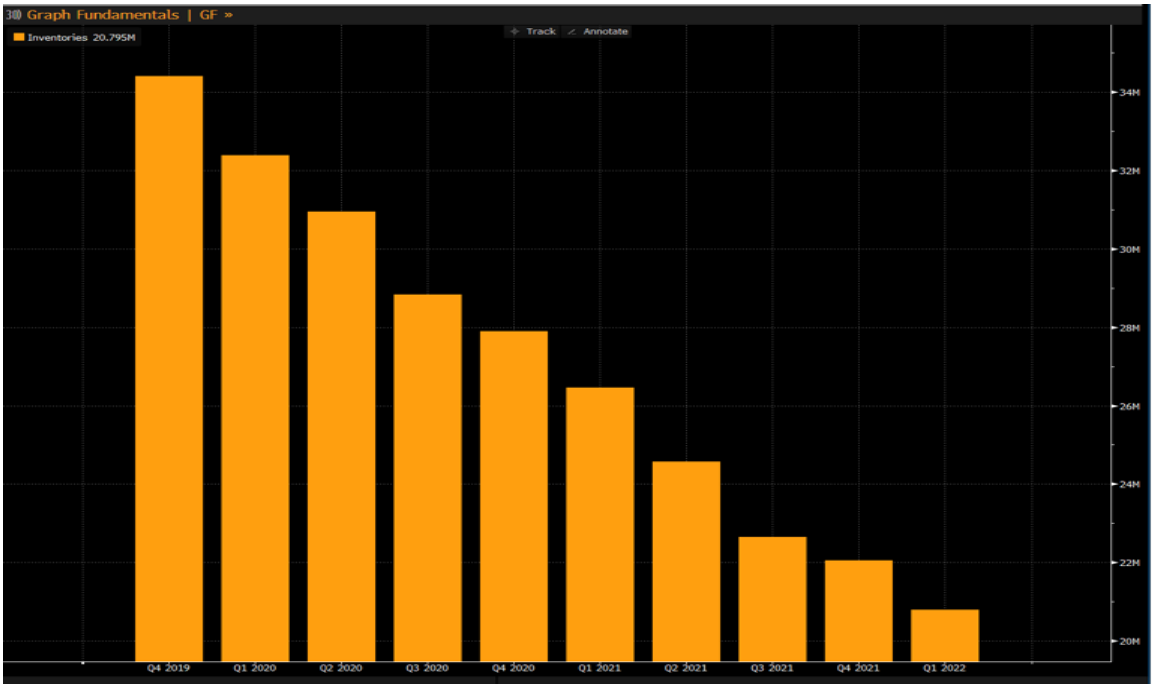
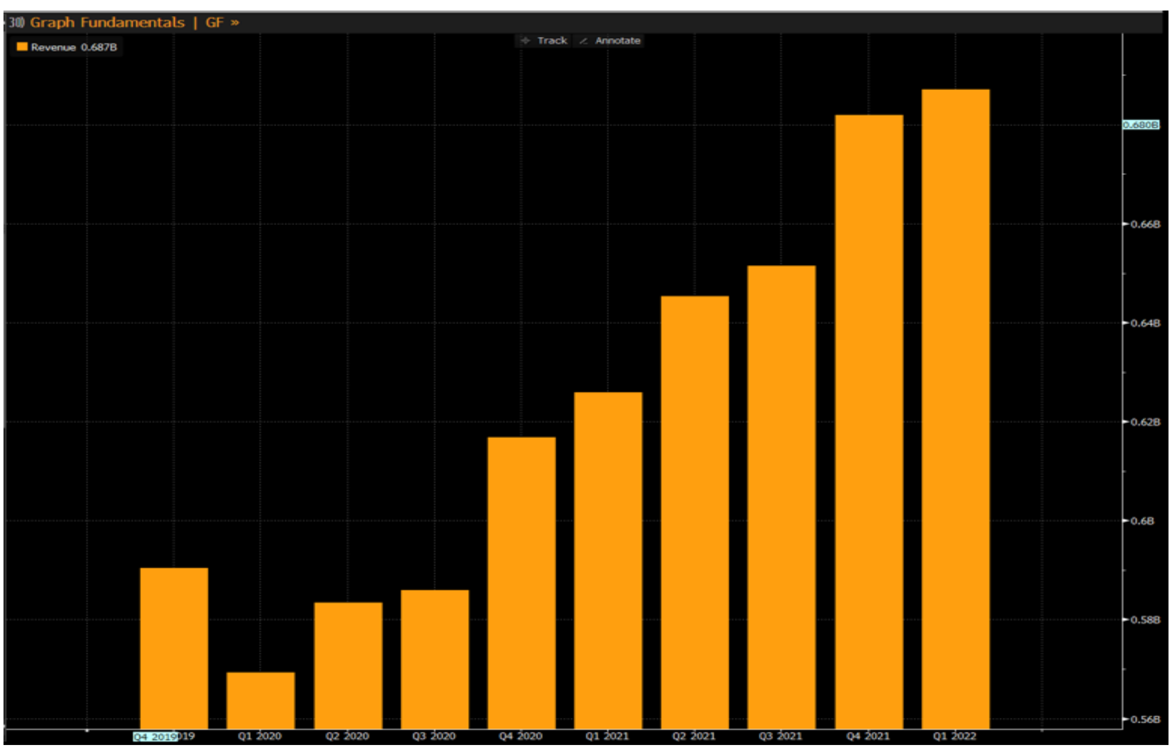
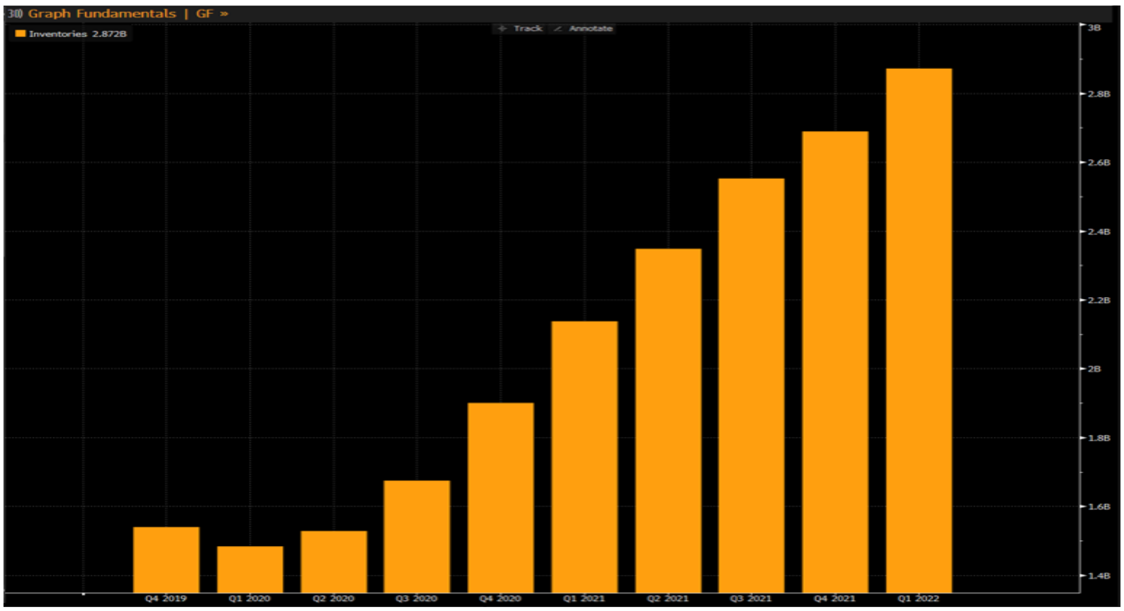


Source: Bloomberg



Source: Bloomberg

Lam Research (a semiconductor equipment company) that also just reported, and based on supply chain constraints projected for more subdued guidance revenue growth. However, their inventory to revenue relationship is different. Inventory on the left, revenue on the right. This is a more typical relationship. Inventory turnover and Days Inventory Outstanding hasn't really changed much over the last two years.



Source: Bloomberg

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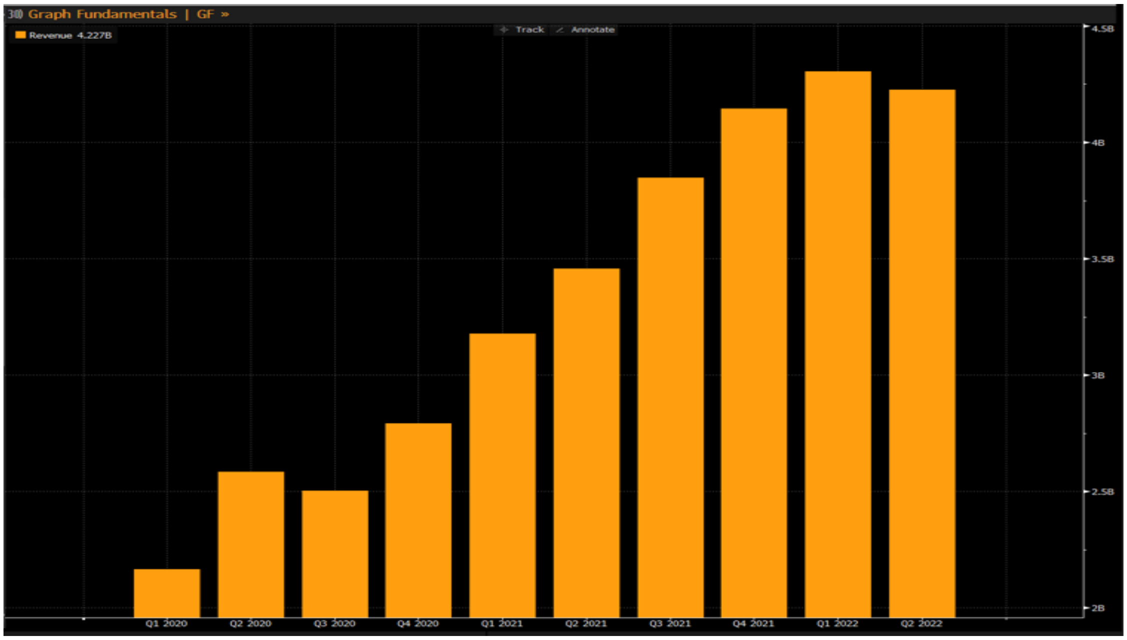

Source: Bloomberg

Both stocks are cyclical and will likely go down when their respective cycles are over. However, we believe the risk associated with F5 (and companies in this inventory position) is much lower. It's 2 turns cheaper (EBITDA multiple) and both are in a net cash position. Both have pretty good visibility into 2022 demand for their products. The difference we also believe, all else equal, is F5 should have a longer runway, and if the music stops early, less difficulty managing the downturn.

Please visit www.mgmtetf.com for more information on MGMT, an active smallcap and midcap ETF managed by Ballast Asset Management.

Best,

Ragen Stienke

Important Risk Information

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