

Case Study: Lam Research (LRCX) — Too Cheap to Ignore, Eight Years On

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Buy world-class businesses, don't overpay, and let compounding work its magic.

I run a concentrated, quality-focused equity strategy: roughly 120 businesses I know well, evaluated against the same checklist every time, held with a multi-year horizon. What follows is one real example of that process — Lam Research (LRCX), the semiconductor-equipment maker, which I first wrote up in February 2018 and returned to in depth in October 2018 in a presentation titled *Too Cheap to Ignore*, published on SumZero and syndicated by ValueWalk and Barron's. It sets out the checklist as I applied it then, and what the business and the stock did over the following years, to September 2026.

What happened

The call itself. The October 2018 write-up was published at \$141.27 (\$14.13 on today's basis, after the ten-for-one split of 2024). On 24 September 2026 Lam closed at \$307.16. Put simply, \$1 million invested at the price of the call would have grown to about \$21.7 million — about 47% a year for just under eight years — and to about \$24 million with dividends reinvested. The same \$1 million in the S&P 500, with dividends reinvested, would have become about \$3.2 million (15.6% a year).

The business did about a third of the work; the market's re-rating did the rest. Between fiscal 2018 (the year to June 2018) and fiscal 2026, revenue grew from \$11.1bn to \$23.2bn and net income from \$2.4bn to \$7.3bn. With the share count down 30%, free cash flow per share grew about 2.9 times — a compound annual growth rate of about 14.4%. That accounts for roughly a third of the return. The rest came from the market paying far more for each dollar of that cash flow than it was willing to pay in 2018: the price was wrong, and it corrected.

The forward projections. My SumZero target, set with the October 2018 write-up, was \$300 (\$15 of earnings per share at 20 times) within two years. The stock reached \$364.96 in October 2020, about 22% above the target, when trailing earnings per share were \$15.12 — within 1% of the \$15 projected. In July 2020 I raised the two-year target to \$500 (\$25 at 20 times); it was cleared by the end of 2021, inside eighteen months. Both projections were right on the earnings and conservative on the multiple.

The price question

Nobody in 2018 disputed that Lam was earning a great deal of money. The dispute was whether it could keep doing so. At the call Lam traded at about 5 times enterprise value to EBITDA, 8.5 times enterprise value to free cash flow and under 11 times trailing earnings — the cheapest in its peer group (KLA at about 9 times EBITDA, Applied Materials at about 7) and about 40% below its high of \$234. A buy-side reader asked the obvious question in the thread: *"do you believe we are on the wrong side of the near term semi-cap cycle?"* My answer was that the criticism would fit Micron, not Lam, and that at 5 times a great deal of bad news was already in the price. Earlier that year Credit Suisse had gone further, calling Lam *"the most attractive buyout candidate among Semicaps."*

The same call had been made twice, independently. I first published on Lam in February 2018, at around \$168. Through the second half of the year the whole semiconductor sector sold off. I went back

through the numbers, found the business had only grown stronger while the stock had grown cheaper, and republished a fuller version in October at \$141.27 — the same conclusion, reached twice, eight months apart.

Eight years on, the price question has a clear answer. At the call the stock stood at under 11 times free cash flow per share; on 24 September 2026 it stood at about 63 times the free cash flow of the twelve months to December 2025 (79 times on the latest twelve months, which a temporary slowdown in customer payments has held down). Free cash flow per share grew 2.9 times; the multiple rose roughly sixfold. That is what buying a world-class business when the market prices it as broken can deliver.

What kind of business, and what kind of price

Free cash flow per share can compound in three ways: a business can grow the cash flow itself, through a durable competitive position and high returns on capital (the permanent compounder); it can shrink its share count by buying back its own stock at sensible prices (the cannibal); or it can buy cash flow, acquiring smaller businesses cheaply and without issuing shares (the serial acquirer). Lam is the first kind, and the presentation opened on it: *"A world class business trading at a mouth-watering price level."* It has also been a determined second kind: since 2018 it has bought back almost a third of its shares.

Price opportunities come in two kinds. In one, a great business suffers a temporary setback and the market prices it as if the damage were permanent, so it trades at a substantial discount to fair value. In the other, nothing is wrong and nothing is cheap: the business is fairly priced, and the return comes from the compounding. Lam in 2018 was the setback case. The market was pricing it as if it carried the same boom-and-bust economics as its customers, the chipmakers. The numbers said otherwise. Between 2013 and 2018 Micron's gross margin swung between the teens and the thirties before jumping to 59%, while Lam's rose steadily to 46.6%. Micron had four years of negative free cash flow between 2004 and 2017, and in the twelve months to mid-2018 generated 13 times its average of the previous three years; Lam had one negative year (2009), and in the same twelve months its free cash flow was 1.8 times its average of the previous three years. Lam makes the equipment, not the chips, and about a quarter of its revenue came from servicing and upgrading an installed base that lasts twenty-five years. The market had the wrong business model priced in.

Linearity: why it matters

The principle behind everything that follows. A world-class business shows linearity: its revenue, earnings and free cash flow per share rise steadily, not in fits and starts. That steadiness makes it predictable. Predictable and sustained growth over many years gives its free cash flow quality — cash that can be counted on, not cash that happened to arrive. The market recognises that quality and pays a higher multiple for it, which is why such businesses are seldom priced cheap. So a world-class business becomes a world-class investment only through the price paid for it. Bought at fair value, the compounding does the work. Bought during a temporary setback — when the market prices a passing problem as if it were permanent — the investor gets the compounding and the multiple re-rating as well. Lam in 2018 was the setback case.

I measure that steadiness as the correlation of a series with time, using half-yearly figures: a perfectly straight line rising scores 1, and around 0.9 and above is what I look for. Lam is where the measure has to be read with judgement, because it serves a cyclical industry. The thesis never claimed Lam was free

of the cycle; it claimed Lam was far less exposed to it than the market assumed.

On trailing-twelve-month figures at every half-year from December 2012 to June 2018 — the period the 2018 notes chose, *"given the transformative Novellus acquisition"* — Lam scored 0.95 on revenue, 0.94 on net income, 0.92 on free cash flow and 0.92 on free cash flow per share.

Since the call, on the same basis, the scores were 0.87 on revenue, 0.84 on net income, 0.84 on free cash flow and 0.89 on free cash flow per share — just under the line I look for, through two industry downturns, in 2019 and 2023–24. The line bent; it did not break. Free cash flow per share went from \$1.32 to \$3.88, about 2.9 times (a compound annual growth rate of about 14.4%).

The checklist, applied

The criteria are the same for every business: easy to understand and not exposed to obsolescence; a durable moat that shows up as pricing power; leadership in its industry; margins above the average business and stable or rising; a long record of high returns on capital; sustained operating leverage; durable economic goodwill — low capital needs; copious free cash flow; a strong balance sheet; management that allocates capital in shareholders' interest; a strong likelihood of continued growth; and a price that does not require heroic assumptions. The 2018 presentation took them one at a time. Here is each, as it stood then and as it turned out.

A leader in its industry. Lam's share of industry equipment spending rose from 14.2% in 2013, the first full year after the Novellus merger, to about 21% in 2017, and the company was aiming for about 27% by 2021. Revenue was \$11.1bn in fiscal 2018 and \$23.2bn in fiscal 2026, about 10% a year compounded.

Likely to be around in ten or fifteen years; little obsolescence risk. The 2018 case was that data would keep multiplying — data centres, cloud, artificial intelligence, 5G, cars — and that every chip needed to store and process it is made on equipment like Lam's. Micron's chief executive put it that year: *"AI is in the very, very early innings."* Fiscal 2026 revenue was a record.

A sizeable moat. Lam's installed base is an annuity: spares, service, upgrades, refurbishment, software and training over a machine's twenty-five-year life earn more than the original sale. Between 2013 and 2017 installed-base revenue grew about 90% while the installed base grew about 50%. The chief financial officer called it *"an annuity that just keeps going."* The margins below are the evidence that the moat held.

Margins well above the average business, stable or rising. Gross margin rose from 39.0% in fiscal 2013 to 46.6% in fiscal 2018, and to 50.5% in fiscal 2026. Operating margin went from 29.0% in fiscal 2018 to 35.3% in fiscal 2026.

A long record of high returns on capital. In 2018 return on equity was about 35% and return on invested capital about 25%, both rising steadily since the merger. In fiscal 2026 return on equity was 58%. (As cash has gone back to shareholders the equity base has shrunk relative to earnings, so the figure now says something about the buybacks as well as the business.)

Sustained operating leverage. Operating leverage is how revenue growth turns into faster profit growth. Between 2012 and 2017 Lam grew operating income at more than 1.9 times the rate of revenue, and earnings per share at 46% a year. From fiscal 2018 to 2026 revenue rose 110%, operating income 155% and earnings per share 337% — operating income 1.4 times faster than revenue, and earnings per share three times faster, with the falling share count doing much of the

second.

Durable economic goodwill. This is the test Buffett set out in the appendix to his 1983 letter, and the cornerstone of my screening: a high return on net tangible assets that does not need heavy capital spending to sustain it. In 2018 Lam's free cash flow was more than 50% of its tangible book value including cash (up from about 25% in 2013), and more than 100% of it once the net cash is set aside; capital spending had fallen from 4.5% of revenue to 2.5%, and each \$1 of it went with \$8.70 of free cash flow, up from \$3.50. In total over the ten years 2009–2018 Lam spent \$1.4bn on capital expenditure while generating \$8.5bn of free cash flow — about \$6 for every \$1. Over the eight years 2019–2026 it spent \$4.0bn while generating \$29.8bn — about \$7 for every \$1, even as capital spending rose back to 4.2% of revenue in fiscal 2026.

Copious free cash flow. Free cash flow was 21.5% of revenue in fiscal 2018 and 21.1% in fiscal 2026. The presentation's comparison still makes the point: in the twelve months to mid-2018 Lam generated \$2.2bn of free cash flow — against \$8.2bn in the fourteen years 2004–2017 combined, with only one negative year.

A strong balance sheet. In September 2018 Lam held \$3.9bn of cash and investments against \$2.4bn of debt — \$1.5bn of net cash — and \$3.5bn of tangible equity. Set the net cash aside and the operating business was running on about \$2.0bn of tangible equity, against \$2.25bn of trailing free cash flow: a free-cash-flow return on tangible equity, net of cash, of more than 100%. In June 2026 Lam held \$5.6bn of cash against \$3.7bn of debt, net cash of \$1.8bn, after returning more than all of its free cash flow to shareholders.

Shareholder-friendly management with a record of good capital allocation. The presentation pointed to three things: a commitment to return at least 50% of free cash flow over five years; about 88% of free cash flow returned between 2013 and June 2018; and a 120% increase in the quarterly dividend, to \$1.10 (\$0.11 on today's basis). On the same measures since: over fiscal 2019–2026 Lam returned \$31.1bn, 104% of the free cash flow it generated; the quarterly dividend has risen to \$0.33, about 14% a year compounded; and the diluted share count has fallen by 30%.

A strong likelihood of continued growth. At its March 2018 investor day Lam set out a model for 2021: revenue of \$14.5–15.5bn, an operating margin of 32–33% and earnings per share of \$23–25 (before the split), assuming industry equipment spending stayed flat. In calendar 2021 Lam delivered revenue of \$16.5bn, an operating margin of 32.2% and earnings per share of \$32.47 on the same adjusted basis. In fiscal 2026, the twelve months to June 2026, revenue was \$23.2bn, the operating margin 35.3% and earnings per share \$5.76 (\$57.60 before the split) — on reported figures, against the 2021 model's \$14.5–15.5bn, 32–33% and \$23–25.

Three judgements in the piece, checked

On capital allocation, a reader asked whether Lam would raise its dividend or buy back stock. I suggested a major buyback — \$5 billion, affordable from \$1.5bn of net cash and less than two years of free cash flow. On 23 January 2019, three months later, Lam's board authorised a \$5 billion share repurchase, stating that *"funding for this repurchase program may be through a combination of cash on hand, cash generation, and borrowings."*

On the cycle, the reader who asked whether we were on the wrong side of it was right about the near term: revenue fell 13% in fiscal 2019. But free cash flow rose that year, to \$2.9bn, and the stock closed above its March 2018 high in September 2019, eleven months after the call.

On growth, the 2021 model assumed flat industry spending, and Lam beat it on revenue, matched it on margin and beat it on earnings. Part of that beat belongs to the industry rather than to Lam, because spending did not stay flat. The presentation's point was narrower: the business did not need a boom to grow.

It was not only the buyback call that was tested in public. The write-up drew unsolicited engagement from people whose job is to stress-test exactly this kind of call: the COO of a well-known long/short hedge fund wrote in with detailed capital-allocation questions and, more than a year later, followed up unprompted to note the call had worked; an analyst covering the sector at a large asset manager asked for help framing questions ahead of a management call; and portfolio managers and analysts at a European asset manager, a US fund and a large diversified asset manager engaged with the thesis over the following two years — one noting in March 2020, seventeen months in, that it *"has been a great call so far."*

This is a specific, dated call, made twice, independently, checkable against public filings and a public research platform, and argued with in real time by people who had no reason to be generous. It's the standard I hold every idea in the portfolio to — not just this one.