Value Investing: Applying Graham and Buffett

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments
- For short term traders and technical analysis adherents:
 - This talk is about fundamentals and long term investing (usually 6 months to "forever")
 - I will not cover any topics of how to integrate TA or trading with value investing
- This talk covers the way I practice Value Investing, there are other ways to value invest that are not covered
 - Not exact Buffett and Graham but my adaptation

Value investing - buying something cheaper than for what it is worth

- Not very useful definition this talk digs into it
- Different value investing approaches
 - "Buffettology" buying cheap earnings in great companies
 - "Net-nets", Graham buying assets cheaply

Buffettology

- Buying stock is buying a business
 - Is it a good business?
 - Is it cheap?
- Is it good business?
 - High ROE
 - High margins
 - Moat

ROE - Return on Equity

- Equity = All assets all liabilities
 - In simple cases: capital put into business
- ROE = Earnings/Equity
 - How much business returns on what you have put into it
 - Buy windmill for \$10K, returns \$1K in electricity production per year = 10% ROE
 - Most businesses more complicated

Good ROE: >15% for last 5-10 years

- Based on cost of capital
- Businesses with lower ROE may not be returning cost of capital to owners
- Examples:
 - NKE 19.80 21.50 22.10 21.20 24.10
 - GRMN 28.90 25.00 23.70 23.80 22.00 26.90 33.00 36.40
- Assumes low debt
 - Usually < 1 D/E or < 0.5 D/E
 - Zero debt is best overcapitalized
 - Can use ROIC if there is debt
 - ROIC = Earnings / (Equity + Debt Cash) = Earnings / (Assets non-debt liabilities - Cash)
- Cash flows vs. earnings

Net margins >10%

- High margins usually indicate some economic moat
 - Pharmaceuticals, branded goods
- >15% operating margin, >10% net margin
- Possible to buy low margin businesses which are category killers
 - Nike (7-10%), Walmart (3-4%), Cemex(4-8%), BNI (8-12%)

Company should have good moat

- Somewhat indicated by high long term ROE
- Somewhat indicated by high margins
- Subjective analysis
 - Have things changed?
 - Diworsefication buying unrelated low margin businesses
 - Squeezing out returns without regard to risk FNM, monoline insurers
 - Loss of patent protection pharmas
 - New threats newspapers
 - Value chain destruction ratings agencies (Moody's)
 - Fads Krispy Kreme, Crocs
 - New moat creation railroads
- Areas of expertise and areas outside "circle of knowledge"

Is business cheap?

- Value business for its earnings
 - How much money would I make if this was my private company?
- How much money company will make in 10 years?
 - Assuming average ROE what will be the earnings in 10 years?
 - P/E in 10 years?
 - Rate of return?
- Example: NKE
 - Average ROE 20%
 - Earnings in 10 years = ROE*Equity*(1+ROE)⁹ = \$8B
 - Market cap = \$8B x P/E (15) = \$121B
 - Rate of return = ~13% after tax (calculations omitted)
- "Approximately right" calculation
 - Do not decide 13.6 vs 13.2% situations, decide 5% vs 15% situations
 - Discounted cash flow if needed

Caveats

- Very few companies are really "Buffettology" companies
 - \bullet Few examples in these slides may not be true "Buffettology companies" $\ensuremath{\textcircled{\sc on}}$
- Need careful scrutiny
- Usually cheap when something is going wrong is this temporary?
 - New Coke, Amex disasters temporary
 - FNM, FRE gone
 - Moody's?
 - Think and discuss meticulously
- Usually large caps followed by a lot of other people!
 - Are you right while others are wrong?

"Net nets" - Graham - Asset based investing

- Buying a dollar for half dollar
- Still looking at whole business but very different from Buffettology!
- Buy business, sell all assets = PROFIT!
 - Buy antique watch from pawnshop for \$1, sell to collector for \$1000
- Usually small cap
- Usually smelly dinky cigar butt companies
 - Can't boast in a bar! 😊

Is this dollar selling for half-dollar?

- Best: below net cash value = cash + equivalents all liabilities
- Very good: below net current assets = current assets all liabilities
- Good?: below book or tangible assets = tangible assets all liabilities

Analyzing assets

- Cash is king
 - Cash equivalents may not be so! Need to check
- Current assets
 - Inventory how sellable it is?
 - Accounts receivable will company receive them?
- Other assets
 - Plant, equipment does it have any value at all?
 - Land, real estate may be undervalued or overvalued
- Usually no need to analyze liabilities they are all real

Analyzing assets examples

- GSIT 1/2008:
 - Current assets: 78M, liabilities 10M = 68M Net current asset value, 74M book value
 - Sold for 2.3-2.5 x 29M shares = 67-72M cap
- ACTS now:
 - Current assets: 284M, liabilities 20M = 264M Net current asset value, 286M book value
 - Sells for about 2.8, 240M market cap

Beyond assets of net-net

- Earnings of net-net
 - Profitability is preferable even if it is marginal
- Low debt
 - Like in Buffettology
 - High debt companies can go BK even with positive net assets
- Business outlook
 - Perennial net nets: distributors
- Examples
 - GSIT profitable in Sep-Dec 2007, Jan-March 2008, no debt
 - ACTS profitable, no debt

Safety in value investing

- Buffettology
 - Safety of great business
 - Moat ensures that company will continue to earn great return on capital
 - Future earnings returned to shareholders can ensure good return even if there was no stock market
- Net-nets
 - Safety of asset value
 - Company can go private, be acquired, etc.

When to sell value investment?

- Buffettology
 - Hold forever, pass to your kids and so on
 - KO
 - Hold till overvalued expected return of future cash is too low
 - BNI, KO in 2000, MA
- Net-nets
 - Shorter term hold usually up to 2-3 years
 - If does not work out in that time, probably perennial net-net
 - Sell at 1.5-2x book
 - Takeovers, takeunders, etc.
 - Possibly short term capital gains, better in tax protected accounts

What to do when prices drop?

- For most value investments, prices drop after you buy them
- Buffettology
 - If fundamental business has not changed add
 - If fundamental business has materially deteriorated sell
 - In reality decision is difficult, since business usually changes negatively
 - AXP, MCO
- Net-nets
 - If balance sheet has not changed and business is not going to lose a lot of cash - add
 - If balance sheet has deteriorated and company is no longer a net-net OR business is going to lose a lot of cash – sell
- May be possible to use TA, stops, etc.

Value investing resources

- Value investors are cheap \odot
 - Don't buy subscriptions, don't buy charting tools, don't buy Value Line (well, maybe ☺), don't buy mansion, BMW, yacht, etc. ☺
- Company information
 - 10 year data: <u>http://www.gurufocus.com/</u> some errors!
 - 10 year data, graphs only for Quicken users: http://investing.quicken.com/research/evaluator.asp?symbol=nke
 - Recent financial statements: Yahoo Finance, Google Finance, SEC
- Ideas from other value investors
 - Buffett, Berkshire Hathaway news, SEC fillings, etc
 - Whitman, TAVFX letters to shareholders
 - Ariel Fund letters to shareholders
 - Blogs just know which ones are value investors $\ensuremath{\textcircled{\sc o}}$
 - Value Investing Congress

Questions and Future Plans

- Interested in:
- More in depth income sheet or balance sheet analysis talk?
- Value investing meetings analyze concrete companies, stocks, etc.
- Any other suggestions
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