Value Investing:
Applying Graham and Buffett

Raimondas Lencevicius
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
  • Few examples in these slides may not be true “Buffettology companies” 😊

• 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 😊
  - 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: http://www.gurufocus.com/ - 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 😊
  - 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

• Raimondas@hotmail.com