The Five Keys to Value Investing by Jean-Jacques (332.6)

The goal is to obtain adequate and consistent performance. Regardless of the performance of the general market, I am looking for a satisfactory return over time, based on the amount of risk taken.

Today price is important and value matters. Investing in what each corporation was made up of-ideas, products, and management with a specific set of business goals in mind.

Returns go to those who are best at analyzing the available information.

Know the economic reality versus the accounting reality.

Value opportunities:

1. Pure value opportunities, such as identifying significantly undervalued companies or well-run cyclical companies at the bottom of their cycles.
2. Event-driven opportunities, such as corporate restructuring and spin-offs
3. Bankruptcies, and mergers and acquisitions.
4. Search for the true value and the potential catalyst.
5. To begin your journey as a value investor requires sincere drive and hard work.
6. Reading Federal Filings is the center of your effort.

THE MIND OF THE VALUE INVESTOR

Good business + Excellent Price = Adequate Return over Time

Buy companies when their value is deeply discounted. Implementation is not so simple. The art is in assessing a management team or identifying a good business.

Be an analyst: independent work, analytical thinking and a relentless work ethic.

Good value investors:

1. Exude emotional discipline
2. They possess a robust framework for making investment decisions
3. They apply original research and independent thinking.

What is needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.
THE NEED FOR EMOTIONAL DISCIPLINE

Controlling spontaneous reactions and not letting them guide one’s decision making is what having emotional discipline is all about.

Discipline is training oneself to act in accordance with a predetermined set of rules.

Lack of emotional discipline:

We often believe what we want to believe, and tend not to take into account what the facts dictate.

Short on courage, we at times lack the conviction from our own work.
We are often too short-term oriented.

Trading causes a loss through missing critical signals of asset deterioration or a larger, more meaningful investment.

Weak convictions can lead to herd mentality.

Investing is a patient game.

Investors pass through concern, complacency, and capitulation.

OBTAINING EMOTIONAL DISCIPLINE

1. have a disciplined framework

Investing is an individual sport with individual consequences. Your approach and the tools you use must all fit together. The delicate balance between the rigidity and flexibility of techniques and frameworks is the cornerstone in obtaining emotional discipline.

THE SEVEN FUNDAMENTAL BELIEFS

The world is not coming to an end, despite how the stock market is reacting.

Investors will always be driven by fear and greed, and the overall market and stocks will react accordingly. The volatility is simply the cost of doing business.

Inflation is the only true enemy. Trying to predict economic variables and the direction of the market or the economy is a waste of time-focus on businesses and their values, and remember belief 1.

Good ideas are hard to find, but there are always good ideas out there, even in bear markets. Especially in bear markets.

The primary purpose of a publicly traded company is to convert all of the company’s available resources into shareholder value. As shareholders, your job is to make sure that happens. Companies
are also resource conversion organizations—often need a catalyst such a launch of a new product to the break-up of the company.

Ninety percent of successful investing is buying right. Selling at the optimal price is the hard part. As a result, value investors tend to buy early and sell early. Use dollar cost averaging to get the best average price.

Volatility is not risk; it is opportunity. Real risk is an adverse and permanent change in the intrinsic value of the company. Stock price oscillates around value—has the company’s fundamentals changed.

THE FIVE KEYS VALUE FRAMEWORK

Mike Price:

- Buy below asset value
- Management that owns shares
- A clean balance sheet

Five key questions:

- Is this a good business run by smart people?
- What is the company worth?
- How attractive is the price for this company, and what should I pay for it?
- How realistic is the most effective catalyst?
- What is my margin of safety at my purchase price?

First, in business assessment, the value investor focuses on a full range of relevant business and industry issues that affect the value of the enterprise. Including quality of earnings, product lines, market sizes, management teams, and the sustainability of competitive positioning within the industry.

Second, value investors perform fair value assessments that allow them to establish a range of prices that would determine the fair value of the company, based on measures such as normalized free cash flow, break-up, take-out, and/or asset values. Exit valuation assessment provides a rational “fair value” target price.

Why is the company afforded its current low valuation?

Fourth, catalyst identification and effectiveness bridges the gap between the current asking price and what value investors think the company is worth based on their exit valuation assessment. Not all catalysts are created equal.

Never chase a stock.

The MD&A is the most critical filing value that investors read: it puts color behind the numbers.
Varian Associates: I like the business and mgt team. Mgt held ownership in the company.

I valued the company using sum-of-the-parts (enterprise value/EBITDA, FCF and P/EPS, historical valuations and on a deal basis.

**Keep a list of deal valuations announced in the market over time.**

Own the company at a 40% discount to fair value and limited downside.

Downside protection is at a price below replacement value and a level that mgt would go private.

How to get to fair value? Break-up the company.

Varian Associates and the Five Keys of Value Framework:

**Business:** Excellent Company with strong market positions and management teams with a great outlook.

**Value:** Fair value at $55 per share.

**Price:** at $33, buying at a 40% discount to fair value

**Catalyst:** Breaking up the company.

**Margin of Safety:** Downside is 12% with a 67% upside potential, getting an entire division for nothing.

**Chapter 2: Business and industry Assessment**

How do we answer the question: Is this a good business?

Factors for buying a Business:

Earnings and cash flows
Management
Products and markets
Competitive Advantage
Fair/Intrinsic value
Margin of safety
Catalysts

Know where to get the best information to make a proper assessment, they know the approach to employ based on the business they are assessing, and they have the tools to dig deep into SEC financial filings and financial statements of the business to minimize risk.

Value analysts assess the degree to which the accounting of a company resembles the underlying economic reality of an enterprise.

Link cash flows to the quality of earnings.

The Value Line Investment Survey: A “Must Have” for the Value investor.

**THREE APPROACHES TO ANALYZING A BUSINESS**

Buy facts not dreams. At the heart of any business analysis is the company’s strategy. Strategy is about making trade-offs. Choosing certain activities in order to deliver a unique mix of value to its stakeholders.

**VERTICAL ASSESSMENT APPROACH**

Sales and CGS based on competitive Strategy and Industry Assessment

The value analyst can use a common size financial statement. Uncover the strength and consistency of a company’s margins, and how they might change.

Develop a list of industry contacts to understand the business. Read about industry framework in Competitive strategy. The five forces that drive industry profitability: threat of new entrants, the threat of substitute products, the bargaining power of buyers, the bargaining power of suppliers, and the degree of rivalry among competitors. These factors affect on unit volume, price and cost to produce goods.

**To outperform their competitors, companies use cost leadership, differentiation, and focus.**

Some of the best businesses are simple ones.

**ROE DECOMPOSITION APPROACH**

ROE is a function of the company competitive position it its industry, the operating strategies it employs, and the financial flexibility it possesses.

Net/Income $ \times$ Sales/Assets $ \times$ Assets/Equity $ = $ ROE

Return on Sales $ \times$ Asset Turnover $ \times$ Financial Leverage

Company Profitability $ \times$ Assess the operations of the business $ \times$ Financial Flexibility

**CASH FLOW BASED APPROACH**

Cash flow provides insight into the quality of a company’s earnings.

CFs: net CF, DCF, CF from operating activities
FCF: Free Cash Flows: Company’s net income plus non-cash items, such as Depreciation and amortization, minus mandatory or promised outlays of cash, such as capital expenditures.

All analysis has to be focused on the company’s ability to sustain and improve its free cash flows.

**BUSINESS QUALITY FED FLAGS**

There is a difference between the company’s accounting policies with other companies in the same industry. Changes in accounting found in footnotes and 8-K filing.

Management incentive package is based solely on increasing EPS and they have discretion over the accounting treatment.

There are unjustified changes in estimates, accounting and financial policies in the 8-K.

There are special business arrangements and deal structures to achieve accounting objectives, such as earnings growth.

The letter to Shareholders does not adequately disclose the company’s business strategy and its economic consequences.

Abnormal high increase in receivables or inventory.

Net income growing faster than cash flow.

Large write-offs.

The company is lending money to customers.

Any changes that enhance earnings without economic substance.

Compare annual reports over several years to see if management kept promises. Compare its annual reports to competitors' reports. Management’s credibility is extremely important.

Use EVA to see if management was able to generate excess capital over their cost of capital.

Herman Miller uses EVA.

**Chapter 3 PRICING AND VALUE ASSESSMENTS**

TO APPRECIATE PRICE IS TO UNDERSTAND VALUE

To understand price is the attempt to understand how prudent investors are valuing a company and why.

Metrics change. Essentially, you will need to see today what potential buyers of the enterprise will see tomorrow, and the metrics that they will use to measure it.
Focus on Earnings and cash flows today.

**ASSESSING VALUE: TOOLS TO CONSIDER**

Comparison based tools.

P/E, P/B, EV/EBITDA and P/S and EV/R.

Value investors look for absolute not relative valuation/performance.

Valuation is counting cash, not hopes or dreams.

EPS problems: Manipulation of earnings, excludes business and financial risks. Earnings exclude the financial commitment to keep the business operating and growing.

The market focuses on the long-term cash flow growth.

Price-to-book, or P/B. Take out preferred shares. Using book value without looking at depreciation rules and practices in the particular industry would be misled. As the economy becomes more service and technology oriented, book value means less.

Ideas and human capital are more important than tangible capital.

Options: the typical value investor adds the market value of the options to the market value of the equity before calculating the P/B ratio.

Some investors believe that the strong relationship between ROE and price-to-book value gives some of the best clues to uncover undervalued companies.

P/B influenced by the cost of equity

**Chapter 4: Catalyst Identification And Effectiveness**

“Dramatic change in required. Unlock the value, or let someone else do it for you.” Michael Price

While buying assets at a discount from underlying value is the defining characteristic of value investing, the partial or total realization of underlying value through a catalyst is an important means of generating profits. Furthermore, the presence of a catalyst serves to reduce risk.

Stock splits are “perceived” catalysts that do not change value. Sector rotation is another stock catalyst.

Management prerogatives such as share issuance or repurchases, subsidiary spin-offs, recapitalizations, and, as a last resort, liquidation or sale of the business all can serve to narrow the gap between price and value.
Internal Catalysts:

New management can be installed.

The company can employ a new corporate strategy.

If a company receives high returns from the use of one strategy, competitors will mostly likely imitate it and reduce the strategy’s profitability. The best opportunity for such a catalyst, based on superior strategy, is for a company in a high-barrier industry or a firm with a business plan that requires significant resources and experience to imitate. Enough of an edge for a long enough time.

Is capital being allocated to more profitable areas without raising the risk profile of the firm?

Companies can also implement new product strategies. What is the level of “stickiness” found in the company’s product and services—the ability to draw in repeat customers. Advertising is often used.

Improved operational efficiencies can also be a catalyst. A company can improve the culture of a firm to changing operational procedures. It is more difficult for companies to separate resources that do not contribute to tangible benefits from those that do contribute.

Investors often view a new financial strategy as a potential catalyst. A delicate balance of the right amount of debt.

A sustained tax rate reduction can be a potent catalyst.

Reduce working capital, which can free up cash. Increasing working capital is a cash outflow, and it can only increase firm value if the investments in working capital are decreased. Beware of losing sales by reducing inventory or reducing A/R.

Reducing capital investments to create value is very tricky. If a company reduces investments in fixed assets, it risks reducing the lifespan of those assets.

Share buybacks are one of investors’ favorite catalysts.

A company buys back stock in three ways:

1. Open markets repurchase
2. Through a privately negotiated buyback
3. By way of a repurchased tender offer.

Six reasons why companies buy-back their own stock:
1. Reduce the company’s dividend cash outflow without reducing the dividend itself.
2. To signal to the stock market that the company’s stock is undervalued.
3. To increase earnings per share
4. To change a company’s capital structure
5. To buy the shares of a big seller of the stock
6. To give current shareholders a tax-friendly cash distribution

Spin-offs and equity carve-outs can be a good way to spur a company’s share price. A carve out raises money for the parent company. Spin-outs do not.

Four reasons for spin-outs:

1. Refocus on their primary core competencies by allowing them to separate business divisions that do not fit strategically, operationally or financially.
2. Value differences between parent and spin off.
3. The spun-off company also has an opportunity to create shareholder value by giving it a new corporate structure.
4. Fourth, the tax advantage. The parent company and the recipient shareholders are not taxed, despite the fact that the parent company and the recipient shareholders are not taxed, despite the fact that the parent company recognizes a financial gain, as if they had sold assets. The recipient shareholders are not taxed, even though they receive dividend income.

Split-offs. Investors must choose which company to own. Pg 89

Asset Sale: An asset sale is only part of the valuation creation. The other half is the use of proceeds.

Three uses of cash:

1. Invest in the stock market
2. Invest in the company

EXTERNAL CATALYSTS

The presence of shareholder activists. Proxy fights, letter writing campaigns. Try to improve corporate governance.

Avoid companies with large poison pills. Managements usually nominate the Boards.

Industry merger activity can also be effective since it provides metrics to value other companies in the industry.

Acquisition candidates: a firm that is doing a poor job of managing its assets. Conglomerates often do not have best of breed businesses but a hand full of weaker companies.
Unused debt capacity.
Having substantial tax benefits—note the presence of NOLs and the handling of depreciation.

**THE “MARGIN OF SAFETY” PRINCIPLE**

The margin of safety is based on the price of the shares and their value. The best price to value is found in undervalued companies.

Never be caught off guard. Use break-up value, favorable dividend yield, and price-to-cash flow.

Buying companies with a margin of safety prevents owning companies with a high burden of proof to justify their stock valuations.

The Five Keys of Value looks at margin of safety as a support level for the stock.
It essentially asks the question, “What is supporting the stock price at its current level?” or, “Why shouldn’t the stock fall significantly from today’s current price?” FKV’s margin of safety is heavily conscious of what can go wrong, and not what the discount it is to fair value—the safety is thus purely based on the value of the assets.

The fact that only tangible assets are calculated understates the value of an enterprise.
Intangibles: firm culture, customer loyalty, reputation, etc. It takes experience to properly adjust for goodwill.

Having too much debt is a red flag.

Interpreting the replacement value.

Book value assessment. One must make proper adjustments.

**Chapter 6 ASSESSING THE INVESTMENT OPPORTUNITY**

The difficulty never lies in identifying what a good business is today. The true difficulty is finding what will be a good business five or ten years down the road.” Jean-Marie Eveillard.

Buffett: Take your time and wait for the right pitch.
Emotional discipline is critical to the success of both the investor and the golfer.

Know in advance how you plan to play each hole. The value investor has a specific approach for each investment opportunity, whether it is a cyclical company, a break-up opportunity, or a fast grower.

Properly identifying the type of opportunity that is presented is critical to successful investing because the type of opportunity determines one’s approach and the analytical tools to consider.

Ask: what circumstances have afforded me this opportunity?
Modest/slow growth, high growth, event driven, cyclical, temporarily depressed, hybrids and value traps.

Applying the five keys to a modest and slow-growth business: RH Donnelley Corporation in 1998

Use vertical analysis through the income statement. An independent marketer of yellow pages. An attractive part of their revs were that they were aligned on a LT basis, with the established and leading telephone provider in each of its major markets.

RH Donnelley has a strong competitive advantage due to size, renewal rates and expertise. It has strong recurring ad revenues. It had plenty of free cash flow.

It traded at 5 x enterprise value to operating cash flow and 7 x P/E, the price seemed right. Then I had to find the value. Private equity deal summaries came out empty. But an international deal came at 13 x Enterprise Value to Cash flow. I believed the market would pay 8 to 9 times enterprise value to operating cash flow. $28-$32 was a target.

First I liked the business, second I liked the price, and third I thought that the value was significantly higher-80% to 100%.

The fourth lever was the catalyst. Management would buy back shares and seek restructuring opportunities.

Fifth, The margin of safety. The safety level of $13 per share-taken private or sold. The asset value yielded a price close to $13.00. Upside potential was 75% and downside was 19%. Risk/reward on my side.

HIGH GROWTH: NETWORK ASSOCIATES IN THE SUMMER OF 1999-THE APPROACH AND ANALYSIS.

I liked the antivirus and network security business because this business would be the same many years down the road without huge change that many tech companies are subject to.

Network Associates trading at 7 x EV/CFO and 17 P/E and 1/Sales vs. 3 x Sales for competitors. Inventory down to 12 from 22 weeks. A carve out of McAfee was worth $3.50 at the low end. Co. buying-back stock. If the price stayed low, then it would be a take out candidate given the company’s market position, brand strength and financial flexibility. Finally the end of Y2K lock-out would resume security spending.

At $15 per share, the safety level was about $12.50 per share. $9.50 in asset value and $2.50 in cash. A 100 percent return vs. a 17% downside. A risky trade.

Sybron International: Event driven.

Stock price driven down 41% by negative event driven problems that I saw as temporary. The company had significant Board members and investors who would work to unlock value. Hicks, Muse.
CYCLICAL COMPANIES

These companies have temporary, industry-related issues, which cause the up and down nature of their stock prices.

Newhall Land and Farming in 1994 had significant assets, which were not being considered by the market. Break-up value much higher.

Buy for three reasons: I was purchasing the company at a discount to its tangible and adjusted book value. The Southern California economy would turn around some day. And I was willing to wait for these catalysts to occur. Three years later the stock had doubled. The downside risk was very limited.

Long Term Cyclical with a Near-Term Catalyst: EATON CORPORATION in 2000.

Using various multiples for each business, the values summed to $97 per share vs. a buy price of $53.00 not including the $11.00 value of the spin-off. The stub value is the value left after the spin-off. Seeking a turn-around in the economy in 18 to 24 months.

TEMPORARILY DEPRESSED VALUE; PACTIV CORPORATION IN 2000

It sold plastic storage bags for food—“hefty.” It had a breadth of products, one stop shopping and its long-term relationship with distributors gave it a leading position. Management was required to own three to five times their salary in stock. Pactiv hurt due to high resin prices. The current price was $9.00. I looked at Pactiv on a “normalized” basis by analyzing the company in an environ that excluded the peaks and troughs of resin prices. The company could make at least $1.00 per share.

To calculate valuation, I triangulated a valuation. I used sum of the parts, discounted cash flows, and take out valuations to come to a fair price of $17.83 to $18 per share.

With sum-of-the-parts, I valued the food packaging, protective packaging and the company’s stake in PCA differently. I used the different twin companies for each business and calculated the sum values on an operating cash flow basis, and then subtracted the company’s debt to arrive at the company’s equity value.

How will the stock go to $18 per share? Reduction of resin prices. Given quality of Pactiv’s management team, the price was temporarily depressed.

Margin of safety was based on a calculation of the company’s asset values, which took into account the company’s free cash flow generation possibilities, brand value, market position, and product variety. The margin of safety, which I thought it would take to make the company a prime candidate to be taken private or sold, weighed on the share price. Share price of $7.50 with upside at $18.00.

HYBRID OPPORTUNITIES

The restructuring on Thermo Electron Corporation in Chapter 4 is an example of a hybrid opportunity, where the situation was rich with catalysts of various types—new management, asset
sales, divestitures, new strategy, spin-offs, share repurchases, etc. In such situations, value investors use a variety of tools specific to each case. The segment the opportunity and value each in isolation.

**AVOIDING VALUE TRAPS**

Value traps are inexpensively priced companies that **do not possess positive catalysts or that may operate in declining industries.** Here are some of the more common examples of potential value traps.

Buying cheaply on valuation despite the fact that it may be a bad business

Buying a cyclical company with low valuation at the top of its cycle

Buying a stock solely because it has a low dollar value of say, $3 per share.

Buying simply the cheapest company in an industry in an industry without understanding the economics of the business.

**CHAPTER 7 BUYING RIGHT AND BEING AN OWNER.**

The art is taking the inclusion of the current environment in one’s investment thinking.

When investors "buy right," they must identify excellent businesses, ad they must also purchase them at good prices. It is straightforward.

Think of the stock market as an owner/partner.

Second, think of the economic environment without predicting the future.

Third, think cyclically. Avoid thinking that the strong trends will stay strong forever, and that companies undergoing hardship are always doomed.

M. Market gets very emotional and he can offer you a very attractive price for your business.

Emotional discipline is key.

Mr. Market can offer to sell shares of businesses at very low prices. Being able to separate the good companies from the bad is critical. Employ the five keys framework. When Mr. Market is discouraged, he frequently sells the good companies along with the bad companies. Watch for when sellers are irrational or fearful. The short-term performance of a stock is not relevant.

Mr. Market exists to serve investors, not to advise them on their decisions. Those who buy businesses do so proactively, making decisions backed by sound research that prepares them to take advantage of such price swings.

The true value investor must buy the best businesses at ridiculously low prices, and know when to sell shares of overvalued companies.
Mr. Market as a disciplinary tool.

Understanding that Mr. Market is emotional helps value investors remain calm during market fluctuations. Second, an investor can be patient in assessing opportunities if a price is missed because the market mostly likely will offer the same again.

**THINK ABOUT THE ECONOMIC ENVIRONMENT WITHOUT TRYING TO PREDICT IT.**

Be aware of the direction of interest rates and corporate profits, and be mindful of inflation. Buffett, "Interest rates act on financial valuation the way gravity acts on matter: the higher the rate the greater the gravitational pull."

Value investors' awareness of interest rates, corporate profits, and inflation help them buy right by getting a better understanding of the mood of Mr. Market. Investors often are looking into the rear view mirror instead of the windshield. This is part of the herd mentality.

Think in cycles. Sell the high performers, since the good times are not going to last forever. It is just as critical to buy selectively the excellent businesses undergoing difficult times, because hard times do not last forever. The key is identifying the proper catalysts.

To ID catalysts is a critical factor in a bull market, while having an ample margin of safety is paramount in a down market. To buy right is to purchase a piece of a good business at a great price, while staying cognizant of the economic and market environment in which the company operates.

**OWNERSHIP IS A VERB WHEN MONITORING YOUR INVESTMENTS**

The responsibilities are twofold: First, the investor must know as much about the company as possible. Second, an investor must hold management accountable for creating value for all stockholders.

**OWNERS’ RIGHTS**

Earn a proportionate part of the profits and have influence over major decisions of the company.

**ASSESSING QUARTERLY EARNINGS ANNOUNCEMENTS AS A TOOL**

Understand what the numbers mean. What do the numbers mean for history?

Look at the trends in numbers such as the top line and margins, and how they relate to management's outlook for the company. Calculate the percentage changes on a sequential and year over year basis.

Get behind the numbers by taking a closer look at each key line item in the income statement and balance sheet, n order to assess what might be implied over the next few quarters. Recurring "one-time" events are a red flag since it calls into question the business model.
Note changes in tax rates. Watch for the current assets vs. the current liabilities and long-term debt. How effective is the company in managing working capital?

**WRITE DOWN THE KEY REASONS FOR WHY YOU PURCHASED THE STOCK.**

Continually reevaluate your thinking.

Spin off years are usually filled with unusual items.

Why own Pactiv:

The company generated strong free cash flow, driven by excellent brands with great market shares. Note that the company was able to raise prices and operating margins and reduce interest expense.

The management team is very strong and has the proper financial incentives in place.

Cost cutting and asset sale opportunities are significant and real.

Raw materials costs, such as resin prices were a temporary "negative" catalyst.

The company was cheap on a private-market basis. It was likely to be a take-out candidate if the stock continued to languish, based on the stability of its free cash flows.

Many sophisticated investors never ask questions during conference calls. Focus on risks to cash flow.

[www.proxyvote.com](http://www.proxyvote.com)

Shareholders have the right to vote on major issues affecting the company.

**BUY AND HOLD BUT NOT FOREVER**

3-5 years seems to be an appropriate holding period.

Selling occurs when:

- On-going research reveals deterioration of the business fundamentals or permanent impairment of the assets of the firm.

- The company reaches fair value.

- The catalyst that I identified prior to making the investment is unlikely to materialize, or is proven ineffective.

**GENERATING VALUE ISEAS AND BUILDING AND INDEPENDENT PORTFOLIO**

Search for value and then wait for the right price.
Use the financial media:

The most useful mechanism is the print media. When reading financial publications:
- Company/industry specific knowledge,
- Potential catalysts
- Insight into valuation

Catalyst identification can come from mgt. change to new product breakthroughs.

Searching for value in the WSJ. Look for prospects with low margins operating in high margin businesses. When significant declines occur in one sector, they often represent good places to look for value.

Barrons: look at 13-D filings.


Building Your Portfolio.

Focused investing. Good businesses at attractive prices are hard to find.

Diminished utility once past 16 stocks. If you over-diversify, you risk becoming a high cost index fund. A focused portfolio is geared towards creating wealth, while a diversified portfolio is geared towards capital preservation.

Own 15 to 18 good businesses at excellent prices.