Moats, Castles, and Lords

Investment philosophy and competitive strategy

Agenda

Education – Week 6
What is value investing?
Drivers of stock returns
Business quality
Investment checklist

What is value investing?

The art of buying dollar bills for 50 cents

What is value investing?

The three big ideas of value investing

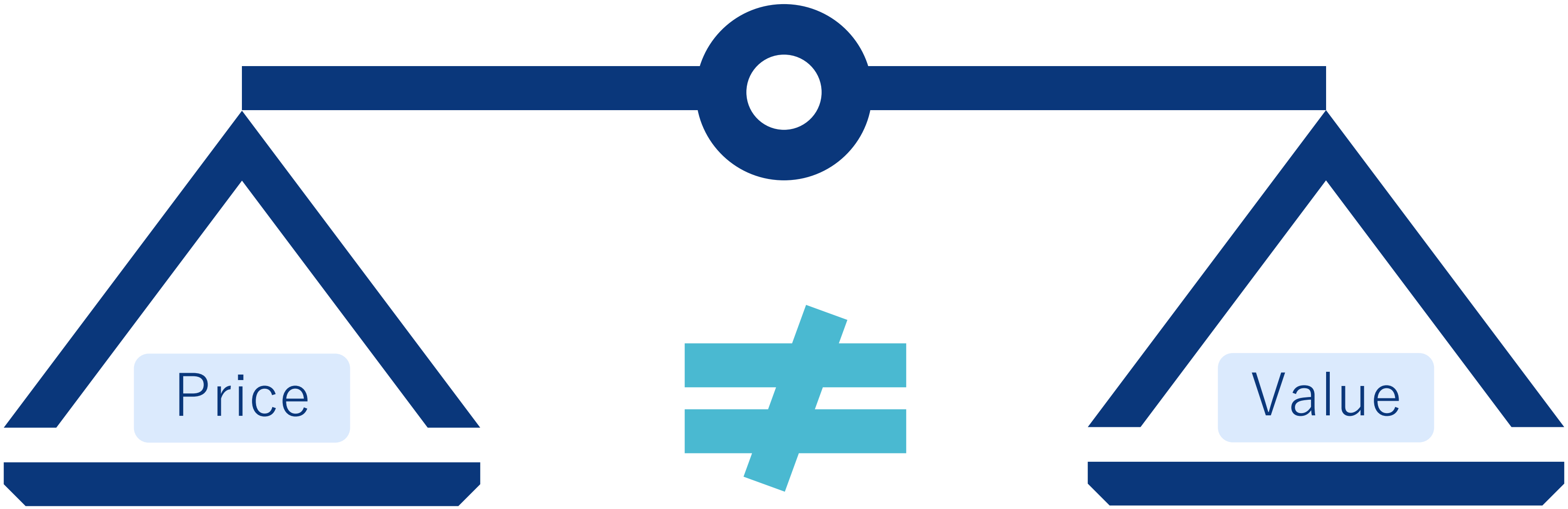
From the teachings on Ben Graham to Warren Buffett to SCM…

1. Stocks are not blips on charts that bounce around in price, they are **pieces of businesses**
2. The **stock market** is there to **serve you**, not to instruct you; take advantage of Mr. Market
3. The future is unpredictable, so you must invest with a substantial **margin of safety**

Graham's three big ideas are just as relevant today as they were when he co-authored the first edition of *Security Analysis* in 1934

Price vs. Value

“Price is what you pay. Value is what you get.” – Warren Buffett



Established by Mr. Market

Sum of future cash flows

Buying dollar bills for 50¢

“We define value investing as buying ***dollars for 50 cents****.”*

-Seth Klarman

"I try to buy a dollar for 50¢, and if I think I can get that, ***I don't worry too much about when****.”*

-Warren Buffett

*“****Nobody can predict the market****. Take that premise to heart and look to invest in* ***dollar bills selling for 50 cents****.”*

-Irving Kahn

Why do dollar bills sometimes trade for 50¢?

Opportunities to invest in undervalued securities exist because the market is not perfectly efficient… What are reasons for mispricing?

Overvalued	Undervalued
This is when **Price** > **Value**	This is when **Price** < **Value**
Exciting, new, popular, hyped, overappreciated, well-covered by sell-side, etc.	Disliked, unpopular, complex, boring, misunderstood, neglected, low coverage by sell-side, etc.
Investors have unreasonable growth expectations	Investors focused on short-term headwinds not long-term value
Market overacts to good news	Market overacts to bad news

“Security prices reflect investors’ perception of reality and not necessarily reality itself.” – Seth Klarman

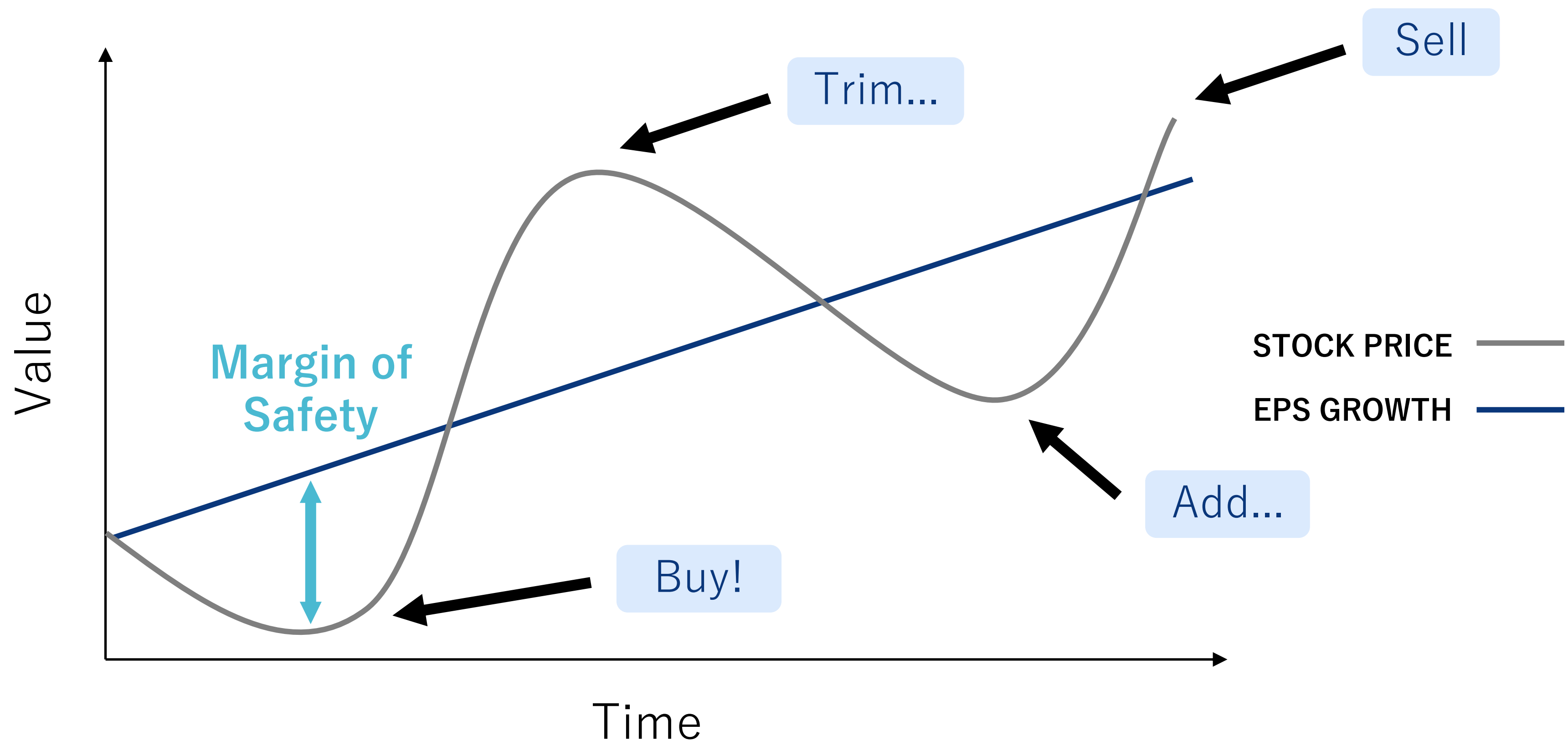
Value investing process

1. Identify potentially undervalued opportunity
2. Conduct qualitative and financial analysis
3. Value the underlying security
4. Invest if the price < intrinsic value
5. Sell when price > intrinsic value

Margin of Safety

The future is uncertain, so you need a "Margin of Safety"

Buying stocks below intrinsic value gives you better downside protection + more upside



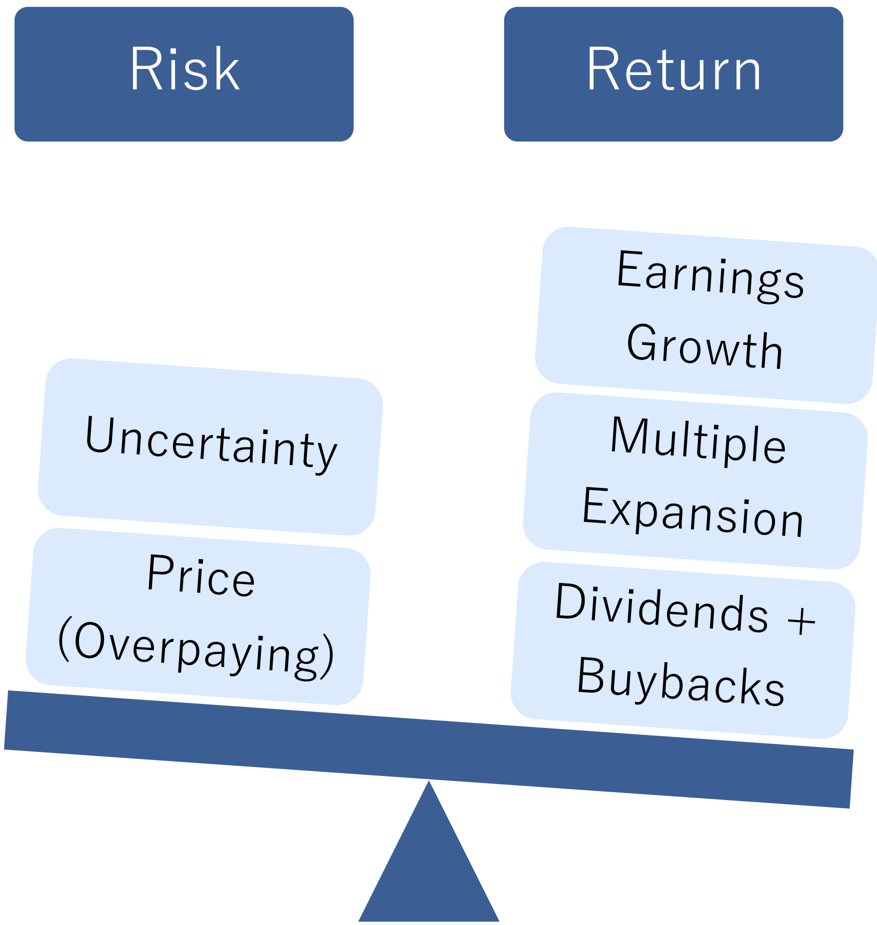
“Riskier investments absolutely cannot be counted on to deliver higher returns. Why not? It’s simple: **if riskier investments reliably produced higher returns, they wouldn’t be riskier!** The correct formulation is that in order to attract capital, riskier investments have to offer the prospect of higher returns, or higher promised returns, or higher expected returns. But there’s absolutely nothing to say those higher prospective returns have to materialize.

HOWARD MARKS

Chairman of Oaktree Capital

Risk vs. return

All investment decisions should be assessed on risk vs. return



"Even if you don't know what the upside is – if you just know there's upside – you can create scenarios where you have an excellent risk/reward. Positions with limited downside are the types of positions that I have loaded up on in the past. Not the positions with the biggest payoff."

– Joel Greenblatt

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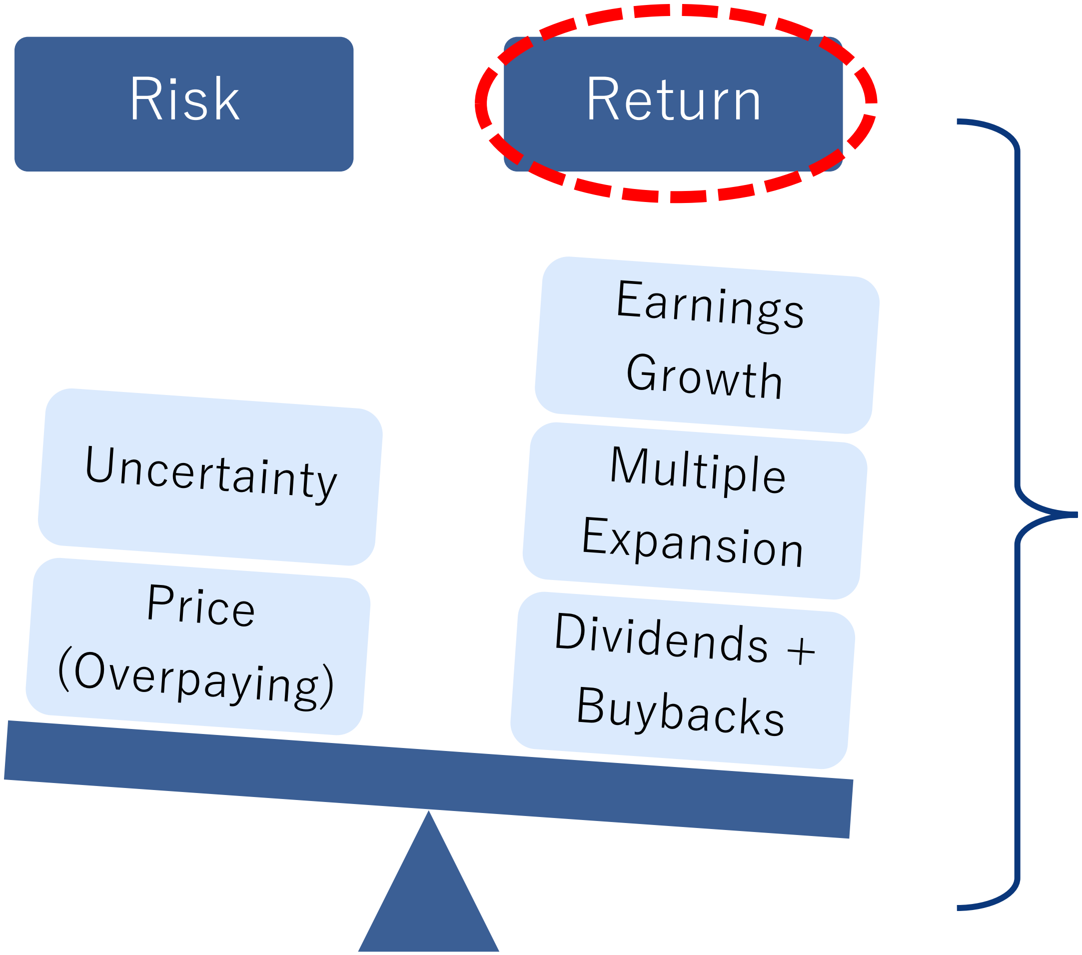

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Drivers of stock returns

Earnings growth, buybacks, dividends, and multiple expansion

Drivers of stock returns

$$Return = Earnings\ Growth + Dividends\ and\ Buybacks + \Delta\ in\ Multiple$$

Stock returns over time can be broken down into three buckets:

1. **Earnings Growth**
   - Increase/decrease in revenue
   - Increase/decrease in margins
2. **Capital Returns**
   - Dividends paid to equity holders and share repurchases
3. **Multiple Expansion/Compression**
   - Change in expectations for a company's earnings growth
   - Change in discount rates (risk-free rate or perceived risk)
   - Increase/decrease in capital intensity

Back-of-the-envelope return example

$$Return = \Delta EPS + Dividends + \Delta P/E$$

<u>AAPL from 2018 to 2021:</u>

1. **Earnings Growth**
   - Net income grew 60% and bought back ~15% of shares out.
   - EPS grew from ~$3 to ~$5.7 (increase of ~80%)
   - Annualized EPS growth of ~24%
2. **Dividends**
   - Dividend yield was ~2%
3. **Multiple Expansion/Compression**
   - P/E multiple grew from ~12x to 30x (increase of ~150%)
   - Annualized growth of ~35%

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90% (ΔEPS) + 2% (dividend yield) + 150% (ΔP/E) = 242% return
From 2018 to 2021, AAPL went from ~$40 to ~$135, ~240% return

Back-of-the-envelope return example

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All that's nice, but how do we accurately predict all three return drivers?
And which of these drivers is the most important driver?

Types of capital-return-focused investors?

$$Return = Earnings\ Growth + \boxed{Dividends\ and\ Buybacks} + \Delta\ in\ Multiple$$

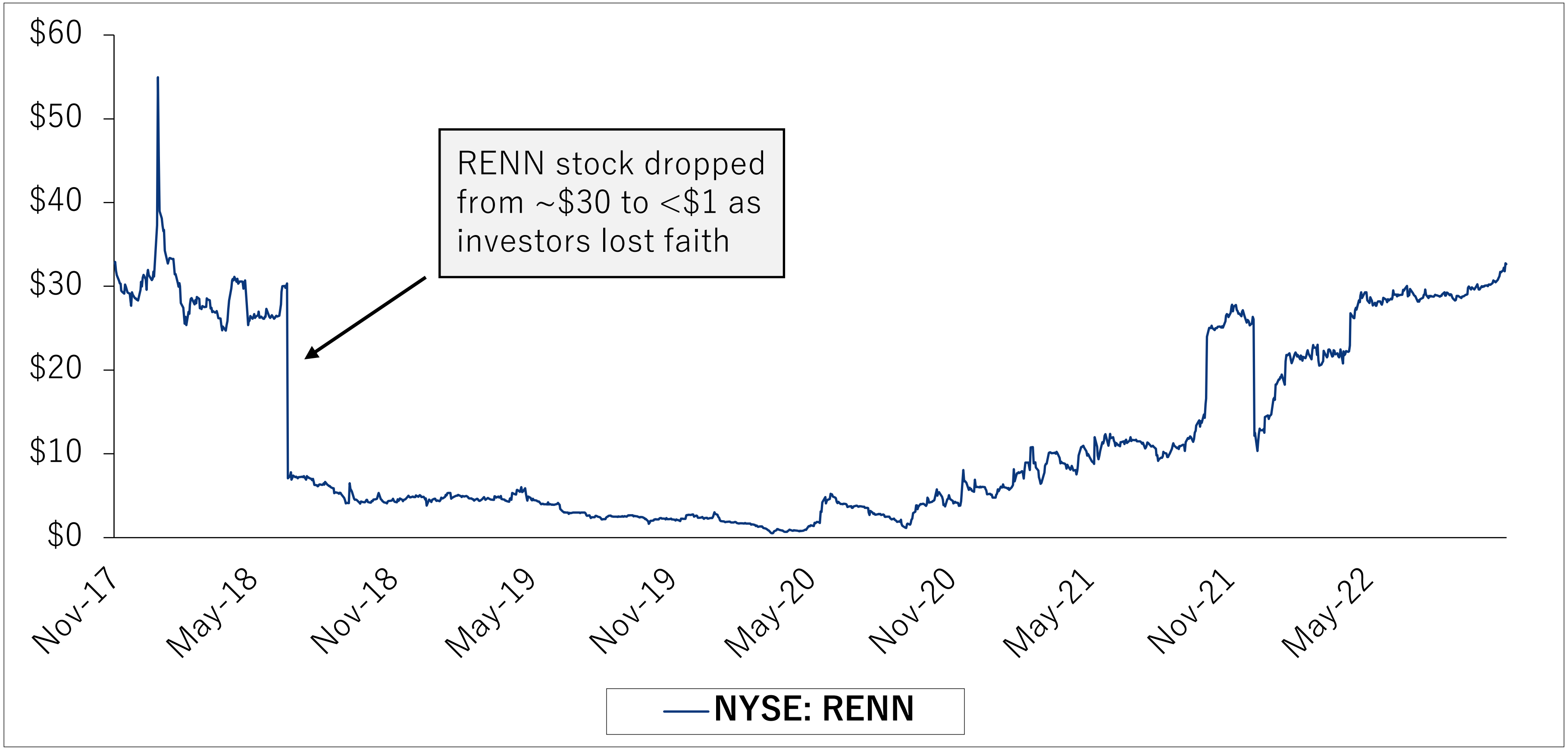
<u>What type of investor focuses on capital returns?</u>

1. **"Value" Investor (the way academics refer to "value")**
   - Likes stocks at low P/E multiples that pay high dividends
   - Focus more on valuation than growth or business quality
   - Owns boring, low-growth, free cash flow generative stocks
2. **Distressed / Special Situations Investor**
   - Looks for companies undergoing distress or a special event
   - Perhaps a company will go bankrupt, but will pay out a dividend that exceeds the current share price…

These investors typically don't care much about business quality…

Special Situation: Renren (RENN)

In 2018, the CEO of RENN maliciously spun-off a valuable stake in SoFi that benefited the CEO at the expense of shareholders (self-dealing)



Special Situation: Renren (RENN)

An interesting development occurred when activist fund Oasis Management filed a lawsuit against RENN and reached a settlement…

11/03/22

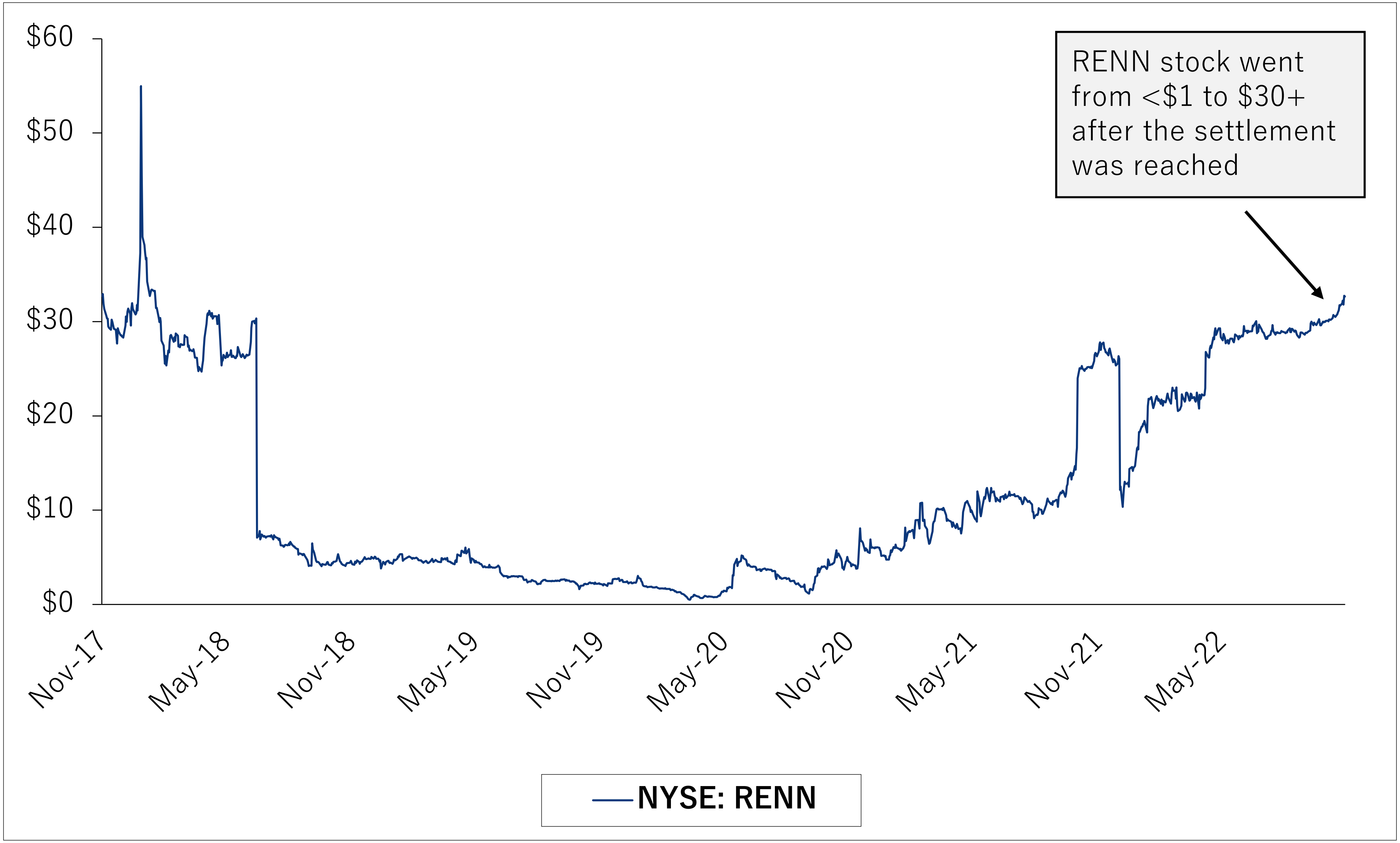
Renren Declares Special Cash Distribution for Settlement Regarding Shareholder Derivative Litigation

PHOENIX, Nov. 3, 2022 /PRNewswire/ -- Renren Inc. (NYSE: RENN) ("***Renren***" or the "***Company***"), an operator of several US-based SaaS businesses, today announced that its board of directors declared a special cash distribution in connection with the settlement contemplated by the Stipulation of Settlement, dated as of October 7, 2021 and as amended on May 27, 2022 (the "***Stipulation***"). As previously announced, the New York State Supreme Court, Commercial Division entered the Final Order and Judgment on June 9, 2022 (the "***June 9 Final Order***"), which, among other things, approves the Stipulation and the transactions contemp… Order became final as of October 20, 2022 following a withdrawal of appeal by cert…

Special dividend of $31.56 per share!

The special cash distribution is payable … A ordinary shares (including those in the form of Renren American Depositary Shares ("***ADSs***"), each one (1) ADS currently representing 45 Renren Class A ordinary shares) of record as of 5:00 p.m. Eastern Time on November 21, 2022 (the "***Record Date***"), other than the Defendants and D&O Releasees (each as specifically identified in the Stipulation). The amount of the special cash distribution is US$0.7013 per Class A ordinary share, or US$31.5585 per ADS, in each case, prior to deduction of applicable taxes, fees and expenses. Pursuant to the Renren ADS Deposit Agreement (as amended), the Depositary will charge a special cash distribution fee of US$0.05 per ADS held, which will be borne by the holders of ADSs.

Special Situation: Renren (RENN)



Investors that focus on multiple expansion?

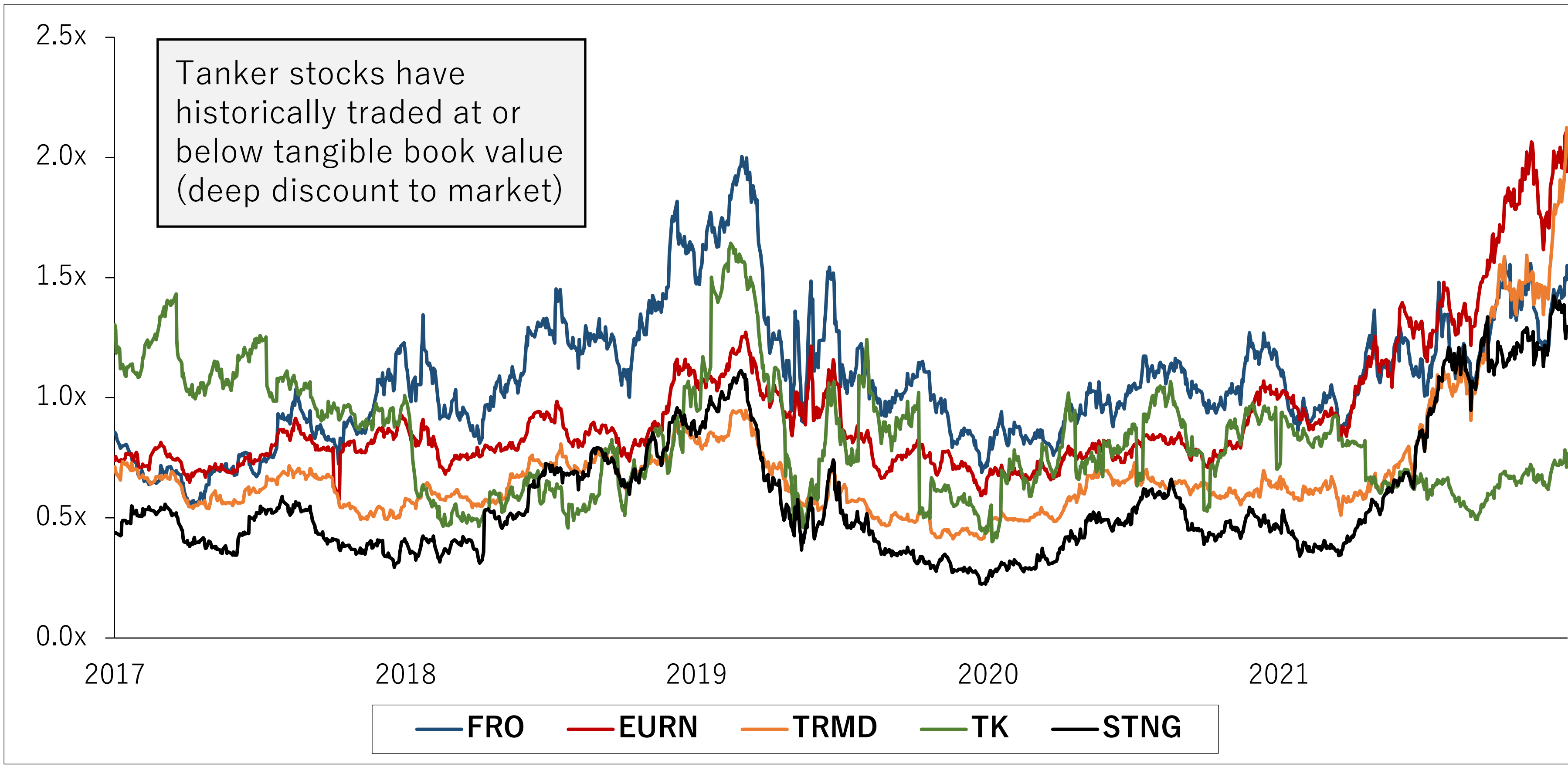
$$Return = Earnings\ Growth + Dividends\ and\ Buybacks + \boxed{\Delta\ in\ Multiple}$$

<u>What type of investor focuses on multiple expansion?</u>

1. **Deep-Value Investors**
   - > Buys stocks at extremely cheap multiples in hope of rerate
   - > Typically means owning disliked and low-quality businesses
2. **Event-Driven Investors**
   - > Takes advantage of mispricings caused by corporate events
   - > Spin-offs, mergers, acquisitions, restructuring, etc.
3. **Traders**
   - > Buys and sells stocks for short-term profits (market timer)
   - > Focuses more on sentiment rather than fundamentals

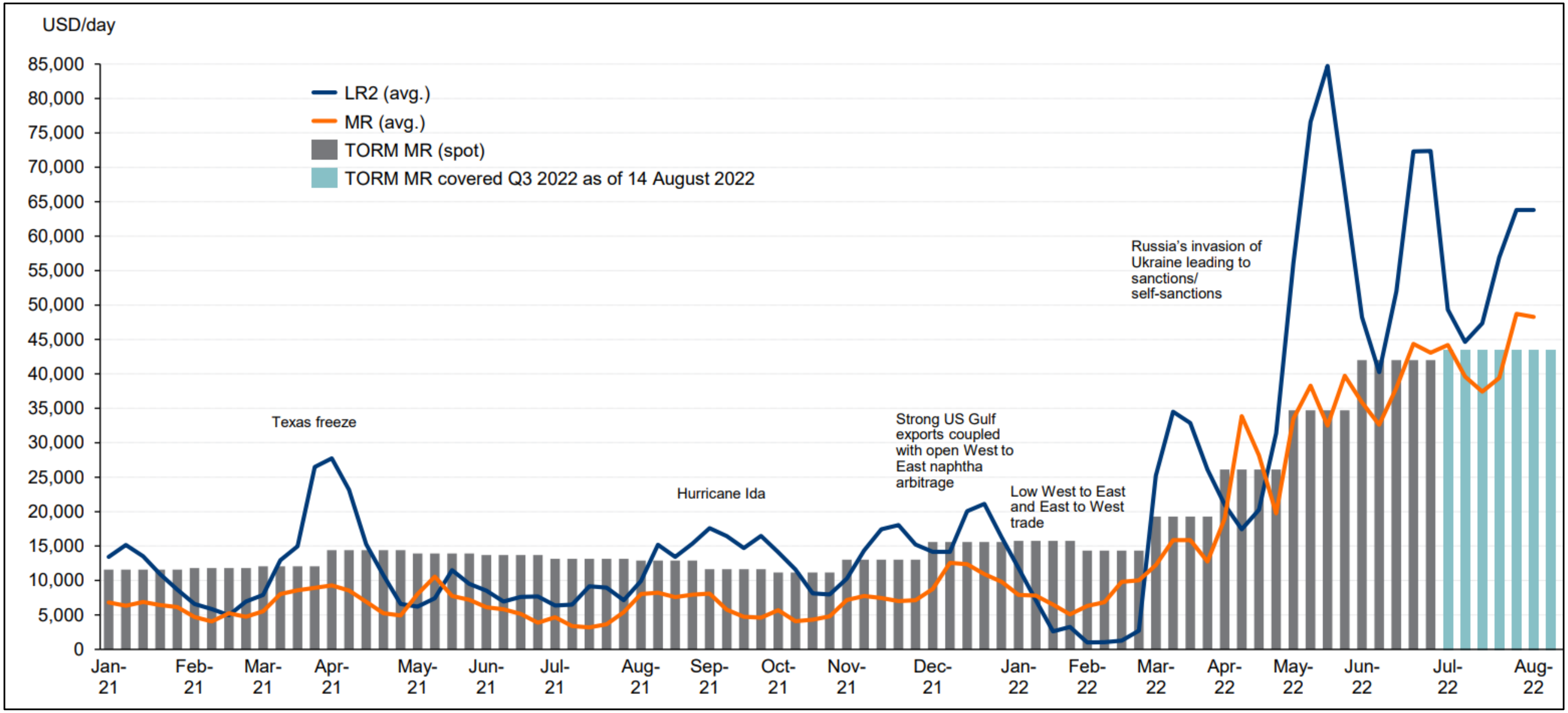
Oil Tanker Stocks: Price to Book Value

Tankers highly cyclical, capital intensive, negative long-term growth businesses and typically trade at distressed multiples…



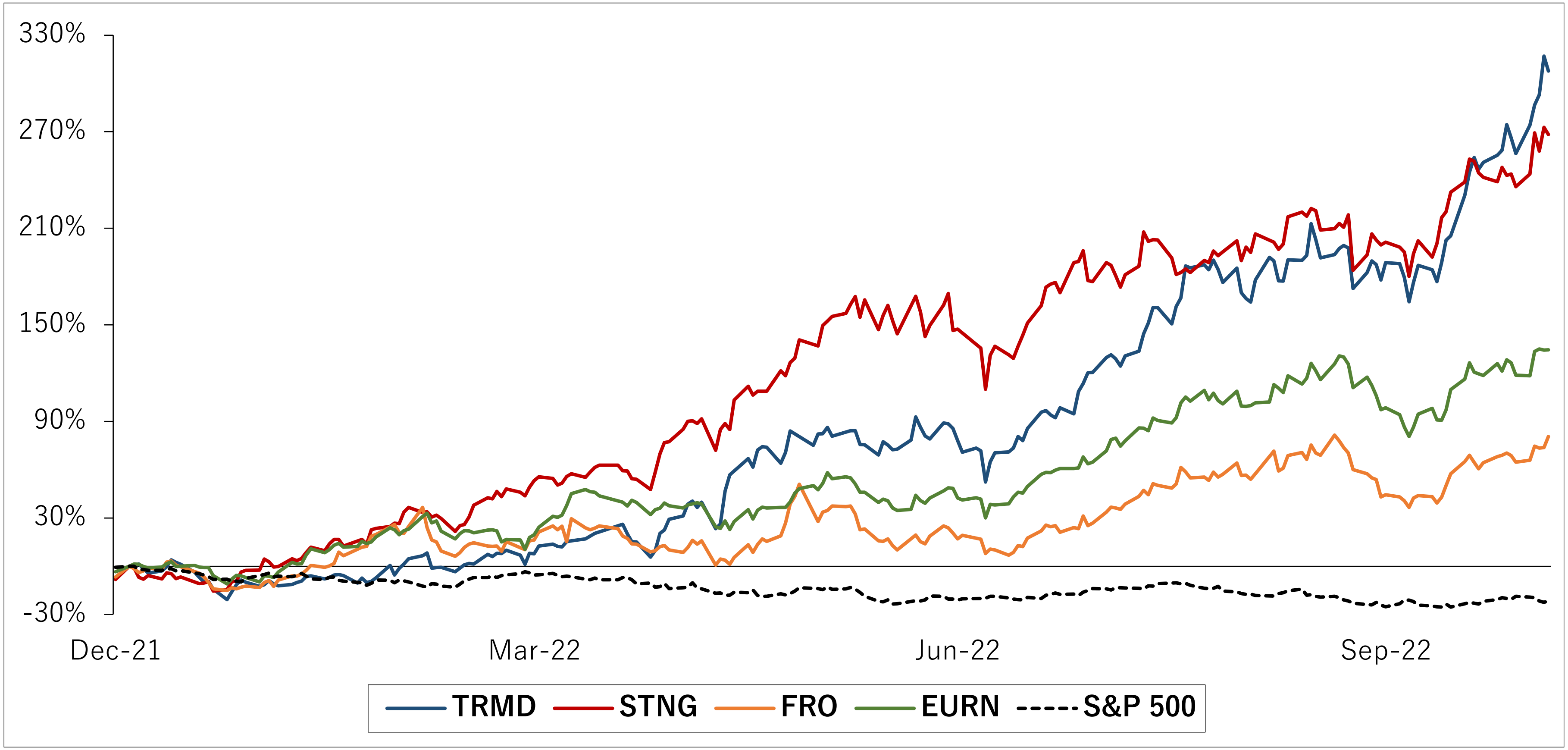
Multiple Expansion: Tanker Stocks in 2022

In 2022, sanctions on Russian oil led to longer international oil trade distances causing tanker freight rates to skyrocket and P/BV expansion



Multiple Expansion: Tanker Stocks in 2022

Average tanker P/BV multiples expanded from 0.5x to >2.0x, resulting in significant outperformance compared to the S&P 500



Disadvantages of no earnings growth?

$$Return = Earnings\ Growth + \boxed{Dividends\ and\ Buybacks + \Delta\ in\ Multiple}$$

Short-comings of investors who don't care about earnings growth:

1. **Lack of Information or Influence**
   - The market is highly competitive and there is oftentimes information asymmetry; cheap is often cheap for a reason
   - Some management teams are not shareholder friendly (don't pay dividends) and are not easily influenced
2. **Higher Turnover**
   - You can't own a business that doesn't grow for the long-term because there's a limit to how long multiples can expand
   - As a result, you must constantly trade, churn through new ideas, and pay higher taxes/fees... Sounds like a lot of work!

Disadvantages of no earnings growth?

$$Return = Earnings\ Growth + \boxed{Dividends\ and\ Buybacks + \Delta\ in\ Multiple}$$

Short-comings of investors who don't care about earnings growth:

3. Time Horizon

> Without earnings growth, time is against you…
> In these situations, your returns are entirely dependent on financial engineering or a multiple re-rate (Δ in sentiment)
> It can be difficult to understand why investors will pay a higher multiple for a company in the future (need catalyst)

Earnings-growth-focused investors

$$Return = \boxed{Earnings\ Growth} + Dividends\ and\ Buybacks + \Delta\ in\ Multiple$$

What type of investor focuses on multiple expansion?

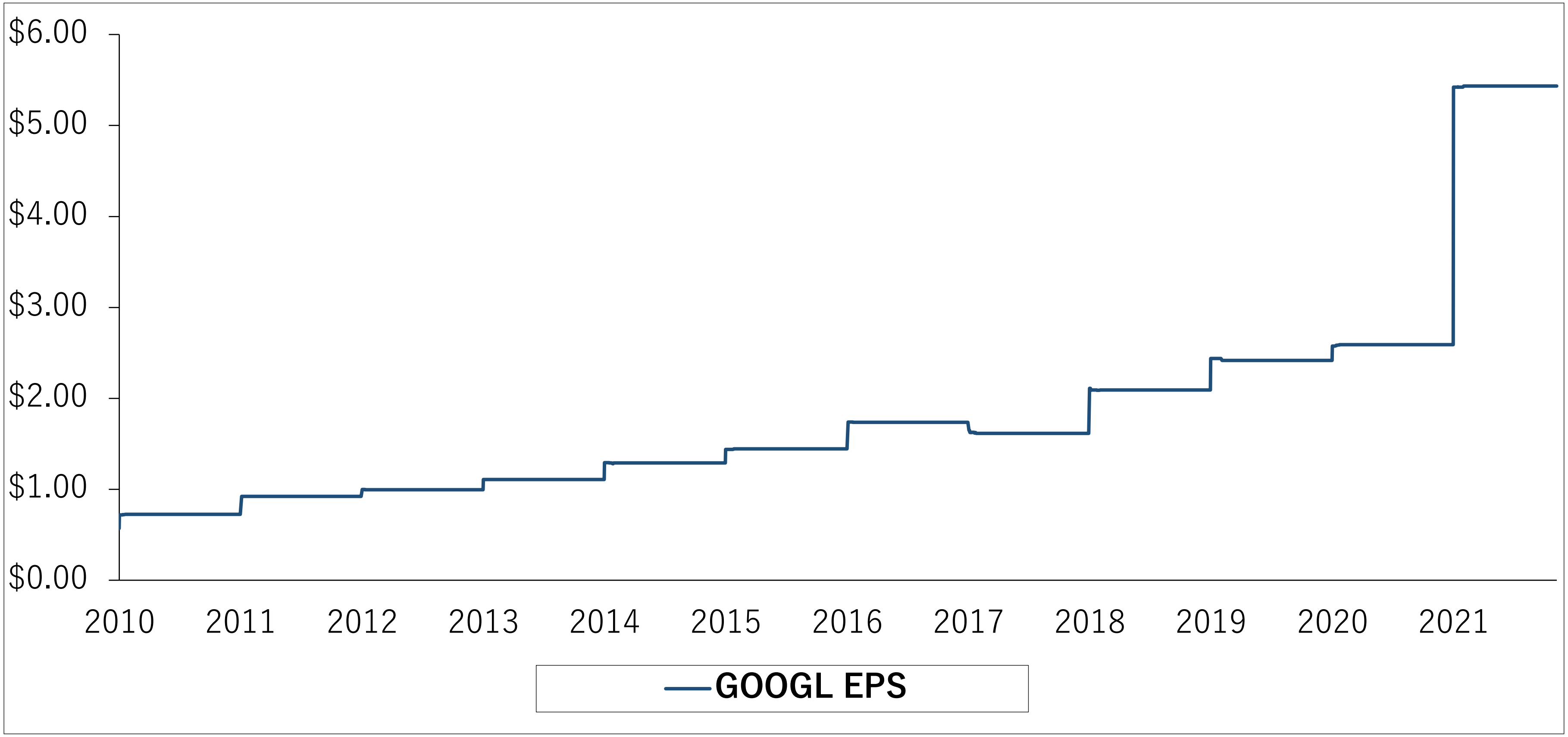
1. **Long-Term Value Investors**

> Thinks of owning stocks as owning businesses, not interested in market sentiment, focused on fundamentals
>
> Highly focused on the qualitative aspects of a company:
> - ❑ Quality of the business
> - ❑ Sustainability of competitive advantage
> - ❑ Reinvestment opportunity and growth runway
>
> Invests in businesses that compound value over time

$$Earnings\ Growth = Return\ on\ Invested\ Capital * Reinvestment\ Rate$$

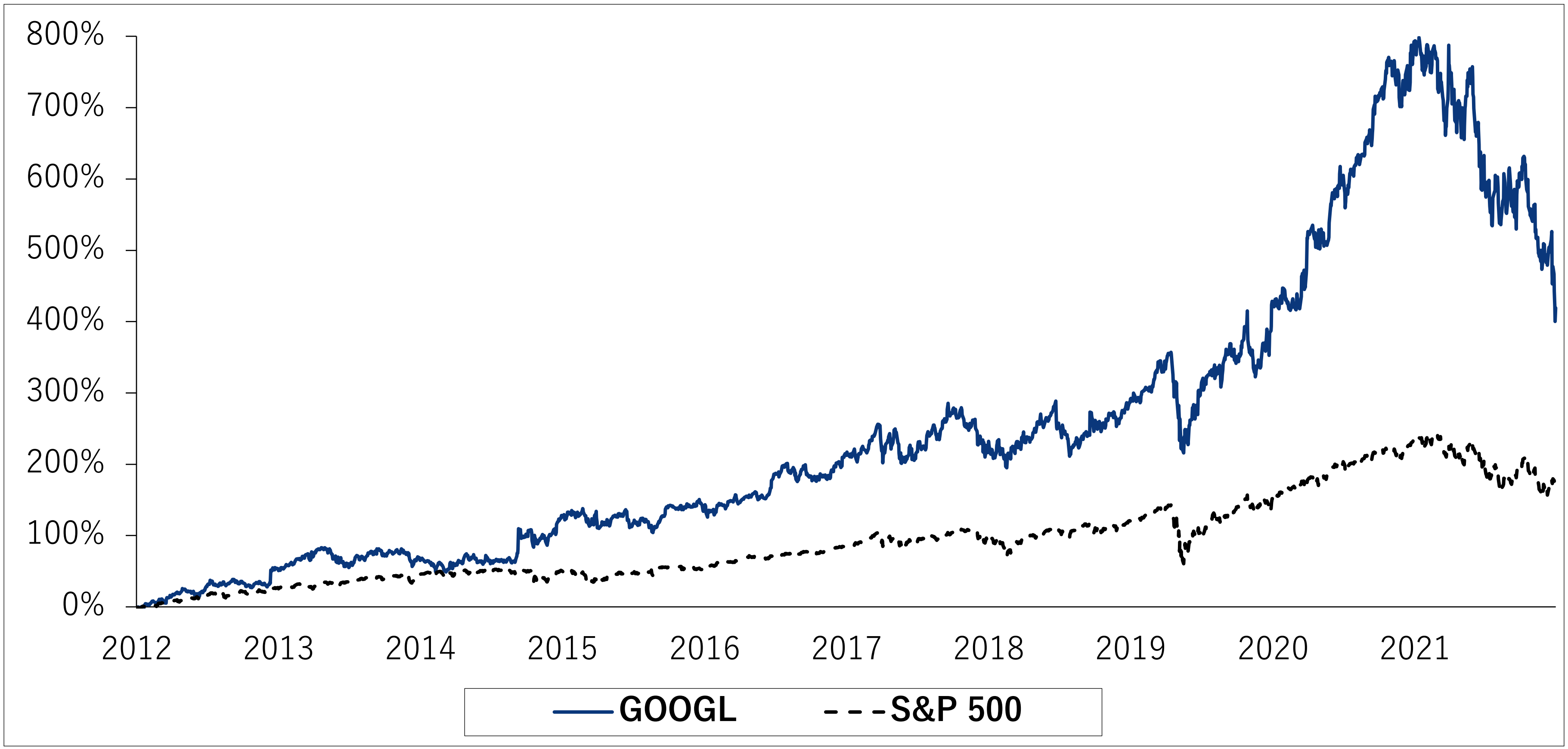
Earnings Growth: Alphabet Inc (GOOGL)

GOOGL has grown EPS at a 30% CAGR since 2004…
Over the past 10 years, GOOGL has grown EPS at a 25% CAGR



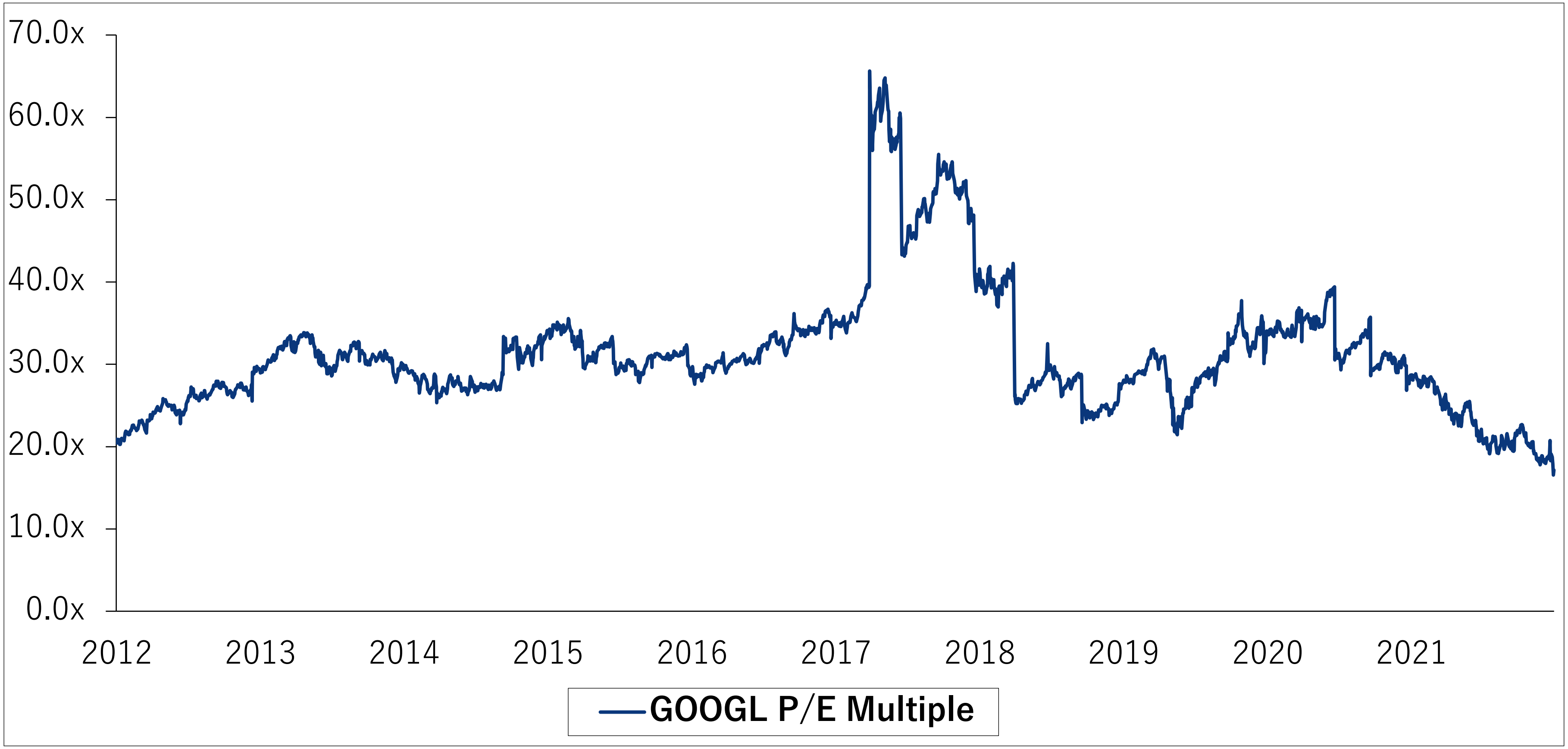
Earnings Growth: Alphabet Inc (GOOGL)

GOOGL has significantly outperformed the S&P 500 over the past 10 years returning a total of ~420% vs. ~170% for the S&P 500



Earnings Growth: Alphabet Inc (GOOGL)

GOOGL had multiple compression over the past 10 years meaning that it managed to outperform despite lower investor sentiment!



Advantages of focusing on earnings growth

$$Return = \boxed{Earnings\ Growth} + Dividends\ and\ Buybacks + \Delta\ in\ Multiple$$

Advantages of focusing on earnings growth:

1. **Time Horizon** + **Less Turnover**
   - > Over the long-term, stock returns roughly equal the rate that a business compounds its earnings per share
   - > If a company rapidly compounds EPS for a long time, your money grows with the business; you don't ever need to sell!
2. **Less Reliance on Investor Sentiment**
   - > You don't need to convince investors to be willing to pay a higher multiple to realize investment returns
   - > In other words, there's no "greater fool theory" in which you need to find a greater fool to pay a higher price than you

Advantages of focusing on earnings growth

"Time is the friend of the wonderful company, the enemy of the mediocre." ***– Warren Buffett***

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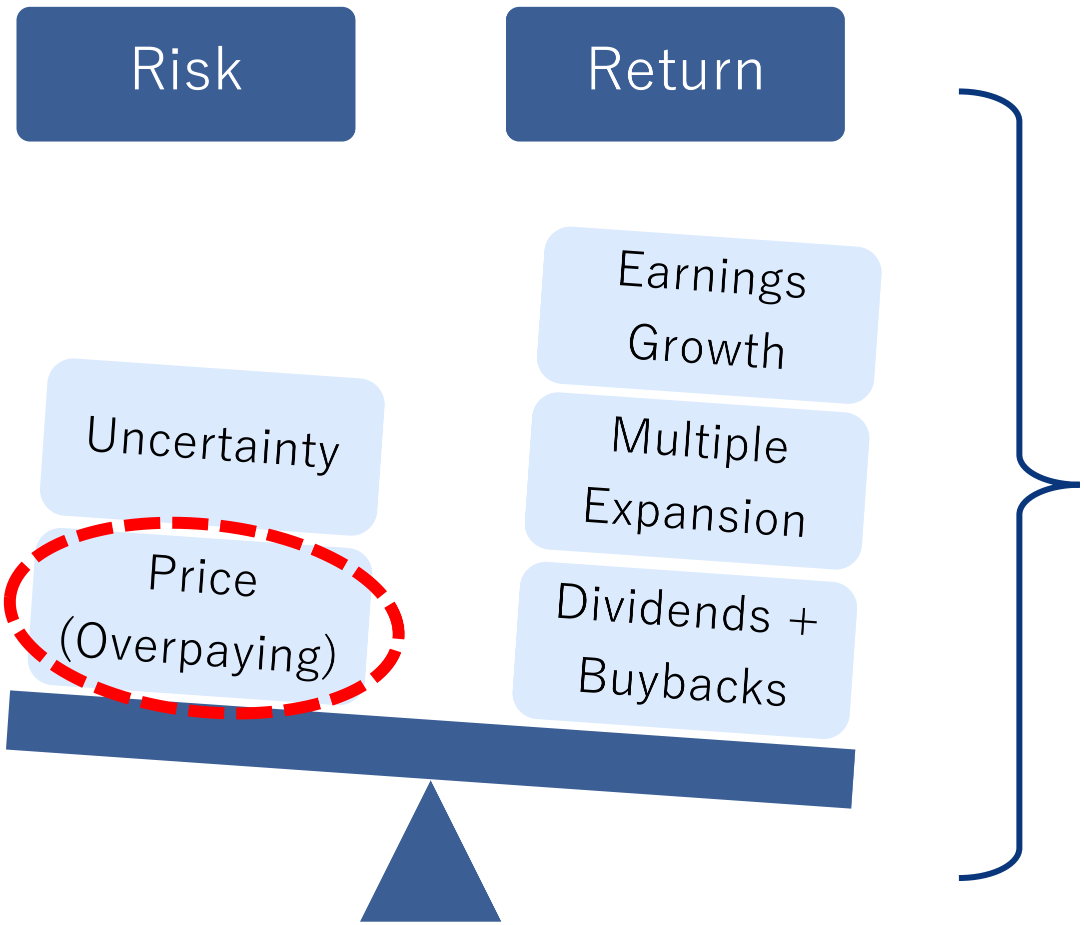
Risk vs. return

You can turn any business into a bad deal by paying too much…



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Good business ≠ good investment

Microsoft—Monopoly software company

Microsoft Corporation (NASDAQ: MSFT)

What makes Microsoft such a great business?

> **Defensible franchise** – Monopoly on PC software; cash cow with almost no marginal cost

> **"Inevitable" Status** – Earnings will very likely be higher 5, 10, and 20 years from now

> **High ROIC & Growth** – Royalty/licensing business model earns high ROIC

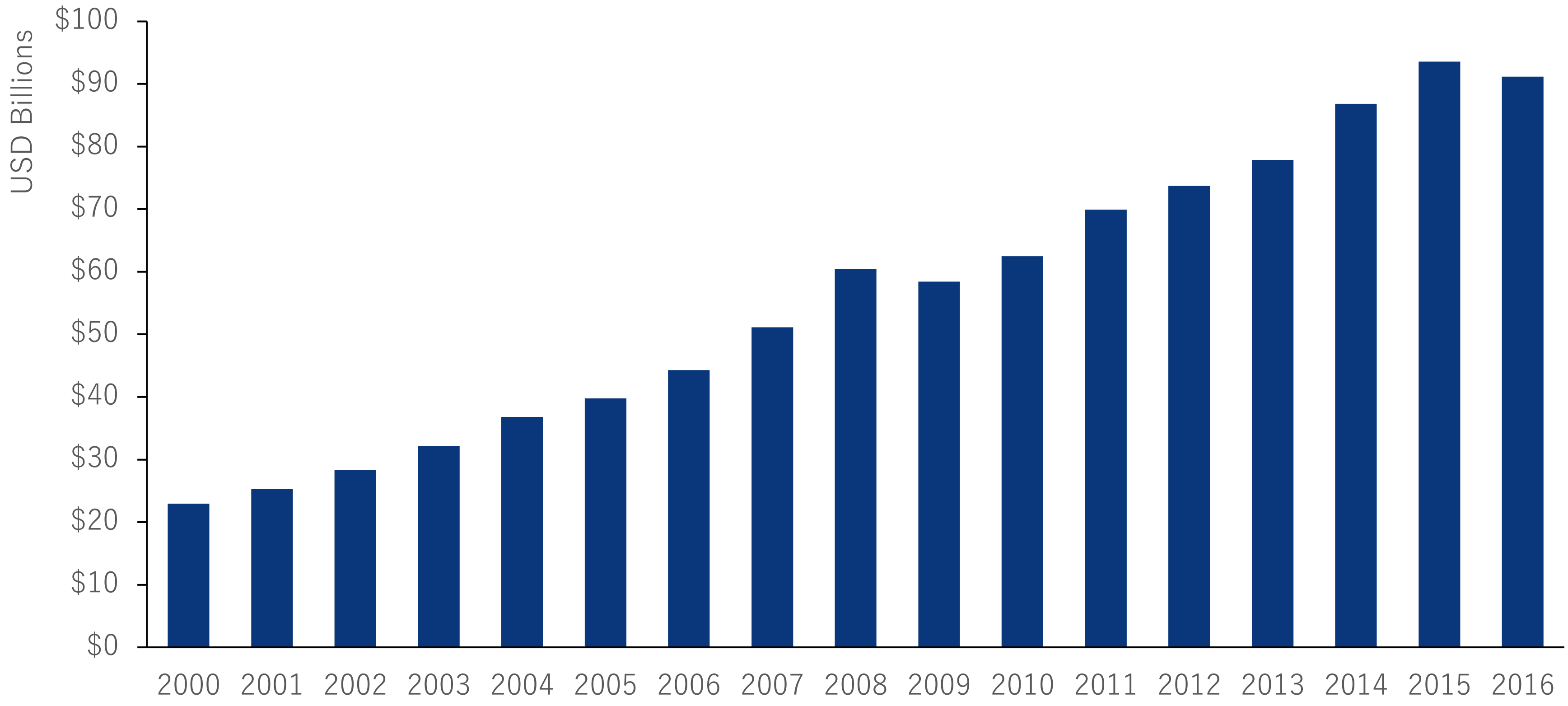
In late 90s early 00s, Microsoft was earning 50-100% ROIC

Excellent company growing topline at 30%+ per annum

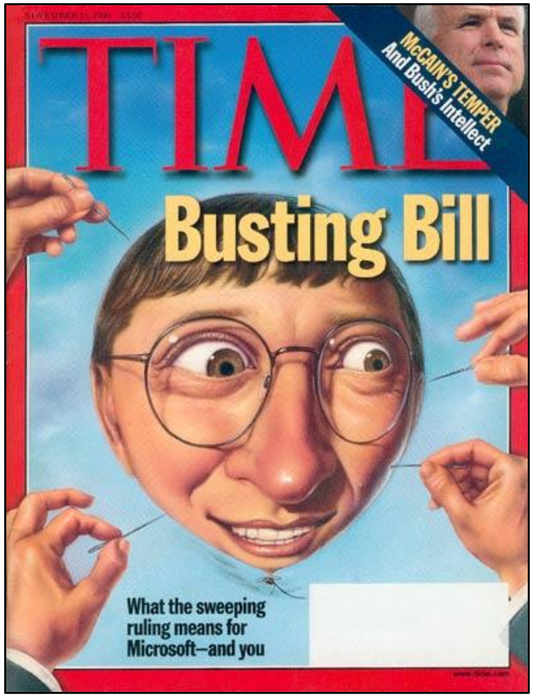
MSFT's revenue from 1999 to 2016

From 1999 to 2016, sales increased almost 5-fold

Revenue basically did nothing but go up for 17 years…



Price Matters: MSFT 1999 valuation



Market cap was ~$600 bn while it only earned ~$4.5 bn per year

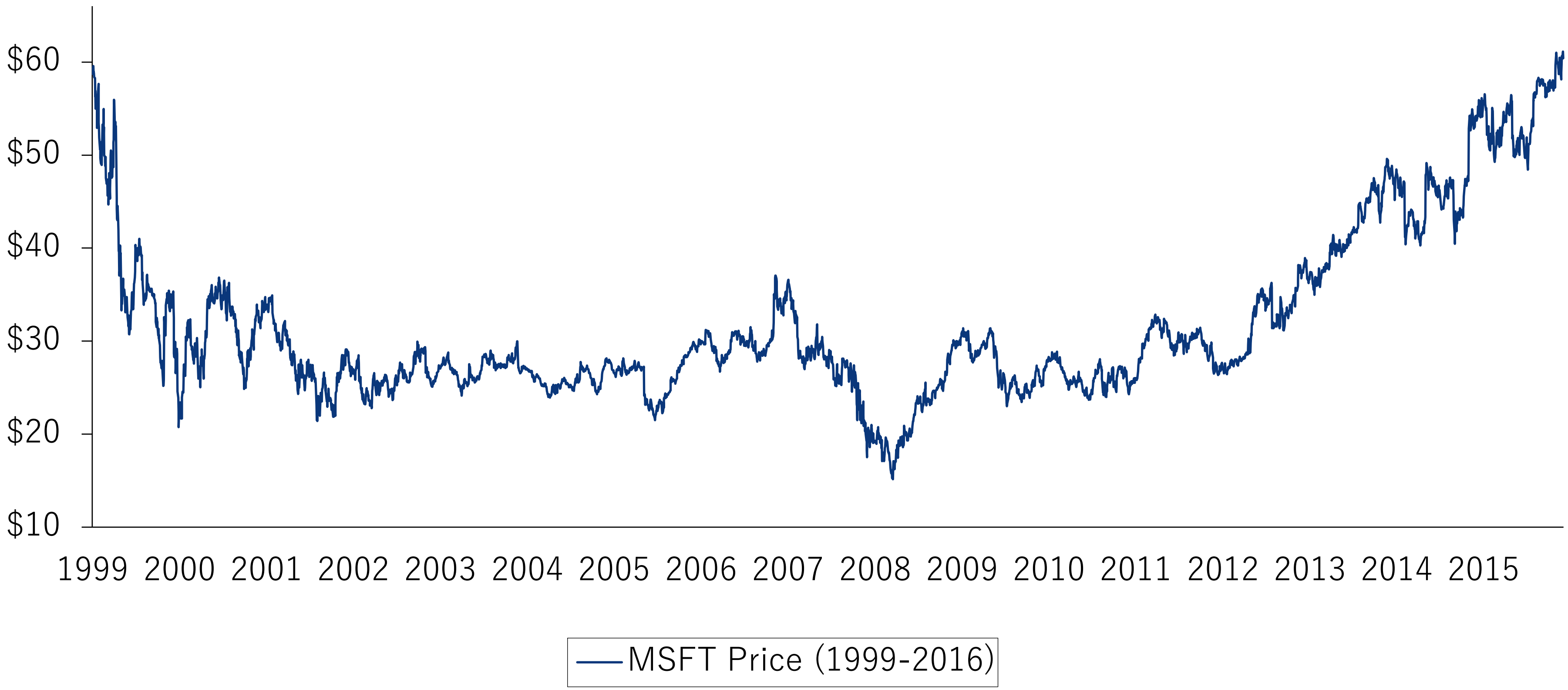
MSFT traded at 28.5x sales at the peak of the dotcom bubble

What's happened to the stock after that?

MSFT's stock price from 1999 to 2016

Stock delivered zero returns for 17 years; ~80% loss in 2008

Buying a great business can turn out to be a terrible investment if the price is too high



Disadvantages of being a long-term investor

<u>Disadvantages of focusing being a long-term investor:</u>

1. **Longer Validation Time Frame**
   > Oftentimes, you won't know if you're right or not until many years pass... Short-term investors are validated quicker...
   > Sometimes, you can look wrong for a prolonged time frame because of adverse changes in short-term sentiment
2. **Psychologically Challenging**
   > It can oftentimes be difficult to be patient
   > It's hard to just do nothing when there is nothing worth doing

"The stock market is designed to transfer money from the active to the patient" – Warren Buffett

Business quality

Competitive strategy: moats, castles, and protecting ROIC

The two most important questions

How does a business earn a high return on invested capital?

How do we know if a business can continue to earn a high ROIC?

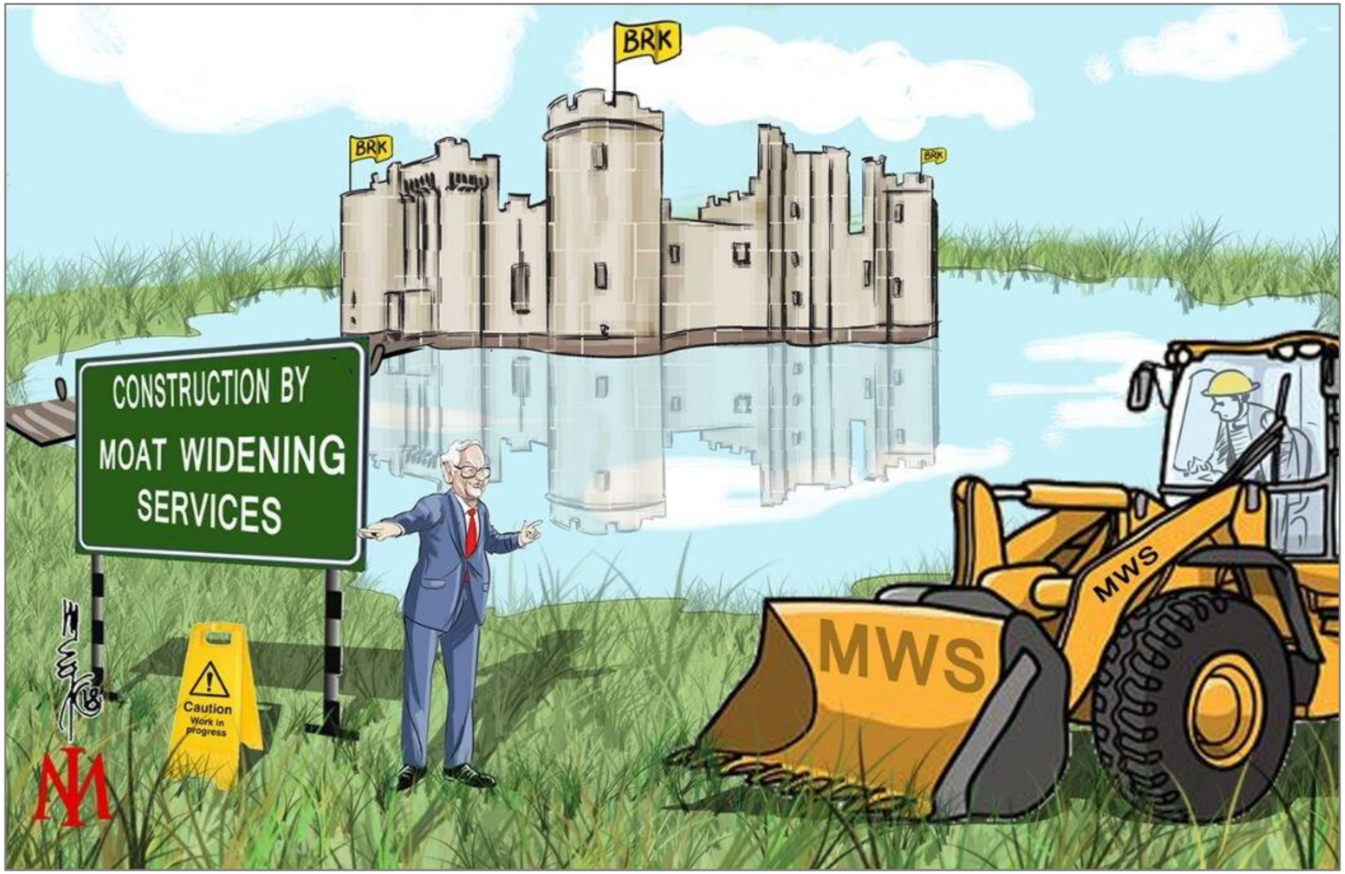
Answer: Competitive Advantage

High returns on invested capital attract competition, so persistent economic profits need to be protected by a competitive advantage

A competitive advantage prevents other businesses from competing on a level playing field

Moats and Castles

An **economic moat (sustainable competitive advantage)** can protect a castle (business) from new entrants who could erode ROIC



Common types of moats

1. Product Differentiation
2. Network Effects
3. Switching Costs
4. Cost Advantages
5. Exclusive Distribution Channels

Product Differentiation

Having a differentiated product that is protected from replication prevents new entrants and allows a company to charge premium prices

What are some examples of product differentiation?

1. **Brand**
   - Apple, Starbucks, Nike, LVMH
   - Not all brands are moats (i.e. Southwest, Verizon, etc.)
2. **Patents**
   - Technology/manufacturing (TSMC), pharma/biotech (Pfizer)
3. **Trade Secrets**
   - Coca Cola recipe

Network Effects

When the value of a service grows as more people use the network

What are some examples of network effects?

1. **Marketplaces**
   > Amazon, Alibaba, Airbnb, CME, Intercontinental Exchange
2. **Social Media**
   > Facebook, Instagram, Tik Tok, Twitter, Snapchat
3. **Payments**
   > Mastercard, Visa, PayPal, Venmo

Switching Costs

High costs (i.e. time, money, regulatory restraints, etc.) that dissuade customers from switching to a competitor's product

What are some examples of high switching costs?

1. **Software**
   - S&P Capital IQ, Bloomberg, Salesforce, Microsoft Office
2. **Equipment and Components**
   - ASML, Transdigm, Intuitive Surgical
3. **Testing Instruments**
   - Agilent, Waters Corp

Cost Advantages

Companies at the lower end of the cost curve are able to earn higher margins or undercut competitors on price

What are some examples of cost advantages?

1. **Economies of Scale**
   - Walmart, Amazon, Samsung, Home Depot
2. **Lower-Cost Resource Base**
   - Saudi Aramco

Exclusive Distribution Channels

When a business has exclusive rights to sell their product within an important distribution channel

Examples of exclusive access to distribution channels?

1. **Exclusivity Contracts**
   - TNT (owns NBA rights), Universal Music Group
2. **Distributor Networks**
   - Gillette (exclusive shelf space), Armstrong World Industries

What is **NOT** an economic moat?

1. **Market Share**
   > General Motors, Telecom (AT&T, Verizon, T-Mobile)

2. **Technology**
   > Technology can be disrupted (Kodak, AOL, Myspace)

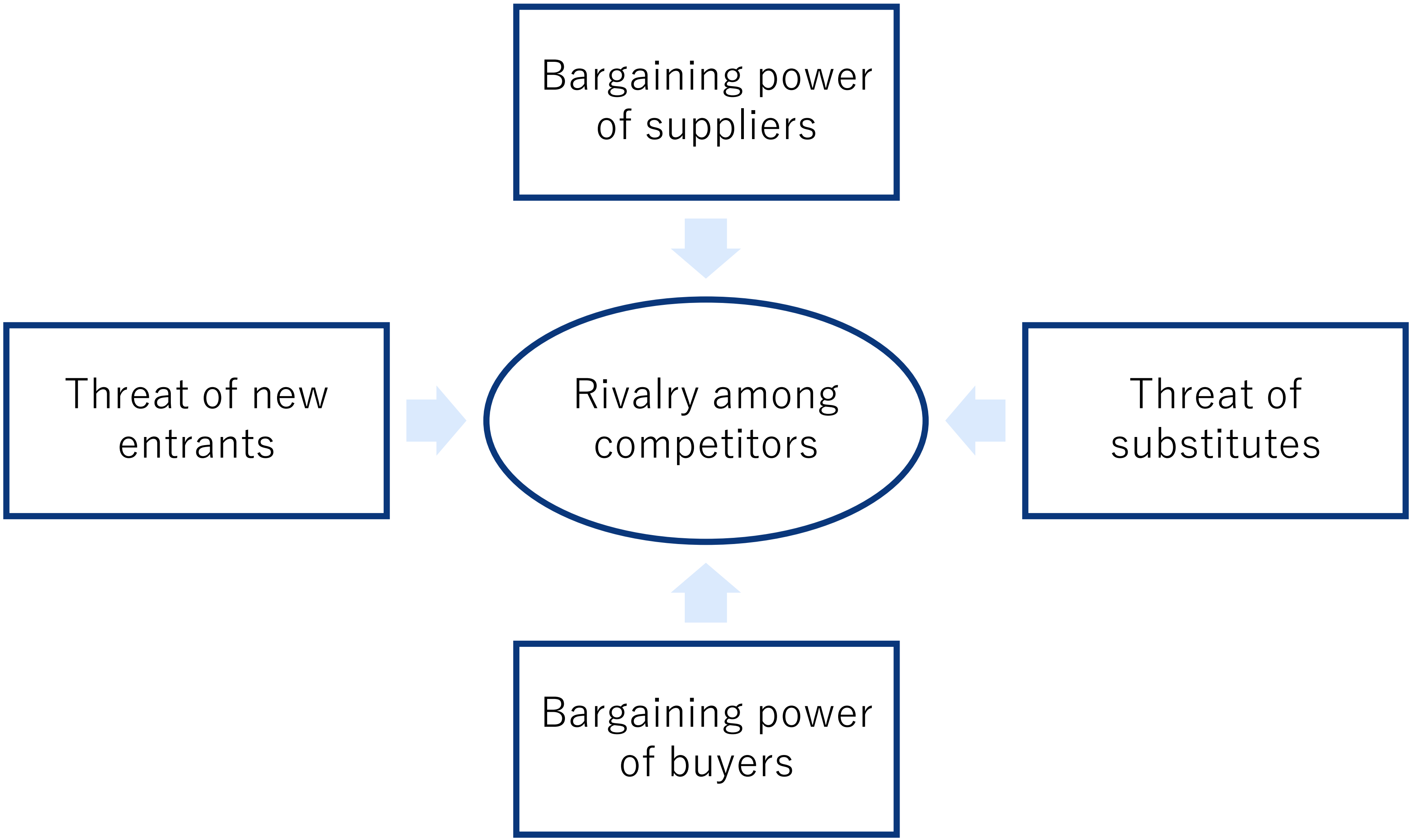
3. **Popular Products**
   > Trendy products can earn high a ROIC in the short-term, but popularity isn't a moat (Heelys, Oatly, fidget spinners)

4. **Management**
   > "Good jockeys will do well on good horses but not on broken down nags." – Warren Buffett

Understanding competition

Competitive dynamics are constantly changing and there are many factors that shape competition… How do we assess the attractiveness of a business on the basis of competition within an industry?

Five Forces Model



Five Forces Model

Strong

Weak

Bargaining power of suppliers

Threat of new entrants

Rivalry among competitors

Threat of substitutes

Bargaining power of buyers

Five Forces Model

Bargaining power of suppliers

Threat of new entrants

Rivalry among competitors

Threat of substitutes

Bargaining power of buyers

Strong

JCPenney

Weak

LVMH

Five Forces Model

Bargaining power of suppliers

Threat of new entrants

Rivalry among competitors

Threat of substitutes

Bargaining power of buyers

Weak

BNSF RAILWAY

Strong

SOUTHERN ROANE FARM

Local Farm Raised Beef and Lamb

TEN MILE , TENNESSEE

615-210-6589

Five Forces Model

Weak

Bloomberg

Threat of new entrants

Strong

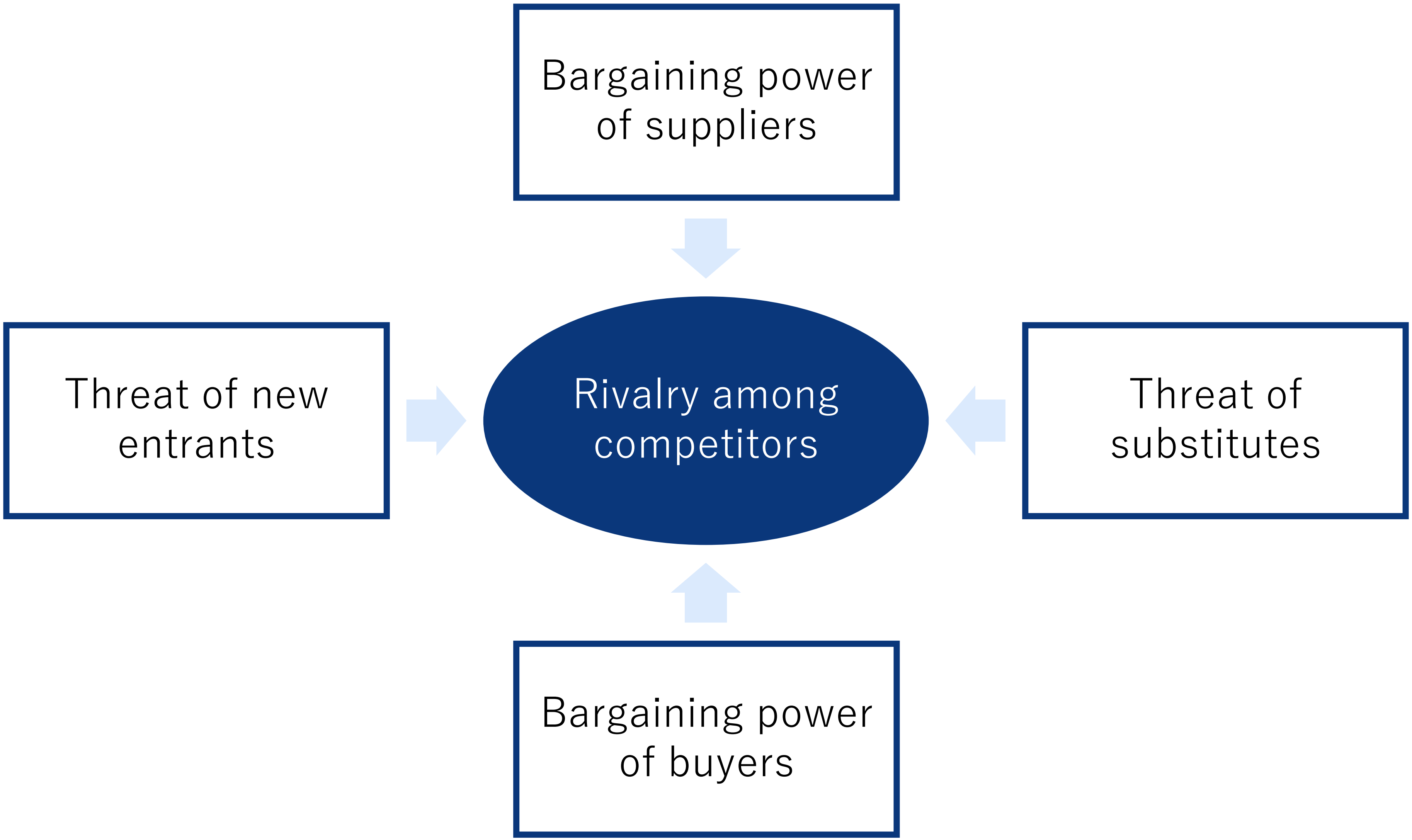
Bargaining power of suppliers

Rivalry among competitors

Threat of substitutes

Bargaining power of buyers

Five Forces Model



Value investing process

- Identify potentially undervalued opportunity
- Conduct qualitative and financial analysis
- Value the underlying security
- Invest if the price < intrinsic value
- Sell when price > intrinsic value

Investment checklist

Having an idea of what you're looking for in an investment can make filtering through stocks and finding good ideas easier

- ❑ Is this a business I can understand?
- ❑ Is it a good business? Does it currently or at least have the potential to earn a high return on invested capital?
- ❑ Do I feel confident in predicting the future cash flows?
- ❑ Is the management honest and competent? What is their compensation and capital allocation track record?
- ❑ Is it cheap? Are there other opportunities that are more attractive?

Remember to stay flexible! You will only learn what your sweet spot is from reading, investing, and repeating.

“Value investing requires a **great deal of hard work, unusually strict discipline, and a long-term investment horizon**. Few are willing and able to devote sufficient time and effort to become value investors, and only a fraction of those have the proper mind-set to succeed.

SETH KLARMAN

CEO of Baupost Group