

Modern Security Analysis

Value Investing

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Instructor Info

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COURSE DESCRIPTION

The purpose of the course is to provide the student with the needed tools to understand and learn the discipline of value investing. This is a course about business valuation, corporate finance and security analysis with an emphasis on analyzing public companies from the bottom up. This is in sharp contrast with traditional academic finance, which is heavily top down and assumes substantive consolidation between the company and its constituencies (managements, stockholders, bondholders, trade vendors, etc.). We examine the company as a stand-alone, separate and distinct from shareholders, managements, creditors, regulators, etc. We study the conflicts of interest and communities of interest among these constituencies and look at the markets where those different constituencies participate, i.e. public markets, private markets, markets for corporate control, markets for distressed credit instruments, etc. The course is focused on the valuation of businesses and how corporate values are reflected or are not reflected in public security prices and why. The student learns the important differences between investing and speculating, which will serve as the basis for understanding what value investing is all about. We make extensive use of corporate filings with the Securities and Exchange Commission (SEC), press releases, and media reporting to understand the issues that are important to real world investment issues. Since I am doing this in Bogota, I have also included examples of Colombian companies. We also touch on issues of corporate law, securities law, credit analysis, and financial accounting. Throughout the course we find it very useful to contrast the academic view against the value investor's view. The course is not based on a textbook but on several books written by professional investors. During class we shall be contrasting both the academic and professional approaches so that you can reflect on the merits and limitations of both views.

BOOKS AND OTHER RESOURCES

1. *Modern Security Analysis: Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, John Wiley & Sons 2013. REQUIRED
2. *Distress Investing: Principles and Technique*, by Martin J. Whitman and Fernando Diz, John Wiley & Sons 2009.

COURSE STRUCTURE AND GRADING

The structure of the course is the traditional lecture combined with in class cases. The course will require a lot of reading. The cases are meant to reinforce the learning of concepts that are best learnt by doing.

The grading structure will be as follows:

Written assignments (In-class cases):	75%
Final case:	25%

During class discussions, you will be called on at random to comment. You can meaningfully discuss anything only if you are prepared, so reading class material is a very helpful habit when you take this course.

Below is a sketch of the topics that we shall be covering in class. Readings are indicated with endnotes.

I. INTRODUCTION

1. *A Conceptual framework for understanding any form of investing.*¹
 - a. What is value investing: a quick definition.
 - b. The five factors fundamental to understanding anything:
 - i. Fundamental finance and what is value investing? Later: Investing vs. speculating.
 - ii. How can corporate values be realized through ownership of corporate securities? Later: The substantive characteristics of securities.
 - iii. How do businesses create value? Later: Wealth or Earnings, Net Asset Value
 - iv. How do we appraise corporate values? Later: Going Concern and Resource Conversion.
 - v. Are there relationships between security prices and corporate values? Understanding public security markets. Later: Understanding Market Efficiency or lack thereof.
2. *Investing vs. speculating*²
 - a. Graham and Dodd's view on the subject.
 - i. Stocks vs. Bonds
 - ii. Outright purchases or margin purchases
 - iii. For permanent holding or a quick turn
 - iv. Income or Profit
 - v. Safety vs. "Risk"
 - b. A Definition.
3. *The substantive characteristics of securities.*³
 - a. What gives securities value?
 - b. Reading Articles of Incorporation
 - i. Zahn vs. Trans America (Case #1)
4. *Markets and market efficiency.*⁴
 - a. Definitions and examples.
 - b. Ben Graham's "Mr. Market" story as a characterization of the market for publicly traded common stocks.⁵
 - c. George Soros theory of reflexivity as an "asymmetric" arbitrage.⁶
 - d. An apparent puzzle: the different pricing of privately owned and publicly owned businesses.⁷

- e. Towards a general theory of Market Efficiency: Forget EVERYTHING you learn or learned at other business schools.
 - f. A case on reading Graham's Business vs. Stock market valuation. Case #2.
5. *Businesses as creators of wealth*
- a. Businesses must be viewed as generators of wealth through:
 - i. Operations
 - ii. Resource Conversion
 - iii. Financings/Refinancings
 - b. Firms and managements as:
 - i. Operations/Operators
 - ii. Investors/Deal Makers
 - iii. Financiers
 - c. A framework for evaluating managements.
 - d. A case on the dynamics of wealth generation and how it is or it is not reflected in security prices. Case #3.

II. BUSINESS VALUATION

6. *Corporate valuation.⁸*
- a. The four ways businesses create wealth:
 - i. Earnings
 - ii. Free Cash Flow.
 - iii. Resource conversion.
 - iv. Accessing capital markets on a super attractive basis.
 - b. Corporate Valuation based to the four ways to create wealth for a specific business: *strict going-concern* and *resource conversion* valuation.⁹
 - c. **Strict going-concern** valuation approaches.
 - i. The basics of cash-flow-based valuation.
 - ii. Using EBITDA as a measure of cash flow.
 - 1. Understanding and adjusting EBITDA
 - 2. Limitations of EBITDA
 - iii. Comparing discounted cash flow and EBITDA multiple approaches.
 - iv. What is enterprise value? Where does it come from?
 - v. Calculating enterprise value.
 - 1. Determining the correct multiple.
 - 2. Using comparable company analysis.

- a. Finding comparable companies.
 - b. Publicly Traded Comparable companies.
 - c. Deal-Based Comparable companies.
 - d. Examples.
 - vi. Developing a pure going-concern valuation framework that accounts for growth expectations and leverage.¹⁰
 - vii. Case #4.
- d. **Resource-conversion** valuation.¹¹
- i. An exercise in establishing how a public company generates wealth through resource conversion activities.¹²
 - ii. Using resource conversion analysis in the appraisal of businesses and managements.
 - iii. Asset-based valuations. (GAAP vs. IFRS)
 - iv. Look-through earnings.¹³
 - v. LBO valuation (recapitalization and changes of control).¹⁴
 - vi. Book value vs. Net Asset Value (NAV).¹⁵
 - vii. Combining sources of value: Case #5

REFERENCES

- ¹ Class notes and Chapter 1: The Scope of Fundamental Finance, Investing, and the Investor Landscape: *Modern Security Analysis Understanding Wall Street Fundamentals*, Martin J. Whitman and Fernando Diz, Wiley 2013.
- ² Graham, B and D. Dodd, *Security Analysis*, The Classic 1951 Edition, McGraw Hill, Chapter 4: Investment and Speculation, pages 33-46, and class notes.
- ³ Read Chapter 4: The Substantive Characteristics of Securities, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013.
- ⁴ Read Chapter 14: Toward a General Theory of Market Efficiency, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013.
- ⁵ Buffett, W., *The Essays of Warren Buffet: Lessons for Corporate America*, 2001, pp. 63-67.
- ⁶ George Soros, “The Full Text of George Soros Speech on “Act II” of the Crisis”, NY Times Deal Blog, June 10, 2010. Edited by Andrew Ross Sorkin. Available on the Web Site.
- ⁷ Class notes and “Business Valuations vs. Stock Market Valuations”, in *The Intelligent Investor*, Benjamin Graham, Harper Business 1971, pp. 102-109.
- ⁸ Read Chapters 2: A Short Introduction to the Going Concern and Resource Conversion Views of Businesses, and Chapter 5: Primacy of the Income Account or Wealth Creation? What are Earnings , Anyway?, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013.
- ⁹ Class notes, and Whitman, M.J. and Fernando Diz, *Distress Investing*, Chapter 10, pp. 133-148.
- ¹⁰ Class presentation and handout.
- ¹¹ Read Chapter 25: The Economics of Private Equity Leveraged Buyouts, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013 and class notes.
- ¹² Class presentation and class material.
- ¹³ Read Chapter 18: Broker-Dealer Research Departments and Conventional Money Managers, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013, pp. 277-79 and Buffett, W., *The Essays of Warren Buffet: Lessons for Corporate America*, 2001, pp. 179-183.
- ¹⁴ Read Chapter 25: The Economics of Private Equity Leveraged Buyouts, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013 and class notes.
- ¹⁵ Read Chapter 6: Net Asset Value: The Static and Dynamic Views, in *Modern Security Analysis Understanding Wall Street Fundamentals*, by Martin J. Whitman and Fernando Diz, Wiley 2013 and class notes.