

MODERN VALUE

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EMBA – Spring 2020

Preliminary Syllabus

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OFFICE HOURS

Office Hours and communication with me: I will respond to emails within 24 hours; make sure the subject line says “Modern Value – Spring 2020”, otherwise we risk losing your email in the endless river that is my Inbox! Please do let me know whether you want to meet and we will arrange to meet before class, on Wednesdays itself. All issues administrative should be addressed to the teaching assistant.

DESCRIPTION AND OBJECTIVES THE COURSE

How are we to think about the future of value investing in the face of the changes occurring in financial markets and in the economy at large? This course argues that we can extend the ideas and principles of value investing beyond the traditional focus on the stocks and bonds issued by sound companies but trading at distressed prices. The course aims to provide a bird’s eye view on the ideal multistrategy fund with a value orientation may look like.

There are three parts to the course. The first part provides foundational material. The basics of the valuation approach are covered here. It is intended to bring up the student up to speed in the basic ideas behind traditional value investing techniques. It is a crash course on valuation, but we will get to revisit the framework repeatedly throughout the course. The second topic in the first part is concerned with the issue of risk management. Value investors' traditional risk management technique has been the margin of safety, the idea that one can embed enough robustness in the valuation to avoid the permanent impairment of capital. The margin of safety is a powerful idea, but it is there to protect the investor against what is not knowable. How do we organize what is knowable so that the margin of safety can be fixed around the appropriate aspects of the business? This is what the lecture on risk management is about.

Many, but not all, traditional value investors focus on particular asset classes, mostly stocks and bonds. Can some of the techniques and ideas of value investing be extended to other domains? This is the second part of the course. First, many value investors shy away from any form of activism, adopting a passive attitude towards management and the operations of the firm. But in a world of plentiful capital and low yields the pressure to improve operational efficiency is going to be relentless and we are in the cusp of a managerial revolution across the world. There are many ways to benefit from the coming wave of activism, which is already taking place not just in the US but increasingly in Europe. In addition, associated with the relentless pursuit of efficiency are the special situations that on many occasions bring about those operational improvements. The third area is private markets. There is a disturbing trend in public markets: There is a decreasing number of firms that are publicly traded. This is not due to diminished economic activity: An even larger fraction of risks are distributed in the private markets, through private equity and other vehicles. The domain of traditional value investors has been the public market, but the future value investor needs exposure to private markets.

The last part of the course is devoted to the issue of disruption and changing trends in the market. The first lecture focuses on the many trends, large and small, affecting businesses and the economy in general. Amongst the large trends is of course the slow death of manufacturing and the rise of the services economy. What are the consequences of this macrotrend for the value investor? In addition, the world we live in is dynamic, bubbly, and uncertain and many shocks are disrupting traditional industries. Is there a systematic way of thinking about disruption or are they all different? More importantly, how are we to understand industry dynamics and valuation? We study two such cases. First, we study the case of the financial services industry which is being disrupted by two forces, regulation and technology. We focus on one particular industry, payments, traditionally dominated by banks ... but not anymore. Why? The second case is more focused on the potential regulatory threat to the technology industry. Indeed, there has been much discussion over the last few years about the need to regulate some of the companies that seem protected by identifiable (and powerful) barriers to entry. In addition, these companies control the access of customers (both individuals and businesses) to a variety of internet services (from on-line marketing to cloud services).

The last segment is devoted to slow moving consumer trends. Here the evidence is clear, consumer spending data speaks clearly to the increasing importance of three items: Health care, education and leisure. We need to understand the reasons behind these trends to better position our portfolio. There are obvious and profound consequences associated with these trends, of course. Health care in particular is an interesting industry. There has been a significant amount of consolidation

in the hospital industry over the last few years and this in itself is an interesting trend (that can be observed across almost all industries in the US and around the world and one that we will study in the class). There is another trend that interacts with consolidation: There are about 16% of US citizens above the age of 65 today; 20% in a decade or so. Seniors have a very inelastic demand for health services. This combined with increasing concentration results in significant profitability but also pressures on the funding of social programs. These are complex issues and almost a warrant a course by themselves, but here we are just interested in the narrow issue of which company is best positioned to benefit from these trends. Leisure is another industry changing fast. As productivity overall increases and automatization continues its unstoppable march, hours worked will decrease (with all the attendant social problems) and households will have more time to devote to their favorite activities, such as sports (we will discuss some of these trends while discussing the Nike case) or for the more fortunate traveling. We study the tourism industry in some detail and try to assess the winners and losers of that trend.

The course is structured so that several cases are covered in class and used to illustrate many of the concepts and idea in this course. These cases will include Bookings, Nike, Adobe, ... but the focus will also be broader, whether on the industry or in the “situation” to try to obtain a bird’s eye view of the issues at hand.

METHOD OF EVALUATION

- The grade will be based on
 - 70%: A final case of an industry subject to disruption and a valuation of one of the companies in that particular industry.
 - 20%: Three (brief) homework assignments
 - 10%: Participation and attendance

RECOMMENDED COURSE MATERIAL

Required Textbooks

There is one required textbook:

- *Value Investing: From Graham to Buffett and Beyond*. Bruce C. N. Greenwald, Judd Kahn, Paul D. Sonkin and Michael van Biema, Wiley Finance, 2004.

Other important references

- *The Intelligent Investor: The Definitive Book on Value Investing. A Book of Practical Counsel* (Revised Edition) [with comments by Jason Zweig and introduction by Warren Buffett].

Other interesting books that immediately come to mind are:

- *Value Investing: A Balanced Approach*. Martin Whitman. Frontiers in Finance Series, John Wiley & Sons, 2000.
- *Berkshire Hathaway, Letters to shareholders*. Warren Buffett.
- *The Essays of Warren Buffett*. Edited by Lawrence Cunningham. Carolina Academic Press.

There are two books in the intersection of accounting and valuation that are useful supporting material

- *The Analysis and Use of Financial Statements*. Gerald White, Ashwinpaul C. Sondhi and Dov Fried. J. Wiley, 2013, 3rd edition
- *Financial Statement Analysis and Security Valuation*. Stephen Penman, 5th edition

CONTENTS

PART I: SETTING THE GROUND

Session 1: January 22nd: Introduction and overview

This lecture provides a broad overview of the course and introduces the basic valuation techniques we are going to be using throughout.

1. *Introduction: What is modern value and what is the future of value investing*
2. *Review of Value investing – 1: Overview of the value investing process*

Session 2: January 29th: The valuation framework

This session will be devoted to an in-depth analysis of the three steps in the valuation. We illustrate these techniques through the analysis of one particular company, Deere.

1. *Review of Value Investing – 2: AV and EPV*
2. *Review of Value Investing – 3: Growth*

Session 3: February 5th: The valuation framework: Two cases

This session is here to provide additional room to explore the issue of valuation.

1. *Review and additional topics in valuation – Additional example*
2. *Case due: Adobe*

Session 4: February 12th: Risk management

In this session we introduce the topic of risk management which so important a role is going to play in the rest of the course. The different classifications of risks are introduced. Risks can be classified depending on the particular approach taken towards the valuation but also by their nature (whether they are idiosyncratic, industry or aggregate risks, for example). Risk management techniques are illustrated through a variety of examples. .

1. *Risk Management: The different taxonomies of risk*
2. *Case due: Bookings*

PART II: EXTENDING THE PRACTICE OF VALUE INVESTING

Session 5: February 19th: Investing in time of crises

The lessons from the session on risk management are illustrated by revisiting the investment environment during the global financial crisis. To offer a perhaps broader perspective, we focus on the Eurozone case and illustrate the opportunities and risks in three different countries, Greece, Spain and Ireland.

1. *Investing in times of (economic, financial, political, ...) crisis*
2. *Case: Anglo-Irish, Ferrovial, Opap*

Session 6: February 26th: Engaged investing, activism, constructive activism

In a world of plentiful capital a possible route to generate returns is to improve the operational efficiency of companies otherwise protected by some form of barrier to entry. To some extent Mr. Buffett's partnership with Brazilian group 3G is an example of the difficulties of generating large returns with a purely passive approach towards management. What are the key ingredients of a successful activist investment approach?

1. *Value investing and activism: How to think about activism*
2. *Speaker/Case*

Session 7: March 4th: Special situations

The value investor brings a disciplined approach to valuation, one that combines a thorough understanding of the business operation of the firms with a margin of safety. In this lecture we explore how to extend these ideas to the case of special situations, such as reorganizations, mergers, spin-offs and so on.

1. *Special situations*
2. *Speaker/Case*

Session 8: March 25th: Private markets

One of the most striking trends in financial markets has been the phenomenal growth of private markets. It is difficult to see how investors can succeed and generate outsized returns without exposure to private markets. In this lecture we explore the reasons for the growth of private markets, the consequences for the economy at large and for the value investor in particular.

1. *The growth of private markets*
2. *Speaker (TBA)*

PART III: DISRUPTION, TRENDS AND VALUE INVESTING

Session 9: April 1st: Disruptions and trends

This is a broad lecture. It intends to think about the issue of disruption from a broad perspective. It argues that the current technological revolution is producing a significant unbundling of services and products traditionally supplied jointly. It lowers the barrier to entry in some industries (finance for instance) but it also comes with significant sources of barriers to entry in others (social media). It also covers the issue of consumer (and other) trends. It will place this in the context of the history of consumer changes throughout history and it will argue that in this ... there is much less that is new.

1. *The many taxonomies of disruption*
2. *Trends ... in consumer spending, in business practice adoption, in policy*

Session 10th: April 8th: Disruption in the financial service industry

Changes in technology are all around us, but they affect different industries differently. Consider banking, perhaps one of the oldest service industries. It is an activity in which traditionally two services were supplied jointly: lending and payments. Technology is allowing for the unbundling of these two services, spelling doom for the banks but also creating attractive opportunities. We study the payments industry and its likely evolution.

1. *Technology disruption: The disruption in the financial services industry*
2. *Case: The payments industry – PayPal, Adyen, Global Payments, Square, Visa, Mastercard, Western Union, ...*

Session 11th: April 15th: Disrupting the disrupters: Regulation

Perhaps no topic is more hotly contested in the business world than the possibility of regulating tech. What are the historical precedents? Why now? How will this possible regulatory overhaul affect the companies in this sector?

1. *Regulatory disruption: Regulating tech in the age of distress*
2. *Case: Facebook, Google, Amazon, ...*

Session 12th: April 22nd: Trends in consumer spending

The growth in productivity and automatization affect households in many different ways. On the one hand it exposes the household to labor substitution shocks. On the other it frees time for other activities and increases the value of life, and with it the demand for healthcare and leisure

1. *Consumer trends: Health Care, Education, Leisure*
2. *Cases: The tourism industry and the future of leisure*

The analysis

- 1) The firm
 - What does the company under study do?
 - What are the reporting segments?
 - Does the firm compete with the same firms across all reporting segments?
 - Is the firm reasonably managed?
 - Suppliers, customers?
- 2) The industry
 - Who are the firm's competitors? Complementors?
 - Do all the firms in the industry have similar reporting segments?
 - Is the industry changing?
 - Are there any barriers to entry in the industry in which it operates?
 - Were there any barriers to entry that are now getting undermined by technological disruption?
- 3) Valuation
 - Asset values
 - What are the critical assets the firm owns?
 - Are the missing intangibles important?
 - Are there any off-balance sheet liabilities that compromise the viability of the company?
 - Earnings power values
 - Is the measure of current earnings a good measure of sustainable earnings?
 - Are there any relevant corrections that need to be made to current earnings to arrive at a reasonable measure of sustainable earnings?
 - Are there cyclical components to earnings?
 - What is the appropriate discount rate?
 - Growth
 - Is the company reinvesting?
 - Are they reinvesting in segments with high return on invested capital?
 - Are they returning cash to investors at the expense of profitable growth?
- 4) Portfolio considerations
 - Would you invest in this company?
 - How does this investment fit on the overall portfolio?
 - What kind of factors is the portfolio loading on?

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