

Modern Value

EMBA Block Week – Summer 2016

Preliminary syllabus

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Getting in touch with the TA: You should contact the TA with any questions throughout the course. All email communications with him or her should have “EMBA-Modern Value” in the subject line.

Office Hours: Given the peculiarities of the block week format we will stay after class to answer questions that you thought were not appropriate to bring up in during class time. As always remember, if you are confused about some concept or tool, chances are that many others confused to so don’t be shy about asking anything during class time. Should you want to make sure that you want dedicated time with us, please send us an email and we will make an appointment (typically before the start of the class in any of the days of the week).

You can also submit questions about class material to us every day until 8:00 p.m. I will answer either by email or next day in class. Questions about any of the assignments should be submitted to the TA. As before, all emails should read “EMBA-Modern Value” in the subject line.

OBJECTIVES OF THE COURSE

In a world of compressed valuations specialization holds the key to a successful value investing strategy. The purpose of the course is to develop a toolbox to analyze industries in depth and build concentrated, information intensive portfolios. The toolbox integrates ideas from economics, and in particular the economics of strategic behavior, accounting, valuation techniques and risk management. Specifically the course builds on three ideas:

1. Specialization: By studying in detail particular industries, the students tackle the systematic study of the economics of that particular industry. Information, both from financials as well as economic data, is organized around the idea of barriers to entry; relations with suppliers, customers and competitors are displayed in an industry map and the students learn to identify in that context how and where the barriers to entry translate into a return in invested capital

that is above the required rate of return. Differences in business models across different firms in the same industry are analyzed and linked to valuation.

2. Risk management: By having an overall picture of the industry one can identify hedging opportunities that are simply not visible when evaluating opportunities in isolation. It is not rare to find investors who take, as theory would predict, a long and a short in the same industry so that industry factors can be hedged accordingly. But more importantly, by having detailed knowledge of the industry one can separate industry from idiosyncratic factors, which is the key to the identification of valuable investment opportunities.

3. Portfolio construction: How are we to build portfolios when specialization limits the field of investable securities?

The course starts with a review of the basic concepts of value investing and the economics of strategic behavior. It then continues with the analysis of the first industry, the auto parts industry. We start with an overview of the industry, an industry map that places the firms that are the object of study in relation to competitors, suppliers, and customers. As mentioned, the organizing principle is that of barriers to entry. Both the economic analysis and the valuation are approached with an eye on the (lack of) existence of barriers to entry. Capital allocation decisions and growth valuation can only be done once an assessment is made about the presence or not of barrier to industry in the auto parts market. We illustrate the valuation approach with two cases: O'Reilly and Autozone. The students are then asked to present their analysis on Advance Auto Parts. This segment of the class features two outside visits, one from an industry analyst and a second one from a top manager from one of the companies covered.

The second industry is the dollar and variety store industry. The industry is going through an interesting process of consolidation with the purchase of Family Dollar by Dollar Tree. We proceed as before, with a thorough analysis of the industry. Then we turn to the valuation of two companies, Dollar General and Dollar Tree and once again the students present the case of another player in this segment, Big Lots. The course closes with an overview of the global spirits industry.

READINGS:

There is no required reading for the class other than the annual reports and supporting material posted in Canvas. Needless to say there is a variety of sources that can be consulted to help with the concepts in the course.

Annual reports

- *O'Reilly, Advance Auto Parts, Autozone, Dollar Tree, Dollar General, Big Lots, Diageo*

General readings

- *Value Investing: From Graham to Buffett and Beyond*. Bruce C. N. Greenwald, Judd Kahn, Paul D. Sonkin and Michael van Biema, Wiley Finance, 2004.
- *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].
- *Competition Demystified*. Bruce Greenwald and Judd Kahn, Portfolio, 2005.
- *Berkshire Hathaway, Letters to shareholders*. Warren Buffett.

- *The essays of Warren Buffett.* Edited by Lawrence Cunningham. Carolina Academic Press.
- *The Outsiders*

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

Other material

- "The Psychology of Human Misjudgment," Talk 11 in Poor Charlie's Almanack, *The Wit and Wisdom of Charles T. Munger*
- Chapter 8 of "The High-Speed Company." Jason Jennings. This chapter is about O'Reilly Auto Parts
- "The Next Warren Buffett?" Bloomberg Business Magazine, 2004.
- *The Economics of Retailing and Distribution.* R. Betancourt, Edward Elgar Publishing Ltd., 2004. A dry but useful book on the basics of retailing.
- *Strategic Retail Management* J. Zentes, D. Morschett and H. Schramm-Klein, Gabler, 2007. This book is full of examples of specific companies facing a variety of challenges in the retail industry.
- Two books on the experience of retailers extending their franchise in what is to become perhaps the largest retail market in the world are
 - *Walmart in China.* A. Chan, ed. Cornell University Press, 2011, in particular Chapters 1 & 2
 - *KFC in China.* W. Liu, John Wiley, 2008

All the materials related to the cases discussed in class will be posted on Canvas. This includes 10Ks, and supporting materials. There will be presentations of the case but this material will not be posted.

REQUIRED PREREQUISITES AND CONNECTION TO THE CORE

Pre-requisite: Capital Markets. The students do *not* need to have taken value investing in order to take this class. Still, it is strongly recommended that the students for whom this is their first contact with value investing that they read *Value Investing: From Graham to Buffett and Beyond* prior to the class. The learning in this course will utilize, build on and extend concepts covered in the following core courses:

Core Course	Connection with Core
Corporate Finance	<ol style="list-style-type: none"> 1. Cost of Capital 2. Valuation 3. Financing Options 4. Time value of money 5. Opportunity cost (of capital) 6. The Capital Asset Pricing Model (CAPM) 7. Firm Valuation Model
Financial Accounting	<ol style="list-style-type: none"> 1. The “accounting equation” 2. Revenue and expense recognition 3. Resources and obligations – measurement and disclosure
Global Economic Environment	<ol style="list-style-type: none"> 1. Risk Management 2. What is Gross Domestic Product and how is it measured? 3. What causes inflation? 4. What causes changes in exchange rates? 5. What are the causes of business cycles? 6. What are the effects of monetary policy? 7. What are the effects of fiscal policy? 8. What is the role of financial markets in the economy?
Managerial Economics	<ol style="list-style-type: none"> 1. Barriers to entry 2. Moats 3. Maximization and thinking on the margin 4. Analyzing complex decision-making under uncertainty 5. Decision-based cost analysis 6. Pricing with market power 7. Market segmentation and other advanced pricing strategies 8. Understanding market competition and equilibrium thinking (in the short-run) 9. Market equilibrium thinking (in the long-run) and barriers to entry 10. Strategic interaction among firms and Nash equilibrium
Strategy Formulation	<ol style="list-style-type: none"> 1. Trade-offs, value-added, efficiencies 2. Creation of value vs. value capture 3. Competing firms 4. Co-option and Complementors 5. Strategic interaction analysis 6. Diversification and scope 7. Ethics & IBS 8. Behavioral and evidence-based strategy 9. Management

CONTENTS

Part I: Concepts

1. A quick review of value investing
 - Basics of Valuation: Asset Values and Earnings Power Values
 - Example
 - Franchise Values: Growth
 - Capital allocation
 - The uses and misuses of cash
 - ROIC
 - Example
2. A quick review of the economics of strategic behavior
 - Analyzing the firm
 - Value networks
 - Barriers to entry and competition: Who captures the value created?
 - Example
 - Nintendo
 - The smartphone industry
3. Understanding management
4. Specialization and risk management
 - Portfolio construction
 - Hedging industry risk

Part II:

1. The retail industry
 - a. A description of the retail industry
 - b. The US retail market and the global retail market
 - c. Economic issues
 - d. Deep dives
 - i. Example 1: The autoparts industry
 1. The economics of the autoparts industry
 - Industry map
 - Firms
 - Barriers to entry and competitive advantages
 2. Firm valuation
 - a. O'Reilly
 - b. Advance Auto Parts
 - ii. Example 2: The dollar and variety store industry
 1. The economics of the dollar industry
 - a. Industry maps
 - b. Firms
 - c. Barriers to entry and competitive advantages
 2. Firm valuation
 - a. Dollar General

- b. Dollar Tree
- 2. The global spirits industry
 - a. A description of the spirits and wine industry
 - b. The global spirits and wine market
 - c. Economic issues
 - d. Firm valuation
 - Diageo

METHOD OF EVALUATION

The grade will be based on:

- 1. Class participation: Students will be asked questions throughout the semester. This is intended simply to elicit participation and attention.
- 2. Team presentations of an assigned case to be prepared during the block week
- 3. A valuation exercise to be handed by each of the teams of an assigned case in one of the industries studied one week after the completion of the course.

The bulk of the grading will be based on the last two items (about 80% of the grade).

CLASSROOM NORMS AND EXPECTATIONS

Class Participation: Preparation, Discussion, Organization, Engagement