

# MODERN VALUE

Tano Santos

David L. and Elsie Dodd Professor of Finance

Heilbrunn Center for Graham & Dodd Investing

MBA – Value Investing – Block Week, 2021

Professor Office Location: Tano Santos – Uris 815

Office Phone: 212-854-0489

Fax: 212-851-9509 (Heilbrunn Center)

E-mail: [js1786@gsb.columbia.edu](mailto:js1786@gsb.columbia.edu) (Tano Santos)

Teaching assistant: TBA

## OFFICE HOURS

Office Hours and communication with me: I will respond to emails within 24 hours; make sure the subject line says “Modern Value – Summer 2021”, 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 do so before or after class. All issues administrative should be addressed to the teaching assistant.

## DESCRIPTION AND OBJECTIVES THE COURSE

You might have heard that value, quant value to be specific, has not performed well over the last decade. Consider the Figure below. It shows the returns associated with investing \$1 in four quant strategies, big value, big growth, small value and small growth. The facts are straightforward. Big growth has outperformed big value, but the value premium is alive and well amongst small stocks. In general, when one looks at value versus growth, growth has outperformed greatly. Does this mean value investing is dead? Absolutely not. Journalists and observers confuse quant value with value investing. Modern value is about value investing: The process by which we estimate the fundamental value of the business operations of the firm in the context of the competitive position the company has in the industry and markets in which it operates. Notice that I wrote “process”. Value investing is indeed structured and systematic, and it needs to be because it is granular, focused on the specifics of the firm under consideration. Thus, it is easy to get lost in the details of the firm. The process helps you assess the importance of each bit of information and integrate them coherently in the analysis that combines tools from accounting, valuation and the economics of strategic behavior.

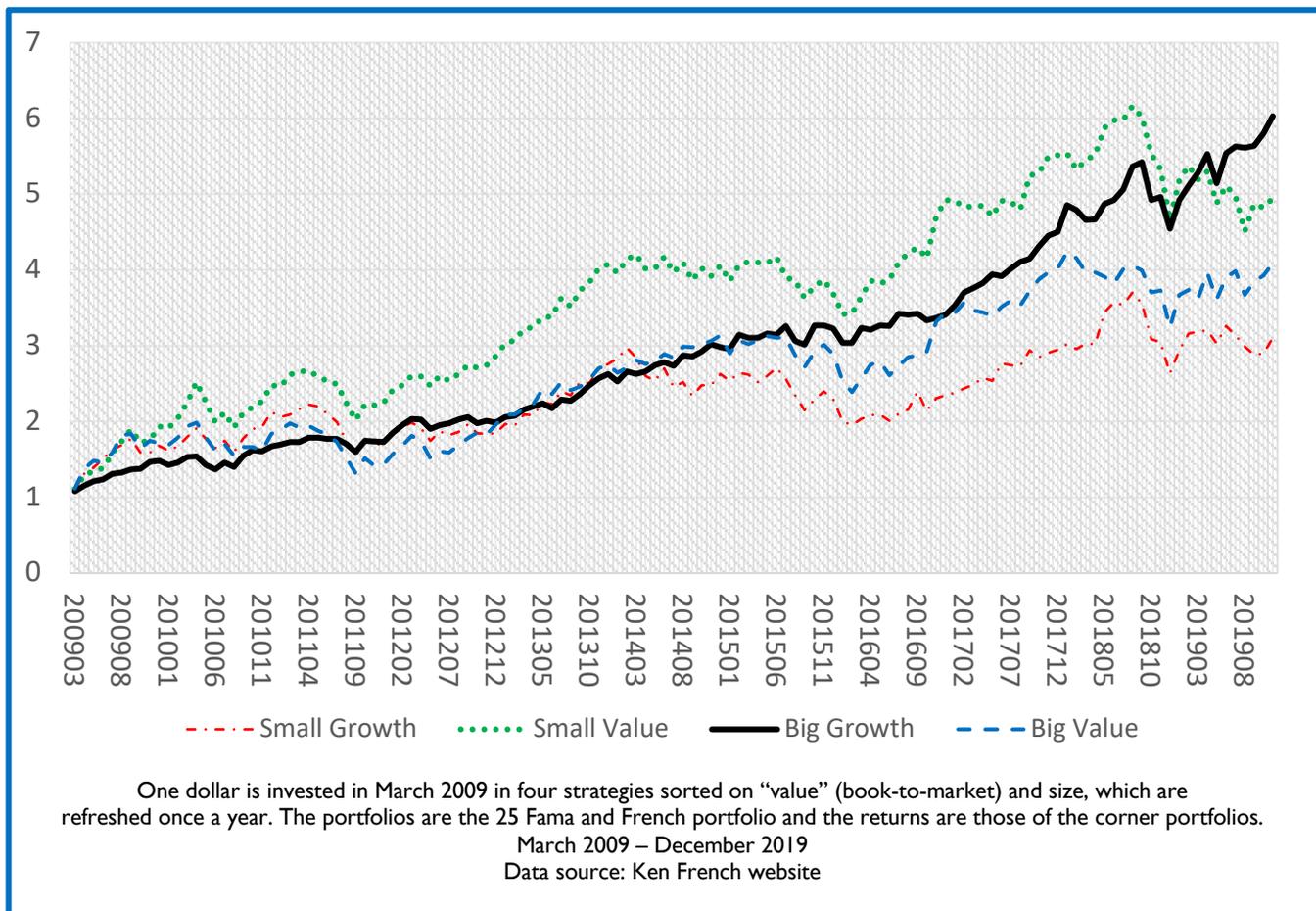
So, what does the word “Modern” stand for? For four things.

First, many observers, and not a few investors themselves, understand value in its opposition to growth, and that you can only be a value investor or a growth investor. This is nonsense. Here is Warren Buffett himself on the distinction between value and growth: *“We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.”* Modern Value tackles the issue of growth head on. First, it recognizes that the growth is an issue if and only if the business operations of the firm are protected by barriers to entry. Second, it focuses on the ability of the firm to redeploy capital at higher return on invested capital (ROIC) and for the foreseeable future, that is, that the total addressable market (TAM) is large enough to absorb sustained capital deployment for the next four to five years. Thus, the focus is on ROIC, its connection with the rate of growth of earnings,  $g$ , and, most importantly, an assessment of how much should we pay for growth.

This brings us to the second theme of Modern Value: The careful treatment of intangibles. Think about ROIC. We are interested in the marginal return on invested capital: how much more NOPAT can the firm obtain per unit of additional invested capital. But most of the capital deployment in many of the modern corporations is not treated as an investment, but rather it is treated as an expense. Value investors have always been clear-eyed about the distinction between accounting, the way the financials are presented, and the economics of the business operations of the firm (think of the perennial example of Coca-Cola’s most important asset, the brand, not being reflected in the balance sheet), but this distinction is today more important than ever. We need to think about the “IC” in ROIC carefully and systematically. Intangibles are the modern economy and it is impossible to be a good investor without having a deep understanding of how companies grow those intangible assets. That is why we devote considerable time to companies such as PYPL, ADBE, and FB. We also explore the limitations inherent in the valuation of the intangibles and we assess how to bypass those limitations (that’s’ the role of BKNG in the course).

The third theme of Modern Value is that of specialization, that the good investor is a specialized investor. Specialization solves the ultimate problem in investing: adverse selection, the fact that one never knows when buy or selling whether the counterparty who is selling or buying is better informed about the prospects of the business operations of the firm being traded. One can be a specialist in many things, in a particular asset class, in an industry, or in a geographic market. We are going to see how to build and integrate specialized knowledge in the valuation framework through the example of the payments industry and the valuation of PYPL. This is a particularly complex industry but going deep into it is not just useful in itself but it will also help in shedding light on the future of financial markets.

The final theme of Modern Value 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?



We consider the issue of risk management in the context of disruption and changing trends in industries. There are many trends, large and small, affecting businesses, consumers, governments, 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, our look at the payments industry case is done through the lens of disruption and change, regulation and technology. 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).

Finally, we discuss the case of 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 last day of the course is aimed at expanding our horizons. The course very much focused on the issue of the valuation of the business operation of the firms in a framework that incorporates the competitive position of the firm in the industry in which it operates. But value investor are increasingly broad, venturing into activisms, alternative asset classes, and even private markets. Why? Take activism. 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. Consider next 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 is 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.

As you can see the course is rich in themes and as a result demanding and intense, but also, hopefully, fun!

## METHOD OF EVALUATION

- The grade will be based on
  - 60%: A final case of an industry subject to disruption and a valuation of one of the companies in that particular industry.
  - 30%: 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 and Judd Kahn (with E. Bellissimo, M. Cooper and T. Santos) Wiley Finance, 2<sup>nd</sup> ed. 2021.

### 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, 3<sup>rd</sup> edition
- *Financial Statement Analysis and Security Valuation*. Stephen Penman, 5<sup>th</sup> edition

## CONTENTS

*Note: The schedule below is intended to give you a sense of the days in which we are going to be covering different topics but, inevitably, lectures will spill over here and there.*

### Day 1: Monday August 30<sup>th</sup>

Lecture 1: Introduction and overview

Lecture 2: Valuation – 1: From the DCF to the Value Investing Approach

Lecture 3: Asset Values and Earnings Power Value: NKE

Cases: DG and WMT (asset values and earnings power values)

### Day 2: Tuesday August 31<sup>st</sup>

Lecture 4: Value and Quantitative Strategies

Lecture 5: Valuation – 2: ROIC and the value in growth

Cases: NKE, WMT and DG (growth)

### Day 3: September 1<sup>st</sup>

Lecture 6: The economics of strategic behavior

Lecture 7: Risk management – 1: External Risks

Cases: DE, NKE during the pandemic

### Day 4: September 2<sup>nd</sup>

Lecture 8: Risk management – 2: Risk, shocks disruption: The payments industry

Lecture 9: Risk Management – 3: Regulatory shocks

Lecture 10: Risk Management – 4: Internal risks

Cases: PYPL, FB

### Day 5: September 3<sup>rd</sup>

Lecture 11: Risk Management – 5: Business transformations

Lecture 12: Trends

Lecture 13: Towards the total investor

Cases: Nestle, BKNG, ADBE

### 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) Risk management
  - What are the relevant risks in this investment?
  - How does this investment fit on the overall portfolio?

## **INCLUSION, ACCOMMODATIONS, AND SUPPORT FOR STUDENTS**

At Columbia Business School, we believe that diversity strengthens any community or business model and brings it greater success. Columbia Business School is committed to providing all students with the equal opportunity to thrive in the classroom by providing a learning, living, and working environment free from discrimination, harassment, and bias on the basis of gender, sexual orientation, race, ethnicity, socioeconomic status, or ability.

Columbia Business School will make reasonable accommodations for persons with documented disabilities. Students are encouraged to contact the Columbia University's Office of Disability Services for information about registration. Students seeking accommodation in the classroom may obtain information on the services offered by Columbia University's Office of Disability Services online at [www.health.columbia.edu/docs/services/ods/index.html](http://www.health.columbia.edu/docs/services/ods/index.html) or by contacting (212) 854-2388.

Columbia Business School is committed to maintaining a safe environment for students, staff and faculty. Because of this commitment and because of federal and state regulations, we must advise you that if you tell any of your instructors about sexual harassment or gender-based misconduct involving a member of the campus community, your instructor is required to report this information to a Title IX Coordinator. They will treat this information as private, but will need to follow up with you and possibly look into the matter. Counseling and Psychological Services, the Office of the University Chaplain, and the Ombuds Office for Gender-Based Misconduct are confidential resources available for students, staff and faculty. "Gender-based misconduct" includes sexual assault, stalking, sexual harassment, dating violence, domestic violence, sexual exploitation, and gender-based harassment. For more information, see <http://sexualrespect.columbia.edu/gender-based-misconduct-policy-students>.