



Pigs Can Fly!

Deep Value Equity Investing Primer

Yale School of Management

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Mainstream Value Investing

- ❑ Generally follows precepts of Warren Buffett (post partnership)
- ❑ Seek out low valuation multiple companies (P/TBV, P/FCF, P/E)
- ❑ Generally a preference for consistent free cash flow, economic moats, strong balance sheet
- ❑ Determine if currently low valuation company is an attractive bargain based on historical data, financial metrics, and near term expectations
 - ▶ Or discounted cash flow analysis if bored
- ❑ Generally long (>3 year) holding period

Deep Value Investing

- ❑ Valuation is the primary consideration
- ❑ Extreme focus on valuation reduces the importance of other items
 - ▶ Balance sheet quality can vary across opportunities
 - ▶ Currently weak to negative cash flow
 - ▶ Currently poor to negative profit margins
 - ▶ Currently unattractive capital return metrics (ROIC, ROA, ROE)
- ❑ Mainstream value investing will seek good to great businesses at fair prices while deep value investing seeks any business at dirt cheap to Armageddon valuations
 - ▶ Cheap enough valuations create attractive risk/rewards despite challenging fundamental issues
- ❑ Time horizon usually <3 years
 - ▶ Time is the enemy of mediocre/bad businesses and friend of great businesses
 - ▶ Investment thesis usually has very defined catalysts that need to materialize for investment to work out

Deep Value Investing (con't)

- ❑ Reconcile current and recent history with the near-term (<2 years) future
 - ▶ How impaired are current operations -> self inflicted and/or industry wide?
 - ▶ What can turn around operations -> industry tide to lift all boats and/or management specific?
- ❑ Buy when valuation suggests that the investment community is disregarding powerful forces such as mean reversion and impounding current operating results into perpetuity
 - ▶ Not all businesses/industries are mean reverting so research and due diligence are crucial to determine if the business can make it past current challenges
- ❑ Recent/current examples of mean reversion: there will never be any drilling in the Gulf of Mexico again, nobody will ever buy a home again, newspapers, television broadcasting, and radio are dead...
 - ▶ If valuation incorporates these pessimistic assumptions and research suggests operations can turn, an asymmetric payout scenario can develop for the investor

Drivers of Stock Price

❑ Operational performance

- ▶ Company Z has LTM EPS of \$1.00 and trades between 6-8x EPS
 - ❖ Company Z generates \$1.12 in EPS in subsequent period and trades between 6-8x EPS resulting in a 12-49% gain

❑ Balance sheet/credit improvement

- ▶ Company Z has \$25MM EBITDA and is valued at 4x EV/EBITDA, assume EV consists of \$75MM net debt and \$25MM market capitalization
 - ❖ Company Z uses cash flow to reduce debt to \$65MM, equity is now worth 40% more assuming same EV/EBITDA multiple

❑ Valuation multiple expansion

- ▶ Market participants are impressed with both operational performance and balance sheet/credit improvement results of Company Z
 - ❖ Participants are now willing to pay 10-12x EPS and 6x EV/EBITDA for Company Z resulting in potential triple digit gains

The right deep value opportunity can capitalize on all three drivers

Deep Value Example: Cash Store Financial (2007 – 2009)

- ❑ Canadian-based payday lender (PDL) that controlled 25% of Canadian PDL market
- ❑ Stock dropped from mid \$20s to <\$4 from mid 2005 – 2007 due to concerns regarding pending regulation
- ❑ Cash Store Financial (CSF) proactively banned the use of rollovers starting in 2005 leading to significant loan losses and a reduction in revenue
- ❑ Research suggested even the most aggressive caps on PDL fees could still result in CSF generating free cash flow
- ❑ Underappreciated positive drivers: very young store base, growing non-PDL revenue streams (prepaid cards, check cashing), impending spin-off of rent-to-own subsidiary
- ❑ Bought shares in 2007 around \$5 when CSF was valued at 2.7x 2007 EBITDA, CSF also had no debt, and insider ownership > 20%
- ❑ CSF shares benefited from improved operating performance in 2008, dividend and share repurchases due to further strengthening of balance sheet, and regulation not being as onerous as expected leading to EV/EBITDA multiple expansion in line with peers (4-6x)



Started to accumulate shares in spring 2007 and made subsequent purchases at lower price levels to reduce cost basis. Sold at prices between \$8-10 in late summer 2009.

Deep Value Example: US Airways (2009 – 2010)

- ❑ US-based legacy airlines were a good investment for 2009-2010 with share prices down 70-90% from peaks and cheap valuations in terms of EV/EBITDAR (typical distressed airline metric as opposed to PE given many had no earnings)
- ❑ Liquidity positions in 2009 stronger relative to previous crises such as 9/11 as carriers had raised cash throughout the crisis with little difficulty
- ❑ Stripped out considerable capacity and despite severe recession maintained impressive load factors
- ❑ Management teams dealt with \$140/barrell oil in 2008, \$60-\$80 oil in 2009-10 was easier
- ❑ Fixed cost structure and tight capacity suggested if carriers made it through H1 2009, significant operating leverage would result as economy stabilizes leading to strong EPS and thus stock price
 - ▶ Low hanging fruit as H1N1 was an unexpected occurrence which adversely impacted summer travel, normalized summer travel alone can provide a degree of operating leverage



Started to accumulate shares in US Airways after outbreak of H1N1 and sold in early 2010.

Deep Value Example: Seahawk Drilling (2010 – 2011)

- ❑ Shallow water driller in the Gulf of Mexico that experienced significant operational challenges in the wake of the BP Macando disaster
- ❑ Moratorium on drilling meant significant cash burn but Seahawk Drilling (HAWK) maintained a strong net cash balance and fleet of 20 rigs which could be valued at \$5-18MM based on comparable transactions by peers as well as HAWK's own asset sales in Q3 2010
- ❑ Investment thesis was that HAWK has enough cash to ride out pause in drilling operations and once permitting resumed would see an increase in revenues, cash flow, earnings and thus yield a higher share price
 - ▶ Also believed equity value larger than implied by market due rig values so worst case was a liquidation of fleet that would yield proceeds above share price or selective sales to raise cash
- ❑ Bad thesis overall, HAWK was burning through cash faster than expected and management was considering financing ideas that seemed risky to equity holders



Accumulated shares between \$10-12 in late summer 2010. After revisiting management's various plans for HAWK which were announced in late 2010, realized I was wrong on the investment and sold the position. Got lucky to sell ahead of HAWK's bankruptcy announcement.

Portfolio Construction

- ❑ Previous examples show the challenges and risks that can be associated with deep value investing
- ❑ The best investors are correct about 60% of the time
 - ▶ Deep value investing allows for large returns from correct calls but can lead to very large losses from bad calls
- ❑ Risk can be mitigated by having a broader portfolio of ~30-40 deep value holdings and limiting initial position size concentrations ~5%
 - ▶ If a 5% position results in a 50% loss it costs 2.5% of performance, difficult but not impossible to overcome
 - ▶ Generally put less weight on the more mangled deep value holdings (~1.5%)
 - ❖ Option like payoff so if they work, they can add enough to performance but if the thesis is incorrect, the loss won't demolish the overall portfolio

Deep Value Investing Challenges

- ❑ Rarely a positive “story” associated with most holdings which can make it difficult for investors to understand and/or stick with a good opportunity
- ❑ Large number of potentially fraudulent companies that pass quantitative deep value filters (low P/TBV, low P/CF, etc)
- ❑ Requires significant independent, in-house analysis as many companies that fall under deep value territory have been abandoned by the investment community
 - ▶ Can’t ride the coattails of popular fund managers
- ❑ Even portfolios of 30-40 deep value holdings can be subject to high degree of volatility which can stoke a “do something” mentality
 - ▶ Bias to action tends to intensify after a period of loss (Zeelenberg *et al*, 2002) so one may be inclined after a significant drawdown or period of underperformance to adjust the portfolio at precisely the wrong time
- ❑ A portfolio of deep value opportunities may diverge from broader indices for a long period
 - ▶ US Airways stock price ended 2009 near where it started in March 2009 while the broader market notched a 46% gain during the same period
 - ▶ Nine months of flat to negative performance against a strong equity market can lead back to bias to action...

These challenges can be overcome by a strong research and investment process along with an awareness of behavioral impediments. Combining a good process and overcoming behavioral obstacles can ultimately lead to outperformance.

Deep Value Investing

Q&A