Real World Stock Investing

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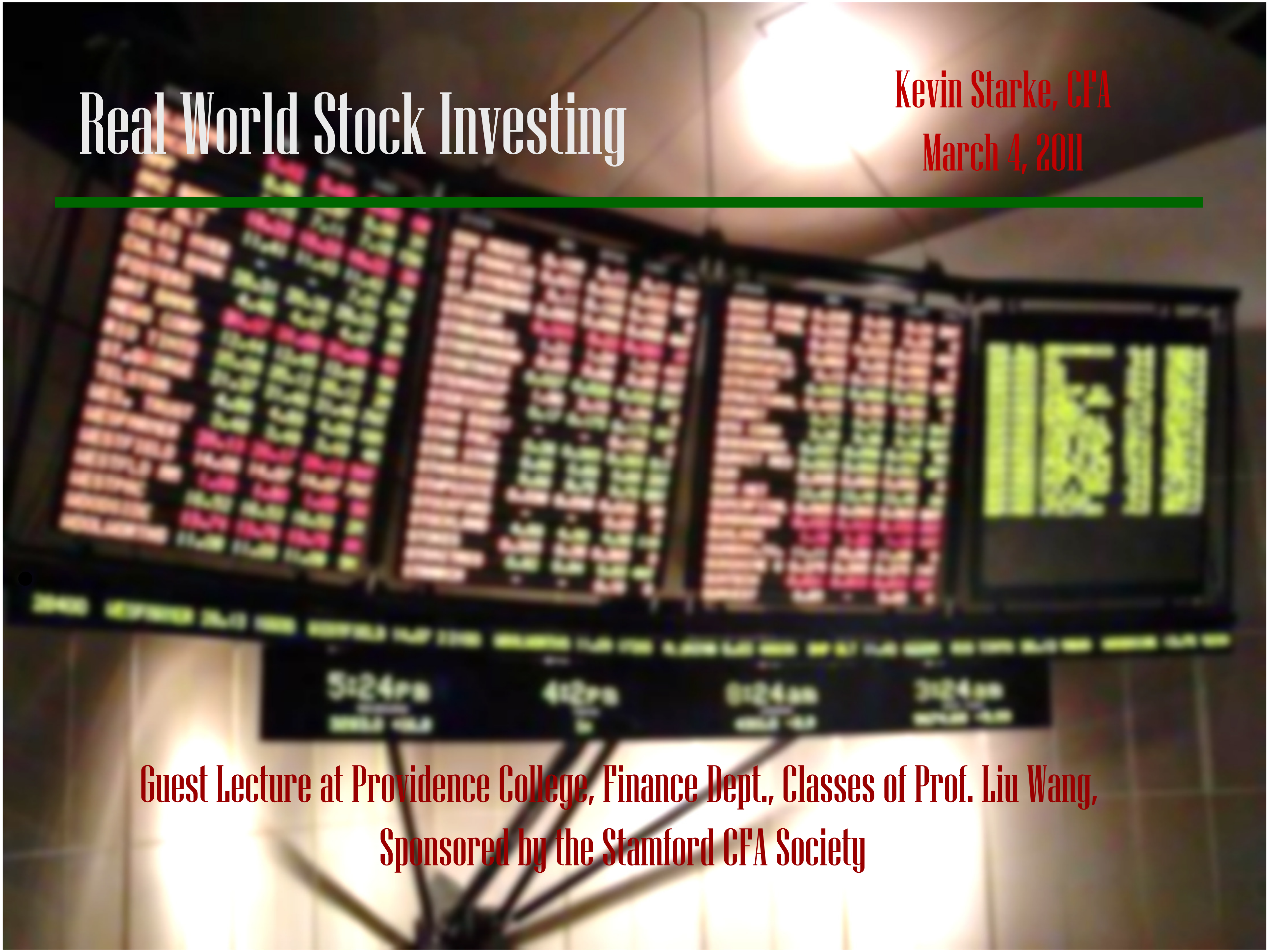

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Real World Stock Investing

- You learn about investing in an abstract context where it is assumed that all participants have equal access to the information needed to make a decision.
- While that is often true in reality, within any specific and immediate time frame, the ability to digest this information quickly and make an investment decision is not always equal.

Quick Decisions

- Finance is an information-driven field. Great decisions can be made on the basis of great information, but sometimes gathering and processing that information can take so long that the investment opportunity disappears.
- Finance professionals sometimes feel they need to make a quick decision, which may mean not taking into account all the facts or re-running the “model.”
- Example: the earnings announcement event.
- Let’s run an experiment with very limited information, and then think about how our decision could have improved if we had had more information.

An Experiment

- Five current investors own all of the shares of both SoftLogic and LogicSoft, direct competitors. One share of each. Each has five shares outstanding.
- Companies up to now have identical income statements and balance sheets. No debt, adequate cash.
- The investors have to make a decision today to sell one or the other based on what they hear.
- Each stock traded before the earnings announcement at $10 per share, or 10x price/earnings ratio based on the expected 2010 EPS of $1.00 for each.
- Set your sell limit price on the one you want to sell.

An Experiment

- Five other investors own neither stock but are going to buy both.
- Pick your buy limit on each stock.
- Let’s see how the market for the stocks shapes up.

CEO Script: SoftLogic Inc. (SLO)

- Good afternoon and welcome to the SoftLogic Incorporated fourth quarter and full year 2010 earnings conference call. This is CEO YOUR NAME HERE. We are pleased to report that we had record revenues of $100 million in the full year 2010 and are reporting earnings per share of $1.00.
- In terms of guidance for 2011, we think we can continue to grow sales at a 10% pace, so that would indicate revenues of about $110 million. Because we think we can grow sales 10% without increasing overhead costs, we think net earnings can grow by approximately 20%, so we are guiding for 2011 earnings per share of $1.20.
- We intend to continue to develop and profit from the success of the current version 2.0 of our Mega Widget Software package, which has seen great demand from cable TV operators, mobile phone network providers, and major internet portal sites. The software has proven indispensible for the delivery of streaming video services across multiple platforms.

CEO Script: LogicSoft Enterprises (LOSE)

- Good afternoon and welcome to the fourth quarter and full year 2010 earnings conference call for LogicSoft Enterprises. This is CEO YOUR NAME HERE. We are pleased to report that we had record revenues of $100 million in the full year 2010 and are reporting earnings per share of $1.00.
- For 2011, we have decided that we need to reinvest in our business to make way for the next version, 3.0 of our Super Widget Software to prepare for broader rollout of 4G services by network services providers across the country. This will mean additional hiring in research & development first and later in sales. We think the product can be put to uses outside of our traditional customer base of mobile phone network operators, cable TV operators, and internet portal sites. The software has proven indispensible for the delivery of streaming video services across multiple platforms. We, like you, would like it to remain so long into the future, so we have decided to take this step. We hope you understand that there are risks to this strategy.
- In light of the projected additional expense, while we think sales will grow by about 10% to $110 million in 2011, we are projecting earnings to decline 10% to about $0.90 per share for the full year.

Missing Information

- What did you need to know that the CEOs didn't tell you?
- What other information would you like to have had?
- 2012 earnings estimates?
- Cash flow projections?
- Better idea of the second CEO's expansion strategy?
- Some idea why the first CEO doesn't see a need to move to a new version?
- More information about who the customers are, what are their relative market shares, and how do customers perceive the two companies and their products?
- Are there other competing technologies outside these companies?

How Do You Pick Stocks?

- Do you already buy stocks?
- Do you buy what you know?
- Do you look at something that is already going up?
- Do you buy when there’s “blood in the streets?”
- How do you decide when to sell it?

Top Down, Bottom Up

- Big picture, top down: where is the economy going? Are stocks the right place to be?
- Are there sectors that you want to invest in or avoid based on expected economic trends? E.g. would you buy a company with a lot of commodities exposure right now?
- When you find a sector that you think is going to do well, look at the stocks in it – bottom up.

Why not (always) P/E?

- P/E is important to valuing common stock but sometimes it can distort the true cash flows from operating assets
- Differences in capital structure can cause interest expense differences
- Tax inefficiencies in one company may make it seem less valuable than another
- As a value investor, your main concern should be about how much cash a company can return to you over time.

Cash Is King

- Free cash flow and FCF yield tend to be very popular tools among value investors.
- Back-of-the-envelope FCF:

  EBITDA (earnings before Interest, Taxes, and D/A)

  -Capex

  -Interest

  = FCF
- FCF yield = FCF over market cap
- Typically looking for yields above 5%

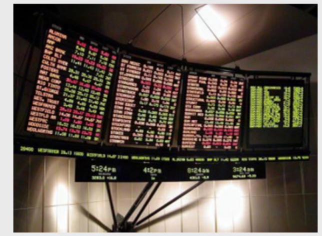
EBITDA, A Quick Proxy for Cash Flow

- Earnings before interest, taxes, depreciation and amortization.
- Measures cash flowing out of operations before paying any stakeholders and before the cost of reinvesting in the business
- Non-GAAP measure
- Inconsistently defined from one company to another
- Often needs to be normalized to make apples-to-apples comparisons

Enterprise Value to EBITDA

- One of the most common valuation metrics, particularly in credit markets
- EV = Market cap + net debt
- Net debt = Total debt minus cash
- Basically, the cost of acquiring an entire business
- Similar calculation to Debt/EBITDA, or leverage, a ratio that often determines a company’s borrowing costs

The Comp Sheet



- Easiest place to start when you find a sector you want to invest in is a valuation comparison.
- First good thing to look at: how have the stocks performed relative to each other.

					Shares	100-Day		Percent Change			Year		
		Price	Cap	Year	Out	Avg. Vol.	Mov. Avg.	3 Mo.	6 Mo.	1 Yr.	High	Low	
	Ticker	**($)**	**($MM)**	**End**	**(MM)**	**('000s)**	**($)**	**(%)**	**(%)**	**(%)**	**($)**	**($)**	**Beta**
AbitibiBowater Inc	ABH	28.21	2,740	Dec	97.1	NA	NA	NA	NA	NA	30.54	21.50	NA
International Paper Co	IP	26.85	11,807	Dec	439.7	5,419	26.72	2.7	20.4	7.9	30.44	19.33	1.82
Domtar Corp	UFS	88.50	3,681	Dec	41.6	572	80.76	9.2	37.5	53.7	93.89	46.24	1.38
Neenah Paper Inc	NP	19.32	285	Dec	14.8	77	18.52	2.2	25.8	22.2	21.95	13.37	1.27
Verso Paper Corp	VRS	5.16	271	Dec	52.5	170	4.12	47.6	83.2	58.3	6.37	2.05	2.38
PH Glatfelter Co	GLT	12.36	567	Dec	45.9	230	12.36	(4.4)	7.3	(9.1)	15.49	10.08	1.16
Sappi Ltd	SPP	5.35	2,874	Sep	537.1	36	5.17	1.1	7.9	32.8	5.95	3.27	1.59
Boise Inc	BZ	9.25	780	Dec	84.4	1,942	7.92	19.9	32.8	86.6	9.60	4.46	2.64
Clearwater Paper Corp	CLW	79.44	912	Dec	11.5	69	80.53	(3.9)	10.1	61.2	85.25	29.24	1.44
Wausau Paper Corp	WPP	7.60	373	Dec	49.1	269	8.41	(5.7)	3.8	(14.5)	10.26	6.01	1.42
Temple-Inland Inc	TIN	23.47	2,539	Dec	108.2	1,518	22.08	5.6	23.0	25.0	26.21	15.48	1.94
Average			**2,409**			**1,030**		**7.4**	**25.2**	**32.4**			**1.70**

The Comp Sheet

- What are the differences in valuation between the companies in the table below?

		Fiscal 2011 Consensus Estimate					EPS			P/E		
	Ticker	EBITDA ($MM)	Sales ($MM)	EBITDA Margin (%)	EV/ EBITDA (x)	EV/ Sales (x)	LTM ($)	FY1 ($)	FY2 ($)	LTM (x)	FY1 (x)	FY2 (x)
AbitibiBowater Inc	ABH	708	5,056	14.0	5.2	NA	NA	3.16	3.71	NM	8.9	7.6
International Paper Co	IP	3,736	26,435	14.1	5.0	0.7	1.50	2.79	3.28	17.9	9.6	8.2
Domtar Corp	UFS	1,008	5,586	18.1	4.0	0.7	14.21	8.55	8.10	6.2	10.3	10.9
Neenah Paper Inc	NP	93	683	13.6	5.2	0.7	1.70	1.70	2.10	11.4	11.4	9.2
Verso Paper Corp	VRS	250	1,762	14.2	5.5	0.8	(2.50)	(0.10)	1.35	NM	NM	3.8
PH Glatfelter Co	GLT	154	1,559	9.9	5.4	0.5	1.18	0.98	1.26	10.5	12.7	9.8
Sappi Ltd	SPP	1,008	7,367	13.7	NA	NA	NA	0.42	0.60	NM	12.7	8.9
Boise Inc	BZ	372	2,328	16.0	3.7	0.6	0.78	1.16	1.22	11.9	8.0	7.6
Clearwater Paper Corp	CLW	230	1,898	12.1	5.6	0.7	6.43	6.11	6.96	12.3	13.0	11.4
Wausau Paper Corp	WPP	105	1,050	10.0	4.8	0.5	0.75	0.55	0.65	10.1	13.8	11.6
Temple-Inland Inc	TIN	560	4,079	13.7	6.0	0.8	1.55	1.61	2.13	15.2	14.6	11.0
Average					**5.0**	**0.7**				**11.9**	**11.8**	**9.3**

Numbers are great

- But they don't tell the whole story.
- Becoming familiar with the mechanics of a business and its assets is critical.
- Know the assets. Know competitors' assets too.
- UFS looks cheapest but isn't really. It's in the least healthy grade of paper. It's also a single product company, as is BZ, which means it can't diversify easily away from grades of paper

AbitibiBowater Inc.

- A company with a great history of burning investors.
- Went into bankruptcy in April 2009 and came out in December 2010. Old stock was wiped out. Bonds got the new stock, but with a big haircut in value.
- Main product is newsprint, for which demand is declining by 3% per year in North America, where all the assets are located.
- Newspaper readership steadily declines as readers move toward online outlets.

Next Step: Build an Earnings Model

- The company and other analysts were putting out very aggressive growth assumptions. We weren't convinced.
- We took data from an industry association about growth expectations and made our own estimates.

In US$ million unless otherwise noted	2009	2010 Mar	2010 Jun	2010 Sep	2010 Dec	2010 Year	2011E	2012E	2013E
Unit Sales by Product Segment									
Newsprint ('000 metric tons)	3,157.0	795.0	763.0	694.0	694.0	2,946.0	2,837.0	2,734.9	2,598.1
Coated Papers ('000 short tons)	571.0	159.0	166.0	175.0	180.0	680.0	675.9	677.3	677.3
Specialty Papers ('000 short tons)	1,819.0	436.0	488.0	505.0	505.0	1,934.0	1,953.3	1,933.8	2,030.5
Market Pulp ('000 metric tons)	946.0	241.0	225.0	236.0	236.0	938.0	909.9	864.4	821.1
Wood Products (MM bf)	1,143.0	331.0	334.0	363.0	363.0	1,391.0	1,321.5	1,255.4	1,192.6
Average Price									
Newsprint ($/metric ton)	571.0	545.0	597.0	619.0	640.0	598.2	685.0	712.0	700.0
Coated Papers ($/short ton)	730.0	668.0	685.0	733.0	750.0	710.3	750.0	800.0	750.0
Specialty Papers ($/short ton)	731.0	684.0	675.0	687.0	700.0	686.9	748.7	786.2	750.0
Market Pulp ($/metric ton)	548.0	676.0	767.0	776.0	775.0	748.3	775.0	750.0	725.0
Wood Products ($/'000 bf)	254.0	300.0	329.0	289.0	300.0	304.0	300.0	300.0	300.0
Sales by Product Segment									
Newsprint	1,802.0	433.0	456.0	429.0	444.2	1,762.2	1,943	1,947	1,819
Coated Papers	416.0	106.0	114.0	128.0	135.0	483.0	507	542	508
Specialty Papers	1,331.0	299.0	329.0	347.0	353.5	1,328.5	1,463	1,520	1,523
Market Pulp	518.0	163.0	172.0	184.0	182.9	701.9	705	648	595
Wood Products	290.0	99.0	111.0	104.0	108.9	422.9	396	377	358
Corporate and Other	(141.0)	-	-	-	-	-	-	-	-
Sales	**4,216.0**	**1,100.0**	**1,182.0**	**1,192.0**	**1,224.5**	**4,698.5**	**5,014.4**	**5,034.2**	**4,802.6**

What the Model Tells Us

- Note the numbers are flat to down.
- Can a business in decline be an attractive investment?
- Look at the free cash flow yield. How does it compare to the S&P 500 Index FCF? S&P FCF Yield : 7.4%.
- We adjust for cash pension and post-retirement benefits expense.
- Our numbers are low compared to competitors.

($MM)	2011	2012	2013	2014
EBITDA	608.7	624.1	595.4	518.1
Capex	(110.0)	(125.0)	(116.0)	(115.0)
Pension	(105.0)	(105.0)	(105.0)	(105.0)
OPEB	(17.0)	(17.0)	(17.0)	(17.0)
Interest	(105.0)	(105.0)	(105.0)	(105.0)
Taxes	(17.5)	(22.2)	(26.8)	(31.5)
FCF	254.2	250.0	225.6	144.6
Yield (%)	*9.2*	*9.1*	*8.2*	*5.2*

AbitibiBowater Inc.

- When we first published our recommendation on ABH, stock was at $22 and the FCF yield was 12%.
- Would it converge with S&P? Probably not, but it could come down, which means stock would have to go up. (Yield moves inversely with price.)
- Even if it stayed at a discount to S&P, it would still generate a lot of cash. It would use that cash to retire debt.
- That means shareholders “own” more of the company.
- It also means the company spends less on interest expense, which helps earnings.
- Stock is now at $28. A 27% gain in under three months.

Good Company in a Bad Business

- Newsprint is a “buggy whip” business, but there are interesting structural considerations.
- ABH shut 40% of its capacity in bankruptcy. Cut expenses 60%.
- Cut debt by about 80%. Will be debt-free in a few years. Low debt is currently (but not always) a competitive advantage, because comps are struggling with debt load.
- Newspapers are down in U.S. but steady in Eastern Europe, Asia, and Latin America. Those places don’t produce enough paper of their own. Must import.
- U.S. dollar is weak. ABH’s products seem cheap. Newsprint is very exportable.

Where to Get Information: Read!

- Investing websites
- 10-Ks and 10-Qs, and not just the MD&A
- Bond prospectuses and indentures
- Loan documentation
- Key contracts
- Lawsuits

Avoid “WACC’d” Out Assumptions

- A competitor put a $39 target on ABH.
- Earnings expectations were only a little bit higher than ours, but WACC was 9.8%.
- How can a company with 10.25% cost of debt borrowing and probably a 15%-20% expected return on equity have a 9.8% WACC.
- Lesson: Don’t fit the means to the end. Reality-check your assumptions. Figure out the worst case first, then build in the optionality of upside.

Other Ways to Look at Value

- Our analysis of ABH was value-investing oriented.
- Growth-stock investing is a different mindset.
- A growth investor might favor a higher-P/E, higher EV/EBITDA, lower FCF yield company.
- Might take the P/E ratio and divided it by the expected long-term growth rate. PEG ratio.
- A 20x P/E over a 30% growth rate is “cheaper” than a 15x P/E over a 20% growth rate.

Questions?

- Questions on the material?
- Questions on individual stocks? (I'm not Cramer, please remember).
- Questions about working in finance?