Paradigm Capital
„The Future of Active Value Investing“

25 April 2018
Ben Graham Centre’s 2018 Value Investing Conference
Toronto
How do we create an edge as Value Investors...

• Imperfect space…
• Deep fundamental research…
• Concentrated portfolio…
• Hedging…
Specialisation is essential...

Ester Ledecká
Czech Republic
At the 2018 Winter Olympic Games in Pyeongchang Ledecká won gold medals in the super-G in alpine skiing and in the parallel giant slalom in snowboarding

Linus Pauling
USA
Pauling won the Nobel Prize in Chemistry in 1954 and the Nobel Peace Prize in 1962
How do we start our journey towards specialisation...
A Focus on publicly listed companies in Europe offers close to ten thousand companies to analyse...

Approximately 700 mid and large caps account for more than 80% of the total European market cap but only for 7% of all companies.

Sources: Bloomberg and Paradigm Capital
Being an Active Value Investor in Europe we needed to have additional selection criteria...
Size and Geography were added to the list...

Approximately 700 mid and large caps account for more than 80% of the total European market cap but only for 7% of all companies.

Markets capitalisation:
- Large cap
- Mid cap
- Small cap
- Micro cap

Paradigm screening process:
- Market Cap €100 to 3,500m
- Geographic focus
- Sustainable EBIT
- Paradigm value & quality screening

Paradigm portfolio:
- Number of companies:
  - 300 Large cap
  - 397 Mid cap
  - 8,766 Small cap
  - 2,748 Micro cap

Sources: Bloomberg and Paradigm Capital
The Search Process generates more success when Behavioral Aspects are combined with Specialisation...

Value Premium- Behavioral Finance
- Lottery Preference
- Ugliness Aversion
- Overconfidence/Uncertainty

Specialisation
- Geography
- Size
- Industry
- Model
Having defined what we think is an Imperfect Space we move to Deep Fundamental Research...
Valuation is the most critical skill for any Value Investor...

- One Size Does Not Fit All

- Valuation Approach Depends On:
  - Quality of Different Kinds of Information
  - Horizon Over Which Events Affect Value

- Four Basic Horizons:
  1. Distressed Debt / Short Term Fixed Income
  2. Real Assets / Competitive Businesses
  3. Franchise Businesses
  4. Growth
We use five pillars when valuing securities...

**Business Quality**
- Licences/patents
- Economies of scale
- Customer loyalty/brand names
- Switching costs
- Culture

**Balance Sheet**
- Financial leverage
- Pension and leasing obligations
- Fixed assets
- NWC

**Capital Allocation**
- Internal projects
- M&A
- Debt reduction
- Dividends/buybacks

**Corporate Governance**
- Auditor/BoD
- Executive management
- Shareholder base
- Related party transactions

**Relative Value**
- Margin of safety
- Growth
- Return requirement
Now the Value Investing Process starts...

**SEARCH**
- Cheap
- Unwanted
- Obscure / Uncovered
- Undercovered

**VALUATION**
- Assets
- Earnings Power
- Franchise
- Growth

**REVIEW**
- Key Issues
- Collateral Evidence
- Personal Biases

**RISK MANAGEMENT**
- Margin of Safety
- Some Diversification, unsystematic risk
- Patience – Default Strategy
Shortcomings of NPV Approach in Practice...

1. Ignores Information – Balance Sheet

2. Method of Combining Information

\[
NPV = CF_0 + CF_1 \left( \frac{1}{1 + R} \right) + \ldots + CF_{20} \left( \frac{1}{1 + R} \right)^{20} + \ldots
\]

- Good Information (Precise)
- Bad Information (Imprecise)

= Bad/Imprecise Information

3. Sensitivity Analysis is Based on Difficult-to-Forecast Parameters, which co-vary in fairly complicated ways
Fixed income valuation...

- **Positive Growth Does Not Matter**
  - Growing Franchise – No Distressed Debt

- **Asset Value**
  - Earnings Power Limited by Contracts

- **Scenario Based Valuation**

- **Priority**

- **Timing**
Basic elements of value...

Strategic Dimension

Growth in Franchise Only / ROCE > Cost of Capital

Franchise Value
Current Competitive Advantage

Free Entry
No Competitive Advantage

Asset Value
Earnings Power Value
Total Value

Reliability Dimension

- Tangible
- Balance Sheet Based
- No Extrapolation

- Current Earnings
- Extrapolation
- No Forecast

- Includes Growth
- Extrapolation
- Forecast
Competitive Businesses, Earnings Power and Entry Barriers...

Case A:
Value Lost to Poor Management and/or Industry Decline

Case B:
Free Entry Industry Balance

Case C:
Consequence of Comp. Advantage and/or Superior Management

“Sustainability” depends on continuing Barriers-to-Entry
Valuation in practice...

- Is this a company with significant competitive Advantages / Barriers-to-Entry?

  ROCE ≤ COC  NO
  1. AV
  2. EPV
  Finished GROWTH HAS NO VALUE

  YES  ROCE > COC
  1. Different Approach Entirely
  MUST VALUE GROWTH
Total value including growth...

- Least reliable
  - Forecast change not just stability (Earnings Power)

- Highly sensitive to assumptions

- Data indicates that investors systematically overpay for growth. Why comes later and at lower rate!

- Orthodox value investors want growth for “Free”
  - (Market Value < Earnings Power Value)
Valuing Growth Basics...

- Growth at a competitive disadvantage destroys value and capital
- Growth on a level playing field neither creates nor destroys value
- Only franchise growth (at industry rate) creates value
Understanding the concept of Cost of Capital and Return on Capital is an essential step in operating a business as well as being a good investor ...

**Investment**: $100 million

**Cost of Funds**: 10% (R) = $10M

<table>
<thead>
<tr>
<th>Return on Investment (%)</th>
<th>5%</th>
<th>10%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Investment ($)</td>
<td>$5M</td>
<td>$10M</td>
<td>$20M</td>
</tr>
<tr>
<td>Cost of Investment</td>
<td>$10M</td>
<td>$10M</td>
<td>$10M</td>
</tr>
<tr>
<td>Net Income Created</td>
<td>($5M)</td>
<td>0</td>
<td>$10M</td>
</tr>
<tr>
<td>Net Value Created</td>
<td>($50M)</td>
<td>0</td>
<td>$100M</td>
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</tbody>
</table>

**Qualitative Impact:**

- Value Destroyed
- No Value
- Value Created

**Situation:**

- Competitive Disadvantage
- Level Playing Field
- Competitive Advantage
## Value Implications of Barriers to Entry...

<table>
<thead>
<tr>
<th>Factor</th>
<th>No Barriers-To-Entry</th>
<th>Barriers-To-Entry</th>
</tr>
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<tbody>
<tr>
<td><strong>Organic Growth</strong></td>
<td>Attracts Entrants - No Value Margins Flat to Down</td>
<td>Creates Value Operating Leverage - Margins Up</td>
</tr>
<tr>
<td><strong>New Investments</strong></td>
<td>Returns Limited by Entry Earn Cost of Capital, at best, no Value</td>
<td>Creates Value if Properly Focused</td>
</tr>
<tr>
<td><strong>Growth Options</strong></td>
<td>Beneficial Opportunities Attract Entrants Eliminates Profit – No Value</td>
<td>Potentially Create Value</td>
</tr>
</tbody>
</table>
**Calculating Returns:**
*A simple example...*

- **Sustainable Revenue**: $3,000M
- **Sustainable Net Margin**: 8%
- **Earnings Power**: $240M
- **No Debt, No Excess Cash**: -
- **Distribution (DIVS, BBs)**: 50%*
- **Cash Distribution**: $120M
- **Retained (Reinvested)**: $120M
- **Market Value**: $4,000M

- **Earnings Return (240/4000)**: 6%
- **Cash Return (120/4000)**: 3%
- **Reinvested (120/4000)**: 3%

*History, Policy*
Calculating Returns:
A simple example (Continued)...

Growth (Organic) - External Factors (Core Mkt)
Population, Income, Consumer Trends, Tech

Consolidated History – 3% Revenue (Same Store Sales)
3½ Earnings (Op Leverage)

Consolidated Context – GDP + Income – Goods
3½ % 0% ½%

Organic Growth Bottom Line – 3½% (Value)

Investment Driven Growth
Reinvestment = Retained Earnings $120M
Organic Growth Requirement = ($6M)
(3% x $3,000 = $90M Sales Growth)
(NWC = 6 2/3% Chg. Sales = $6M)

Active Investment Value $114M
Creation Factor Active 1.25
Value Creation $143M
Active Return (143/4,000M) ~3.6%
## Total Return...

<table>
<thead>
<tr>
<th>Source</th>
<th>%</th>
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<tbody>
<tr>
<td>Cash</td>
<td>3.0%</td>
</tr>
<tr>
<td>Organic Growth</td>
<td>3.5%</td>
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<tr>
<td>Active Investment</td>
<td>3.6%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>10.1%</strong></td>
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<tr>
<td>Market Return</td>
<td>6.0%</td>
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<tr>
<td>Margin of Safety</td>
<td>4.1%</td>
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Fade/Erosion?
Active Research...

- **Research Coverage**
  - Local Research/ Focused Research
  - Collateral Evidence
  - Personal Bias

- **Management Assessment**
  - Cost Efficiency
  - Understand Value Creating Growth
  - Proper Financing/ Distribution
  - Human Resource Mgt.

- **Detailed Local Sources**
  - Community
  - Full Range of Media
  - Industry Contacts
Risk Management: Measuring Risk...

- Not Variance
  - Value investors do not define risk as volatility, but view portfolio composition as critical when measuring risk
  - Serial Correlation
  - Upside-Downside Asymmetry

- Permanent Impairment of Capital
Risk Management: Permanent Impairment...

- Central Management

- Situational Risk (at Purchase) – Margin of Safety
  - General Risk is Usually Idiosyncratic
    - Diversification

- Basic Risk Profiles
  - Fixed Income
  - Real Assets/Basic Businesses
  - Franchise Businesses
  - Inflation risk
  - Deflation risk
  - Protected risk

- Insure Overall Risks
  - Safe Assets
  - Selective Shorts
  - Derivatives
Since inception, Paradigm Capital’s value investing strategy shows a substantial outperformance...

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<tbody>
<tr>
<td>Paradigm Capital</td>
<td>-5.2%</td>
<td>-15.8%</td>
<td>12.5%</td>
<td>43.8%</td>
<td>2.9%</td>
<td>7.2%</td>
<td>3.7%</td>
<td>6.1%</td>
<td>30.0%</td>
<td>22.3%</td>
<td>19.1%</td>
<td>-2.8%</td>
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<td>(Net)</td>
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<tr>
<td>STOXX Europe 50</td>
<td>-5.7%</td>
<td>-40.7%</td>
<td>29.9%</td>
<td>3.9%</td>
<td>-4.3%</td>
<td>13.9%</td>
<td>17.9%</td>
<td>6.7%</td>
<td>7.0%</td>
<td>1.2%</td>
<td>9.7%</td>
<td>-5.8%</td>
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<tr>
<td>(Gross)</td>
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