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MARTIN J. WHITMAN
FERNANDO DIZ

MODERN SECURITY ANALYSIS

UNDERSTANDING WALL STREET FUNDAMENTALS

WILEY

Contents

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Modern Security Analysis

Understanding Wall Street Fundamentals

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To the Deans, Faculty, Staff, Students and Alumni of
The Whitman School of Management
at
Syracuse University

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It ought to be noted that both of us learned a lot from people we came to believe were bad guys a with whom we would never again invest. We won't name names but rather just acknowledge that o tends to learn more from one's mistakes than from one's successes.

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The errors and shortcomings of this book belong to us alone, not at all to the various contributors.

Martin J. Whitm
Fernando D

Introduction

OUR FOCUS

This book is different from other books published about securities investing, securities trading, ar academic finance as embedded in modern capital theory (MCT). It seems to us that all other books o investing and academic finance—ranging from *Principles of Corporate Finance* (McGraw-Hill, 200 by Brealey and Myers to *Security Analysis: Principles and Technique* (America Media Internationa reprinted 2003) by Graham, Dodd, and Cottle (G&D), and to tracts on trading techniques—focus o forecasting and explaining short-run market prices, especially prices at which securities are traded markets populated by outside passive minority investors (OPMIs). This book, in sharp contras focuses strictly on explaining and understanding commercial enterprises and the securities they issu For us, short-run market prices in OPMI markets are so-called random walks except for the speci cases of sudden-death securities such as options, warrants, certain convertibles, and risk arbitrag situations where there will be relatively determinate workouts in relatively determinate periods time.

It seems to us that our approach became more relevant as a consequence of the 2008–200 meltdown, whereas MCT and G&D approaches became less relevant.

In this book the emphasis is on creditworthiness rather than earnings and cash flows, the apprais of managements not only as operators but also as investors and financiers, and understanding th motivations and practices of activists.

CREDITWORTHINESS

Throughout the book we emphasize the importance of creditworthiness. Three elements go into th determination of creditworthiness for functional purposes:

1. Amount of debt

2. Terms of debt

3. How productive are the use of proceeds from incurring the debt

Of these, we argue that the third element is the most important.

Also, there are three tests of solvency, and most entities do not have to pass all three to be deeme solvent.

1. Does the fair value of the assets exceed the claims against those assets (a balance sheet test)?

2. Does the entity have the wherewithal to meet its obligations as they come due (an income account test)?

3. Does the entity have access to the capital markets to meet cash shortfalls (a liquidity test)?

THE APPRAISAL OF MANAGEMENTS

Unlike others who view managements solely as operators of businesses, we appraise managements their competencies as operators, investors, and financiers. Recently we have been acquiring th common stock of Lai Sun Garment, a reasonably fast-growing and reasonably well-financed compar with assets (mostly real estate) in Hong Kong and Mainland China. The common stock at this writir is selling at about an 80 percent discount from net asset value (NAV) and less than two times reporte earnings for the year ended July 30, 2012. The one question we have about Lai Sun Garme management is as financiers. With the common stock priced the way it is, why isn't the compar either buying in its own common stock or the common stock of its 47 percent owned subsidiary, L Sun Development, whose common stock sells at a similar discount from NAV and a similar price to-earnings (P/E) ratio? If a goal of the business is to grow NAV per share, at those prices it is hard t visualize a better use of surplus cash than buying in common stock rather than expanding the ass base or paying cash dividends.

In examining NAV, it is important to examine the dynamics of NAV rather than just NAV as a static concept. For almost all corporations, NAV will grow year by year almost continuously. The quality c NAV tends to be much more important than the quantity of NAV. Certain assets contained in bool value reflect overhead unlikely to ever be recovered through earnings or cash flow. Those are th types of NAV common stocks we try to avoid. There are valuable lessons to be learned from G&D analysis of net nets.

Payments to shareholders in the form of either dividends or stock buybacks has to be a residual u of cash most of the time compared with using cash to expand corporate assets or reduce corpora liabilities. However, from a corporate point of view it sometimes makes sense to pay large ar increasing dividends, because that can give the corporation better access to capital markets than wou otherwise be the case. Also, managements might consider large dividends simply because they a desired by so much of the company's OPMI constituency.

ACCESS TO CAPITAL MARKETS AND WEALTH CREATION

Another factor this book dwells on deeply that others seem to ignore is the importance for compani to have access to capital markets—both credit markets and equity markets. As the book points ou capital markets are notoriously capricious: sometimes not available at all (see the 2008 cred meltdown) and sometimes willing to give companies what might be characterized as "almost fre money" (see the 1999 initial public offering [IPO] boom).

The goal of most corporations and most (but not all) OPMIs ought to be wealth creation, and it important to note that there are four general ways to create wealth, not just the two seemingly cited b MCT and G&D. MCT and G&D believe in the primacy of the income account (i.e., creating wealth b flows, whether cash flows or earnings flows; earnings is defined as creating wealth while consumir cash). For us the four general ways of creating wealth—either corporate or individual—are:

1. Cash flow from operations

2. Earnings from operations

3. Resource conversion (i.e., massive asset redeployments, mergers and acquisitions, liability restructurings, changes of control, spinoffs, and liquidations)

4. Having attractive access to capital markets

It seems as if conventional security analysis puts overemphasis on four factors, which makes i approach much less useful in helping to understand a business. The four areas of overemphasis are:

1. Primacy of the income account (to the exclusion of balance sheet and financial positio
considerations)

2. Short-termism

3. Emphasis on top-down analysis and a consequent denigration of bottom-up analysis

4. Equilibrium pricing (i.e., the price at any moment of time represents an efficient market, anc
that price will change as the market digests new information)

G&D seem guilty on the first three accounts. MCT seems guilty on all four.

THE IMPORTANCE OF CONTROL

Unlike others, control issues and changes in control are a major consideration for us. Control issu are pretty much ignored by G&D and MCT. For us, control common stocks and passively owne common stocks are the same in form, but this book dwells heavily on why control common stocks ar in fact, a vastly different commodity than non-control common stocks, certainly priced ve differently in their respective markets. Control issues are also highly important in restructurin troubled companies. We suspect that subsequent to the 2008–2009 economic meltdown, an increase percentage of changes of control has occurred through recapitalization, asset sales, and capit infusions involving troubled publicly owned companies than has occurred through acquiring commo stocks or using the proxy machinery to effect changes of control of healthy companies.

The book contains three tales about the use of creative finance to create highly attractive returns f various participants:

1. The 2005 LBO of Hertz Global Holdings.

2. The Leasco acquisition of Reliance Insurance—getting control without putting up cash via the judicious use of an overpriced common stock.

3. Schaefer Brewing—letting control shareholders extract large amounts of cash from a company while the control shareholders stay in control.

THE AVOIDANCE OF INVESTMENT RISK

In *Security Analysis*[1] G&D opine on the difference between investment and speculation. “A investment operation is one which upon thorough analysis, promises safety of principal and satisfactory return. Operations not meeting these requirements are speculative.” We agre wholeheartedly with G&D. In this book we attempt to convince the reader that a safe and chea approach is an investment operation, not a speculation. The avoidance of investment risk is at th center of the safe and cheap approach.

There are three general measures of investment risk:

Quality of the issuer

Terms of the issue

Price of the issue

For us, diversification is only a surrogate—and usually a darned poor surrogate—for knowledg control, and price consciousness.

Value investing as practiced by OPMIs is one aspect of fundamental finance (FF). FF covers th following areas:

- Value investing
- Distress investing
- Control investing
- Credit analysis
- First and second stage venture capital investing

The most talented value investors seem to graduate into distress investing and control investin
Such graduates include Warren Buffett, Sam Zell, Carl Icahn, Bill Ackman, and David Einhorn.

We find that there are many, many value investors who are quite competent competitors. As far a
we can tell, however, none seem to put as much emphasis on strong financial positions as we do in th
book.

Safe and cheap investing is basically a buy-and-hold approach focused on the avoidance
investment risk that buys growth without having to pay for it. Security sales take place only when th
security becomes grossly overpriced, when the analyst has made a mistake, when corporate conditio
change, or for portfolio considerations.

MARKET EFFICIENCY?

To others, the default position embodies the MCT view that markets are efficient; to wit, the price
right. To us, in contrast, most prices are quite wrong most of the time.

The conventional thinking seems to be that one has to take huge risks to obtain huge rewards. In th
book, we demur. Rather, for us the royal road to riches is not to take investment risks but rather to la
off the investment risks on someone else. Truly great fortunes have been built by those who hav
successfully laid off investment risk on others. These success stories include the following people:

- Corporate executives
- Hedge fund operators
- Plaintiffs' attorneys
- Bankruptcy attorneys
- Investment bankers
- Securities brokers
- Venture capitalists

We further postulate that the best—but far from the only—way for OPMIs to lay off investment ri
is to acquire securities that are both safe and cheap. The elements that go into safe and cheap investi
in common stocks encompass the following:

- The issuer has to enjoy a super strong financial position.
- The common stock has to be available at a minimum 20 percent discount from readily ascertainable net asset value (NAV).
- The company has to provide comprehensive disclosures, including complete audits, and also be listed or traded in markets in jurisdictions that provide strong investor protections (the United States, Canada, and Hong Kong being examples).
- After thorough analysis, the prospects appear good that over the next three to seven years the company will be able to increase NAV by not less than 10 percent compounded annually after adding back dividends.

We do recognize certain shortcomings in our safe and cheap approach. A strong financial positio especially in the 2012 low interest rate environment, means the OPMI is dealing with managemen willing to sacrifice return on equity (ROE) and return on assets (ROA) in exchange for the insuranc against adversity provided by a strong financial position and the opportunism for companies th arises out of a strong financial position. Also, the OPMI market seems efficient enough so that a larg discount from NAV almost always indicates an absence of catalysts that could result in immedia market appreciation. For example, in our recommended list of securities in Chapter 6, none seem likely to undergo a change of control in the foreseeable future.

DEBUNKING MYTHS

The teachings in this book reject thoroughly a number of commonly held beliefs, including th concept of “too big to fail”; the definition of corporate failure; the belief that creditworthy entitie corporate or governmental, ever repay indebtedness in the aggregate; or the belief that a capit infusion into a private enterprise by a governmental agency is, *ipso facto*, a bailout rather than a investment.

For us, these beliefs are just plain wrong:

- “Too big to fail” is meaningless. The standard has to be “too important not to be reorganized efficiently and expeditiously.” The reorganizations and/or capital infusions after 2008 into General Motors, Chrysler, CIT Group, Citigroup, and American International Group (AIG) are good examples of efficient and expeditious reorganizations of very important companies.
- We define corporate failure as a restructuring in which junior security holders are wiped out or almost wiped out. Chapter 11 reorganization does not define failure. Staying in business does no define success. After 2008, AIG and Citicorp both failed using our definitions of failure, though neither ever filed for Chapter 11 bankruptcy relief.
- In the aggregate, debt is almost never repaid by entities, which nevertheless remain creditworthy Rather, debt is refinanced and expanded insofar as the entity—whether corporate or governmenta —expands its borrowing capacity (i.e., becomes more creditworthy). Each of the companies whose common stocks are listed in Chapter 6 had greater borrowing capacity in 2012 than it had four or five years earlier. Be wary of putting debt limits on corporations or governments.

The difference between a bailout and an investment is that a bailout constitutes a capital infusio without any hope of a return, no matter how return is measured. If there are prospects of a return, well as a return of principal, the capital infusion is an investment. The Troubled Asset Relief Progra (TARP) instigated in 2008 to rescue U.S. banks was an investment by the government, not a bailout.

Great economists Keynes, Friedman, Hayek, and Modigliani and Miller probably could have learne a lot from value investors.

YOU NEED A LOT MORE THAN KNOWLEDGE OF ALGEBRA AND THE ENGLISH LANGUAGE TO UNDERSTAND OUR APPROACH.

A contrast in approaches between academic finance and us is contained in the introduction to Breale and Myers’s *Principles of Corporate Finance*, a leading finance text, where the authors state th