

The ABCs of investing

A look at Saucony, Nike, Lone Star

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To take advantage of market inefficiencies, every investor wants to buy low and sell high. We think buying low is the really tricky part.

An astute investor must discover value that others have not yet noticed or do not fully understand or appreciate.

To improve one's odds of success, remember the ABC's of investing: assets, bargain and catalyst.

In other words, seek companies that boast real, measurable assets, which can be acquired at a bargain price, the value of which may be increased by a catalytic event, such as a merger or new business development.

BUY COMPANIES FOR FREE

In ABC terms, if one can buy assets at a deep enough discount, one can profit even if a catalyst does not materialize. In other words, as the market moves toward efficiency and stock prices come to reflect the company's true value, one realizes a reasonable return. When the catalyst does occur, the gains may be realized.

Consider the case of Saucony shoes.

In mid-2003, Saucony had a market capitalization of \$88 million, with net working capital of \$70 million and a beautiful headquarters building worth \$10 million.

After netting out these assets, the entire company was selling for \$8 million [because one owns the assets when one buys the company].

At the time, Saucony was generating approximately \$133 million in annual sales, \$7.3 million in earnings, and \$13 million in free cash flow. And one could buy all this – in effect – for \$8 million!

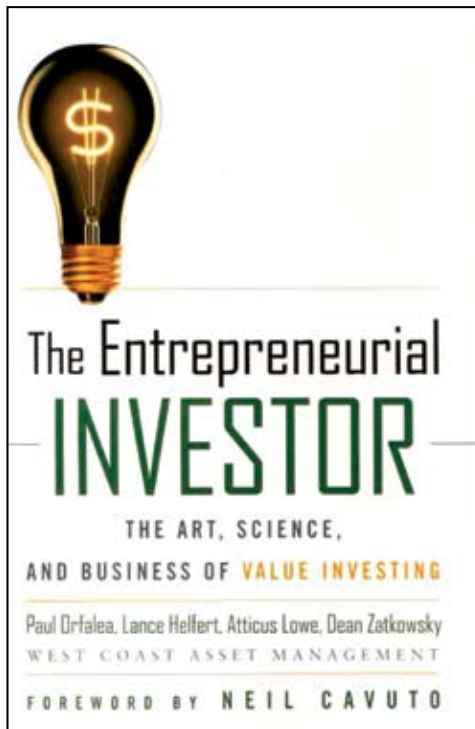
So, clearly, Saucony's assets were available at a bargain price.

Converse had recently been purchased by Nike for one-and-a-half times sales plus the assumption of debt. That formula would equate to at least \$200 million for Saucony, not including its \$80 million in tangible assets.

During early 2004, Saucony reward-

ed shareholders with a special cash dividend of \$26 million, or \$4 per share. That was nice enough, but the true catalyst came when Saucony was acquired at a premium price by Stride Rite in mid-2005.

After the Great Depression, when Benjamin Graham was formulating the tenets of value investing, people were so wary of the stock market that one could regularly find companies selling for less than the value of their net tangible assets.



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From an entrepreneurial investor's point of view, that would be like buying the company for free.

The case of Saucony – \$80 million worth of concrete assets for \$8 million – comes close enough to illustrate the point nicely.

EASY AS ABC?

Buy low and sell high. Investing is just that simple – and just that difficult.

Finding undervalued companies is our business and our passion; online research capabilities improve our ability to generate ideas and refine our

process.

The real challenge for most people is discipline, the commitment to follow their ABCs.

Even so, that commitment will only improve one's odds; it does not guarantee success.

Consider Lone Star Steakhouse.

In January 2004, Lone Star had tons of net cash and real estate on its balance sheet, generated plentiful free cash flow, and paid health dividends. In addition, it had high insider ownership, was aggressively repurchasing stock, and had just authorized an additional repurchase up to 10 percent of the shares outstanding.

Nevertheless, the company featured a low market capitalization because Wall Street did not like the volatility of beef prices due to mad cow disease and the Atkins diet – one a scare and the other a fad. So the company's assets were available for a bargain price; in fact, there was very little downside.

Potential catalysts at the time included the possibility of a buyout – which had been unsuccessfully attempted a few years prior – or a large special cash dividend or share repurchase funded by the monetization of the company's real estate assets. An entrepreneurial investor would have found this situation quite tempting.

But in late 2005, the company decided to stop repurchasing stock and instead reinvest in its existing restaurants in an effort to boost same-store sales.

In addition, the company experienced a steep increase in operating costs due primarily to higher wages and rising commodity prices.

At this point, the scenario had changed enough that our hypothetical investor would have sold and taken the loss, because the company no longer fit an entrepreneurial strategy. Fortunately, the margin of safety achieved by buying the assets at a bargain price would minimize the loss.

The ABCs are a good guide for prudent investing. Look for assets of undeniable value, such as real estate, case, patents, or oil in the ground, available at a discount price.

A probably catalyst ices the cake, turning a good investment [assets purchase at a bargain] into a great investment; for example, the company is ac-



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quired at a premium price.

All three components rarely coincide. When they do, profitable investing is as easy as ABC.

Saucony was a good example of the opportunity to purchase assets at a bargain price, with conditions in the athletic shoe industry suggesting the probability of a catalyst in the future. Such opportunities are rare; even when one can find assets at a bargain price, the catalyst does not always happen, or does not always happen in a timely manner.

But with adequate margins of safety and an opportunistic attention to detail, an entrepreneurial investor doesn't have to win them all.

As Wall Street legend Bernard Baruch said, "Even being right 3 or 4 times out of 10 should yield a person a fortune if he has the sense to cut his losses quickly on the ventures where he is wrong."

Or as we like to say, "It's okay to be wrong, but it's not okay to stay wrong."

To improve one's odds of success, remember the ABC's of investing: assets, bargain and catalyst.

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