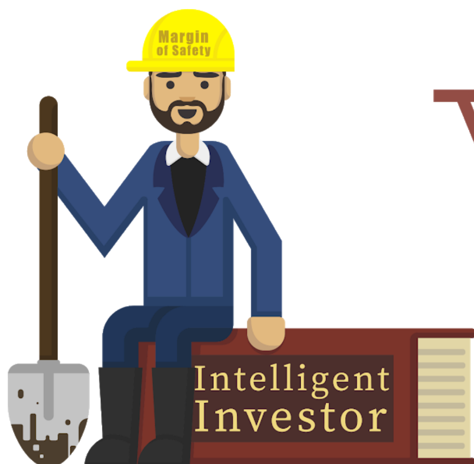
Value Ventures: November 2019
Long-term thinking in a world of short-term orientation.



Value Ventures

A Bullet-Proof Margin of Safety Strategy & Deep Value South of The Border

by Brandon Beylo on 07 November 2019

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Last Month's Must-Reads

Each month I collect various articles, blog posts, research materials, etc. and deposit them here. This month's collection features Howard Marks' memo, Scott Miller's Q3 letter, and interview with (legend) Peter Lynch and Matt Levine's greatest newsletter.

Oaktree Memo on Negative Interest Rates, R Ì ëmÌ

Marks' memos are must-reads. Warren Buffett makes sure to read each memo. So if it's good enough for Buffett, it's good enough for us. This month's memo offers Marks' commentary on negative interest rates, what we know (or better yet *don't* know) and if we'll see them in the US.

I love Marks' honest take on negative interest rates. He doesn't know what will happen. And that's the point. Similar to deflation and inflation, Marks argues that we *don't actually* know what negative rates mean for markets. Further, we don't know why they're here, how long they'll be here and if they'll enter the US.

Greenhaven Road Capital Q3 Letter, šå m ï

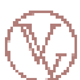
Miller's fund returned a shade under 1% for the quarter. The theme of the letter is "thinking in bets", an ode to Annie Duke's book *Thinking in Bets*. Miller argues that investing, much like poker, is a series of calculated bets. Miller's goal is to skew the odds of a successful outcome in his favor as much as he can.

He gives an example of this positive asymmetry with one of his newest holdings: GigCapital, Inc. (GIGRT/GIGWS). GigCapital is a SPAC IPO on the verge of acquiring Italian company Kaleyra. In his words, Miller has "done everything I can to tilt the outcome in our favor."

Miller also invested in an undisclosed South African company. While he didn't give a specific ticker, he offered clues: high insider ownership, best-in-industry operator, double-digit returns on equity, high discount to book value and a 3x P/E.

Peter Lynch: Secrets to Success, Këï V ï ï

Peter Lynch is on the Mount Rushmore of investing lore. Lynch ran the Magellan Fund at Fidelity from 1977 - 1990. During that time he grew AUM from $18M to an astonishing $14B. That's 677% growth (52% annualized). To achieve those staggering returns, Lynch stomached his share of downturns. In the 13 years he ran Magellan, the market dropped 10% or more nine times. Each time, Lynch noted, his Fund dropped *lower* than the market.



According to Lynch, the most important organ in investing is the stomach. Not the brain.

The entire interview's worth the read. And if you haven't already, pick up a copy of Lynch's book *One Up On Wall Street*.

How Do You Like We Now, mÌ ˘gï ï

FinTwit hails Levine's latest piece as one of the best he's ever written. I can't argue that. Levine takes the reader on a hilarious journey through the history of WeWork's valuation and failed IPO. Seamlessly intertwining humor with fact, Levine breaks down just how diabolical former CEO Adam Neumann was to the company.

It's the perfect bookend to the WeWork saga.

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Margin of Safety: Three Methods of Practice & How To Develop a Bullet-Proof Strategy

Value investors have two rules:

1. Don't lose money
2. Don't forget rule No. 1

But we live in this twilight zone. We whipsaw between adhering to the "Magic Rule", yet double down on our biggest losers. There's a popular phrase within the value community that goes like this: "If you liked stock XYZ at $5, you'll *love it* at $2!"

What gives? Where's the consistency?

In a way, it's the ethos of value investing. We buy things that are on sale, and then buy more when the discount increases.

But here's the thing: **This isn't optimal.**

In fact, there's a way to combine the *best* elements of value investing with the *best* elements of risk management. It's my Margin of Safety Blueprint.

Let's dive in.

The Margin of Safety Blueprint

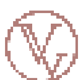
The Blueprint is simple, and that's the point. Simplicity rules in financial markets. Make the game any harder than it has to be and you're setting yourself up for failure.

There's three steps:

1. Calculate the intrinsic value / asset value of an investment
2. Wait until the stock chart forms a basing/consolidation pattern (the longer the better)
3. Enter on a breakout from a base or consolidating low and set a stop-loss below the most recent low price.

Let's go through each step of the process in more detail.

Step 1: Calculating The Value of an Equity Investment



There's two broad methods of calculating margin of safety:

1. Asset-based margin of safety (liquidation value)
2. Discount to present value of future cash-flows (intrinsic value discount)

Each method offers its own unique set of benefits, pitfalls and best practices.

We're going to cover three main topics in this section. First we'll dive deep into the strengths and weaknesses of each calculation. Then we'll discuss which method is best to use in certain situations. Finally, we'll break down how we use each valuation in our Blueprint.

Asset-Based Margin of Safety (Liquidation Value)

Asset-based (liquidation) valuations are the oldest and truest expression of margin of safety. They come in a few flavors:

- Net Asset Value
- Net Current Asset Value
- Net Cash Value

What's great about asset-based valuations is its simplicity. You only needs three pieces of information to calculate asset-based valuations. The stock price, a company's balance sheet and total shares outstanding

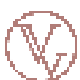
Asset-based valuations are more concrete in their results. This makes sense intuitively as we're valuing *hard* assets on a company's books (cash, PP&E, real estate, etc.). We don't have to guess what revenues will look like over the next five years. In fact, we don't have to make any predictions at all. All we need to know is a ballpark valuation on a company's current and long-term assets.

Example: 1987 Texaco, Inc. Debentures

Before we dive into each valuation method, let's look at an example from one of the greatest investors. Seth Klarman's Texaco debentures investment. Klarman said this investment was, "perhaps the best recent example of investing with a margin of safety." Let's go to the book (emphasis mine):

> *"In 1987 Texaco filed for bankruptcy ... Although the value of Texaco's assets appeared to more than fully cover all of its liabilities even under a worst-case scenario, in the* ïëÌ ïÌ ï Ì *of Texaco's Chapter 11 filing its* å Ì ëă ë ˘ ïë˘ ã̈ *"*

Mr. Market's mood swings strike the hardest (and fastest) in the short-term. These reactions send stock prices plunging with no grip on intrinsic value. Investors quick to



recognize the price disturbance were handsomely rewarded. Klarman continues (emphasis mine) …

> "˙ ˘ ï˘ ˘Ì ï ˘ ˘ å Ì Ì ë˘ ï ï *upon emergence from Chapter 11, these bonds purchased at 90 would provide* Ì Ì ïë˘ï ˘ ˘ ˘ Ì ë *assuming one-year, two-year, and three-year holding periods.*"

If those types of returns don't have you interested, I don't know what will! Let's break down the methods Klarman used to find such ideas.

Net Asset Value

Net asset value (NAV) is simple in its calculation. But in today's market, it's tough finding companies trading below such values. NAV offers a true "floor" for what a company would be worth off assets alone. It's also hard to get NAV wrong (assuming accurate financials).

The NAV is one of the most conservative forms of valuation. You only care about the assets and liabilities on the balance sheet. Income statements and cash flow statements don't matter here. Here's the formula:

(Total Assets - Total Liabilities) / Total Shares Outstanding

Not complicated stuff. You're trying to find a business where it's asset value exceeds its stock price on a *per share* basis.

Recent examples of NAV discounts include the entire shipping industry.

Pitfalls of Net Asset Valuation

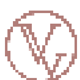
NAV relies on book value of assets, not market value. This gets tricky when dealing with real estate values. Why? GAAP accounting requires public companies to record the value of their real estate at the *historical cost*. Not the current market value. This creates discrepancies between *actual value* and *accounting value.*

Second, NAV doesn't credit companies with *legitimate* intangible assets. The brand power of companies like KO, WMT and LVMH are discounted at a cool 100%. This brings us to our third (and largest) pitfall of all asset-based valuations.

NAV doesn't work for a majority of publicly traded businesses. Asset-light businesses -- usually the darlings of the markets -- have no value at all under a NAV microscope. Said another way, NAV only works for asset heavy businesses. Think industrials. Companies with loads of fixed assets and property, plant and equipment (PP&E).

How to Find Stocks Trading Below NAV

I use two websites to run NAV stock screens: Fintel.io and Stockrow.com. The reason I use two is to help filter and double-check my process. Different screeners will produce different lists of stocks. Even if you use the same metrics.



Here's the screen criteria: (Assets-Liabilities) > Market Cap

It's that simple. I've also found that adding a debt-to-equity ratio <1 produces better results.

Recent Examples

As of writing this (10/28), a few examples from the NAV screener include: DNR, SPTN, FISI and GPRE

Net Current Asset Valuation

Coined by Benjamin Graham, Net current asset value (NCAV) is one of the oldest forms of valuing a company. Here's the calculation:

Current Assets - (Total Liabilities + Preferred Stock) / Total Shares Outstanding

NCAV focuses on the current assets of a business. The benefit of current assets is the liquidity premium. A business can return cash to shareholders without the need to sell hard assets. If the NCAV is positive, it means a business has enough current assets (cash, etc.) to cover all liabilities.

In other words, a positive NCAV points to a rock-solid balance sheet.

The liquidity premium also serves as greater downside protection for investors. If a business can't find a seller for its fixed assets are those assets *actually* valuable? Also, companies in bankruptcy aren't always asking top-dollar for their assets. Almost everyone gets burned in a fire sale.

Pitfalls of Net Current Asset Valuation

NCAV shares near identical pitfalls with NAV calculations. NCAV will filter out 95% of the market. You'll miss technology stocks, software businesses, asset-light compounders and more.

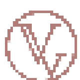
What you *will find* are industrials, shippers, machine-heavy conglomerates and certain commodity businesses. These businesses will most likely be in the middle of an intense drawdown. We're searching the bottom of the garbage can.

How to Find Stocks Trading Below NCAV

I use the same websites for screening NCAV stocks as I do NAV. The only difference is the formula. Current assets instead of total assets. This should give you a longer list of very small companies to comb through.

Recent Examples

Running the NCAV screen this morning spat out: FTK, RELL, MN and OSN



Net Cash Valuation

Net cash is the largest discount section in the entire market. Think of it as the Goodwill of financial markets. It's 99% garbage, but the 1% can make the trip worth it. Net cash valuation sits atop the margin of safety pyramid.

Net cash is the *truest*, most protective form of valuation. It's also the simplest to calculate. There's only three variables:

(Cash and Cash Equivalents - Total Liabilities) / Total Shares Outstanding

The goal is to find companies where the net cash number is higher than its stock price. In other words, we want to find companies where there's more net cash *per share* than the current stock price. The bargain of bargains.

Pitfalls of Net Cash Valuation

Most of the companies that screen net cash are terrible businesses. These businesses burn cash like there's no tomorrow. Many of them operate on failed business models. You also find CEOs using the company as a shell for personal gain. Meanwhile, there's little profits or earnings to speak of.

These are 'ick' stocks. But we're bottom-fishing. We *expect* this.

How to Find Companies Trading Below Net Cash

There are a couple ways to run the net cash screen. You could plug in the above calculation into Fintel.io. Or, you can screen for companies with negative enterprise values.

Negative enterprise value accomplishes the same thing. In order for a company to have a negative enterprise value, it would need more cash than all liabilities.

Recent Examples

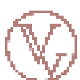
Running the Negative Enterprise Value screen spat out ZVO, GIGM, SPRT, WSTL and LTBR.

Concluding Thoughts on Asset-Based Valuations

Asset-based valuations are a great fishing hole for deep value investors. Yet, it's harder to find these types of discounts in today's quant-filled trading environment. Computers analyze terabytes of data faster than we can load our stock screening website.

This doesn't mean you can't profit from such ideas.

Find asset-based discounts that offer brighter futures, not cash burns. If you can find a business trading at a discount to its current assets or cash AND is on the verge of profitability, dive deeper. That could be a multibagger.



Investment horizon matters. You need to think long-term with asset-based valuations. They won't move in a couple trading days (or weeks, or months!). In fact, many asset-based discount stocks take years before reaching fair value. Often, these stocks sit tight and do nothing. Can you stomach the dead-money?

If you can't, the next method might be more up your alley.

Cash-Flow Method of Margin of Safety

The second margin of safety method focuses on a company's cash-flow. The goal here is simple. You want to buy a business in which the sum of future cash flows are worth more today than the current stock price.

The greater the divergence between the value of the future cash flows and the current stock price, the wider the margin of safety. We'll refer to this method as the DCF (discounted cash flow) method.

Critics like Bruce Greenwald claim the DCF method isn't as reliable as an asset-based method. Greenwald says "when you mix good information with bad information you get bad information."

While this is true, Greenwald misses the point of a DCF. We *know* we're making projections about the future that might not work out. But if we make those projections based on varying degrees of success or failure, we get a clearer picture on what *could* happen. Not what *will* happen. Then, we apply probabilities to each scenario. Each probability tied to *your* personal belief on the future.

That's what makes cash-flow valuation unique. It's not an art nor a science, but something in the middle. You make it your own original work.

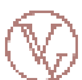
Benefits of Cash-Flow Valuation

DCF valuation is the *best* method for valuing cash-generating entities. Businesses are worth the present value of their future cash flows. If you invest $1 in a business, you expect to receive greater than $1 in the future. The DCF gives us that ability.

You can create future scenarios based off probabilities, creating multiple future scenarios. It also redirects your attention to the long-term. The shortest time-frame for DCF valuations is ~3 years. Your focus shifts from the next quarter to the next 3-5 years.

Pitfalls of Cash-Flow Based Valuation

With great power comes great responsibility. Greenwald highlighted a few of the risks with DCF models. First, it's easy to "fit" any valuation into a spreadsheet. Think of it like overfitting a data sample. If we wanted to, we could make *any* company look cheap. Change a few percentages here, boost revenues there. And before you know it, you've got a bargain.



Many investors fall prey to Excel. Aswath Damodaran likes to say, "use a DCF as a tool, not a crutch." If you find yourself spending hours on a model, critiquing the last decimal place, stop. You've gone too far.

More isn't better. A stock's discount should hit you over the head before you go near a DCF. Here's my rule. If I can't see the bargain after reading the 10-K, earnings transcripts and investor presentation, I don't go to my DCF.

How to Calculate Free Cash Flow

There's different ways to calculate free cash flow, but they all converge around the same figure. It helps to think of short-hand vs. long-hand.

****A caution on using EBITDA. Double-check how the company arrives at their EBITDA figure. I saw yesterday where Pinterest now adds back 'stock-based compensation'. Watch out for legitimate expenses.*

Long-hand: EBIT * (1 - Tax Rate) + Depreciation and Amortization - Changes in NWC- Capital Expenditures

Short-hand: EBITDA - capital expenditures

We then apply a discount rate to the FCF figure. I use a generic 10% discount rate across all DCFs. The discount rate is the 'hurdle rate' for an investment. Since we are investing in uncertainty (the future), we need compensation for that risk.

The higher the discount rate, the more uncertainty. The lower the discount rate, the more certainty. 10% is a healthy medium. Anything higher and you might miss a great bargain. Anything lower and you're fooling yourself.

How To Find Cash-Flow Based Discounts

I use a couple screeners to find ideas for undervalued stocks based on cash-flow:

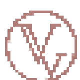
- EV/EBITDA screener
- EV/EBIT screener

Within both screens I'll add a free cash flow yield filter. I prefer companies with FCF yields greater than 6%.

This generates a long list for me to comb through. Once I narrow down my target companies, I'll run a simple DCF model. I use three scenarios: negative growth, stagnant growth and cautious optimism.

Using these scenarios paints a picture of what the future *might* look like in 3-5 years. Again, we want the largest discount between current stock price and future equity value.

Recent Examples



- EV/EBITDA screen: DISCA, URI, HFC and SNA
- EV/EBIT screen: SNE, BIIB, LUV, IMO and WU

Concluding Thoughts on DCF Valuation

DCF valuation is *the best* method of finding intrinsic value. Used properly, DCF models *drastically* improve investment decision making. After all, why would you pay more now for less future cash flow value?

It doesn't make sense.

Yet thousands of investors do this. They invest blind, with no idea of the present value of a company's future cash flows.

Step 2: Find Basing/Consolidating Chart Patterns

This is where I lose most "hardcore" value investors. Mention chart patterns at a value investing conference and you'll see what I mean. Yet chart patterns provide *another* layer of margin of safety. They display sentiment, expectations and company history all in one place.

That's valuable information.

Remember, the goal with the blueprint is simplicity. Simplicity is key. I'm not using Fibonacci numbers, bollinger bands, or fancy cloud indicators. That's not to say these indicators don't work. They just don't serve *our* purpose. We want easy to follow, easy to replicate.

Techcharts.net offers statistics on most reliable chart patterns at the end of each year. These three chart patterns produce consistent 65%+ breakout confirmations:

Rectangle
Ascending Right Triangle
Inverse Head and Shoulders

What Does The Chart Say?

Basing and consolidation patterns tell me a few things about a stock. First, it lets me know all short-term traders left the party. What's left are long-term oriented investors. Second, a basing pattern tells me the stock remains overlooked by a majority of investors. Finally, these patterns let me know a breakout move is on the horizon (downside or upside)

I then combine that information with fundamental due diligence.

That's the bread and butter. Our *sweet spot.*

This idea isn't new, either. Jesse Stine championed this strategy on his way to 14,000%+ gains in 28 months. He detailed the strategy in his book *Insider Buy Superstocks*. I finished it in two days. Grab yourself a copy.

Daily vs. Weekly Charts

Smart money follows weekly charts, so we will too. Weekly charts paint a clearer picture of trends, reversals and changes in sentiment. The longer time frame also keeps us in the trade longer. It does so by reducing the chances of getting stopped-out on "noise".

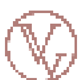
Longer time frames keep away from falling knife investments. Getting the lowest entry point we can matters. The price you pay drastically increases or decreases expected IRR.

Let's take a look at some example charts.

1. Scorpio Tankers (STNG)

Note the almost two year inverse head and shoulders chart pattern on STNG. We had an initial breakout above the $31 resistance line. That new support is being tested on this recent pullback.

2. Capital Product Limited Partners (CPLP)

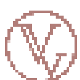


Here's a 10 month long rectangle consolidation pattern on Capital Product Limited Partners (CPLP).

3. Amerco (UHAL)

Check out the near 4 year rectangle consolidation pattern on UHAL.

4. O'Reily Auto Parts (ORLY)



Here's a nice ascending rectangle pattern on the daily charts for ORLY.

Step 3: Entry and Exit

Entering on Breakout & Stop-Loss at New Lows

The last part of the blueprint is the easiest to execute, but hardest to follow. Once price breaks out of consolidation on high volume, I place a buy order near the end of the trading week. I like to see the stock price close above the breakout point on a Friday.

After I place my buy, I'll enter a stop-loss order at either a new low or a price that signals a reversal in the basing / consolidation pattern.

I can feel the virtual tomatoes fly at me from the value community. "But Brandon, stocks are ownership shares in businesses not pieces of paper!"

Yes, I agree!

That doesn't mean we can't protect ourselves. If a stock breaks a new low or fails a breakout pattern, I get out and wait for a better opportunity.

This feels counterintuitive to the buy-and-hold mantra spewed by the financial media. But bear with me. We have one job as investors: ˘ ˘ ї˘ ї . That's it. And the best way I've found to not lose money is to buy only deeply discounted stocks. Buy them after a breakout from consolidation, with stop-loss protection at new lows. It's that simple

Concluding Remarks

This blueprint works for me. It might not work for you, and that's okay. That's the beauty of investing -- finding what works for you. the lessons learned from this section apply to any investing or trading system.

I can't stress this enough: keep things simple. Before moving on to a few new ideas, here's the entire system. Find stocks trading at a steep discount to fair value. Look for a clear base or consolidation, enter on the breakout of the base / consolidation. Put a stop-loss at a new low or at a price that confirms a reversal of the breakout.

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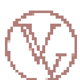


Cliff-Notes: Three Deep Value Plays in Mexico

- **What We Like:**
  - **Durable, competitive advantages within each company**
  - **A cheap purchase price**
  - **Industry leaders**
  - **Sticky businesses with high switching costs**
  - **Macro tailwinds**

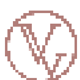
- **What We Don't Like:**
  - **Geopolitical risk**
  - **Government issues**
  - **Currency risk with MXN/USD pair**

- **What We Think They're Worth (BOLSA / CADGF):**
  - **Pessimist: 30% downside / 100% upside**
  - **No-growth: 15% downside / 300% upside**
  - **Optimist: 40% upside / 500% upside**

Deep Dive: Two Ideas in Mexico

Mexico is one of the darker corners of the market. Investors are too busy chasing US dividend-paying stocks to venture outside the North American border. Yet if you're willing to get your hands dirty and look around, you'll find some serious bargains.

But there's plenty of risk to go around South of The Border. Mexico offers currency risk, tariff risk and (can't forget) a corrupt government. These risks dissuade most investors, and rightfully so. One doesn't *need* to invest in Mexican equities to generate a satisfactory return.



Yet we're not in this game for *satisfactory* returns. We want *differentiated* returns. Moreover, we want **positive** differentiated returns.

To compensate for our increased risk, we want to invest in the **äï ˘ ˘ë Ìäï** companies in the space.

Each of these two companies offers durable, competitive advantages. They're leaders in their industries. They generate significant amounts of free cash flow. And best of all, they're cheap.

Let's dive into each company.

Pure Play on Financials: Grupo BMV (BOLSA)

Grupo BMV (BOLSA) holds a monopoly on the financial exchange business in Mexico. The company generates 20%+ ROE, earns over $1B in FCF and returns most of it to shareholders in dividends. BOLSA has little debt, ample assets and a long runway for growth. The company shows resistance to economic downturns as well. EBITDA margins have grown over the last four years. This includes the breaking-up of NAFTA and "mini-recession" of 2018. On top of improved EBITDA, the company's achieved 11 straight years of increased revenues.

You can get all this and a monopoly-like business for 10x current year EBITDA with a near 5% dividend yield.

Monopoly on Financial Exchange Business

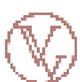
BOLSA has one of the strongest monopolistic positions I've ever seen. They control **97%** of transaction volume on stock exchanges in Mexico. In other words, there isn't another player in the space for consumers to use.

Stock Exchange	Total Value (Million Pesos)	Total Amount Share %
BMV	$1,483,239	97.63%
Competitor	$35,950	2.37%
Total	$1,519,188	100.00%

Due to their monopoly on the industry, BOLSA takes market share and raises prices every year. That's the beauty of monopolies. The switching costs are infinite because there isn't another option.

As of Q3 2019, BOLSA had 458 listed issuers in the local market and 2,116 issuers in global market. For comparison, it's closest competitor in the local and global markets own 18 and 126 issues.

BOLSA accounts for 100% of the equity markets, 96% of long-term debt markets and 89% of short-term debt markets.



How Grupo BMV Makes Money

BOLSA generates revenues through six operating segments: Listing and Maintenance, Equity Trading and Clearing, Derivatives Trading & Clearing, OTC Trading, Central Securities Depository and Information Services

The company receives 37% of their revenue from market-related activities (trading, clearing, etc.). The other 63% comes from fee-related services, such as maintenance, listing, and depositing. BOLSA is a pure-play on the Latin-American financial markets. 85% of their revenues come from within the country.

Mostly every form of revenue is fee-based. This is great because it makes certain segments feel more like annuity streams. The company's Listing and Maintenance segment is the perfect example.

Let's do a quick run-through of their major revenue segments.

Listing and Maintenance Fees

Each public company pays a one-time fee to list on the BMV exchange. Then, BOLSA charges maintenance fees annually after the first year of public listing.

As of Q3, that's close to 2,500 listings paying annual maintenance fees. Every one of those maintenance fee dollars drops straight to the bottom-line. Near 100% incremental margin. BOLSA's averaged around 135-140M pesos in maintenance revenue per year.

Trading and Clearing

BOLSA also generates fees from trading and clearing. While this segment's grown roughly 5% annually since 2012, it accounts for a smaller portion of overall revenues. This is important as we're already seeing the race towards $0 commissions in the US. The average fee per trade is around 0.40bps, with 0.30bps margin fees.

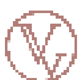
Between equities and derivatives, the company generates around 700,000 pesos in revenue per year.

Central Securities Depository

BOLSA's central security depository (Indeval) is home to 5.3T pesos in daily assets. 40% of Indeval revenues come from custody assets. The company is on pace to do nearly 1B pesos in revenues from Indeval in 2019.

Information Security

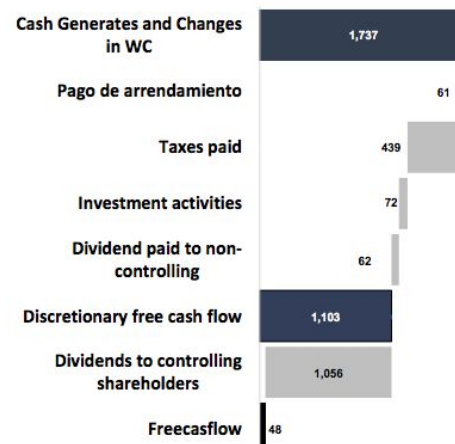
Information Security rounds out their operating segments. While a small portion of total revenues (500M pesos), this segment's grown at a 13.75% 7-year CAGR. Revenues in this segment come from two products: Valmer and Market Data.



Valmer is an authorized price vendor and risk management software provider. It accounts for 38% of the segment's revenues. Market Data provides screens, information stations and data feeds. This segment brings the majority (62%) of revenues.

Financial Brokerage is a Great Business

The annuity-like income streams make financial brokerage a fantastic business. We see evidence of it in the company's financials. BOLSA's expanded EBITDA margins 23% over the last ten years (from 36% - 59%). They've increased net income at a 21.5% 9-year CAGR. And they generate *loads* of free cash flow that they give to shareholders.



Take a look at the free cash flow breakdown on the right (source: company slide deck). If you back out the dividend payment, BOLSA generates an annual run-rate of over 1.1B pesos in free cash flow.

The Power of Branding

Meanwhile, the company benefits from brand recognition in the same way a Fitch or Moody's does. Let me explain. When a private company in Mexico wants to go public, who would they choose? BMV Group or some other no-name brokerage?

They're taking BMV Group every time. It's not *simply* because they're the best. They might not *even be* the best product. It's because they're the most known and respected.

Plus, if you're going public, liquidity is your main goal. BOLSA offers the best liquidity in the Mexican public markets.

Rock Solid Balance Sheet

BOLSA's balance sheet is as good as it gets. The company has nearly $3B in cash, $192M in debt and a 7.8:1 current ratio. In fact, 36% of its assets are in cash and investments. Even if we discount their goodwill by 50%, we're left with a 5-1 current ratio. That's $4.70/share in cash. BOLSA has enough cash on hand to cover *all* liabilities. We like that safety net.

Valuation

The company isn't basement-level cheap by traditional metrics. It trades at 17x 2019 earnings and 10x 2019 EBITDA. But when you think about the type of business you're getting as well as the monopolistic nature of their market, things get attractive.

The NASDAQ trades for 20x earnings and 16x EBITDA, yet generates less returns on equity. It also isn't a monopoly (you have S&P, DOW Jones, Russell, etc.). BOLSA generates higher returns, owns the entire market and is cheaper.

The company jas historically grown revenues 9% since 2008 and increased EBITDA margin from 33% in 2008 to 59%. Given it's dominance, one could assume it would be able to expand EBITDA margins into the future.

For our valuation work we're using the December 2018 conversion rate of $1 USD to 19.64 pesos.

Our Three Scenarios

1. *Negative Growth*

Let's assume the company loses 5% a year in top-line revenue and fails to expand EBITDA margins. We're also assuming no multiple re-rating given the decline in the business.

In this world, we end up with 2023 revenues of $140M, $82M in EBITDA and $44M in free cash flow. This gives us an Enterprise value of roughly $650M and market cap of $802M. Divide that by our shares outstanding and you get around **$1.45/share (~35% downside**).

This scenario isn't likely and assume lower probability to this outcome

2. *No Growth*

In this scenario, we're assuming zero top-line growth, no margin expansion and no multiple re-rating. 2023 enterprise value comes in around $804M, market cap around $964M. This gives us a fair value of **~$1.70/share (20% downside)**.

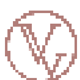
How would we get here? If Mexico follows the US' footsteps of zero commissions, we could see a short-term hit to revenues. The US is a good working model of how to think about this (see SCHW, TD Ameritrade, etc.).

3. *Cautious Growth*

In our growth scenario we're assuming 6% top-line expansion. This is still 300bps below BOLSA's historical growth rate.

We're also assuming a multiple re-rating to 15x EBITDA given the monopolistic characteristics, durable advantages, high returns on capital and EBITDA margin increase.

We end up with over $240M in revenues, $152M in EBITDA and $76M in free cash flow. Dividing our market cap of ~$1.8B by shares outstanding gives us over **$3/share in equity value (44% upside)**.



Concluding Thoughts

Current stock prices are approaching all-time highs. I want to stay patient and see how price reacts to its new-found resistance. If prices shoot through previous all-time highs, we could see our $3/share valuation tested. If it fails to breakout, the bargain gets *even* better.

I'm content with sitting on the sidelines and waiting for an optimal risk/reward entry on a breakout or a consolidation at lower prices.

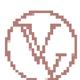
A Boring Business: Bio Pappel (PAPPEL/CADGF)

Bio Pappel is the leading paper and packaging manufacturer in Mexico. It's operations span North America and Colombia. The company operates three business segments: Titan, Scribe and McKinley. They generated over $1.3B in sales on 3 million metric tons of paper in 2018.

The Thesis

PAPPEL is one of the cheapest companies in the BMV exchange. The founding family still runs the business today and has massive skin in the game. The family owns 84% of the stock. It trades at less than 3x earnings and 2x EBITDA. And at $347M market-cap remains outside the scope of most institutions.

They've grown revenues and EBITDA for three straight years. During that span, the company reduced leverage to <1x while increasing interest coverage 20%. Current prices say that in three years you get all your cash back and keep the business for free.



Is This a Good Business?

The company prides itself on sustainability. PAPPEL developed a model that allows the company to produce paper without cutting trees. Think of it as a reverse chain of supply. It takes recycled paper and converts it back into usable paper.

They sell their product at a 23% gross margin with 17% return on equity, both leading the industry. How do they have leading margins? Vertical integration of their supply and sourcing.

Vertically Integrated Model

PAPPEL has the most efficient paper delivery system in the country. They've vertically integrated the sourcing, production and delivery process. Their sourcing and manufacturing centers are close in proximity to one another. This reduces transportation costs and delivery times. The company's then able to charge lower prices for their product while getting it to the consumer faster.

Diverse Customer Base

89% of PAPPEL's sales were within Mexico, 9% to the US and 2% in Colombia.

The company doesn't have customer concentration, either. Not a single customer makes up greater than 5% of PAPPEL's income. Here's a quote from their annual report on customer concentration:

"We do not believe that the loss of a single client has a material adverse effect on our business."

More Than Newspaper

PAPPEL breaks down its revenues into three segments: Titan, Scribe and McKinley. Let's review each segment.

Scribe

Produces white paper, cut paper, notebooks and special paper in Mexico and Colombia. Scribe sold 155K metric tons of bond paper and 183K metric tons of cut paper

McKinley

Produces brown paper for packaging. Operates in Mexico and the US. Last year McKinley shipped 496K metric tons of paper. This segment did $855M in sales last year. Most of the revenue comes from brown paper and corrugated boxes.

Titan

Produces corrugated boxes and paper bags. Leading supplier in the market. Titan shipped 802K metric tons of corrugated boxes and multilayer bags in 2018.

30,000ft View

In general, the company breaks down revenues between Paper Coffee & Packaging and White Paper and Notebooks. Paper Coffee and Packaging did over $855M in revenues last year. Most of which came from brown paper and corrugated shipping boxes.

The White Paper and Notebooks segment generated $489M in 2018. A majority of their sales coming from cut paper, notebooks and bond paper.

Founder-Led Company with Skin in The Game

Miguel Rincon started PAPPEL in 1982. He continues to lead the company as President of the Council, Executive President and General Director. PAPPEL is also a family affair. Eight of the twelve Board Directors are from the Rincon family.

Outside of the Rincon family, the other directors own 11% of the company. That means management collectively owns over 90% of the company. Interests are aligned. And it’s as close to private equity in public markets as you can get.

Valuation: Hidden P/E of 2

Current stock prices imply one of two things happening over the next five years. Either PAPPEL loses 25% revenues annually or their EBITDA margin slashes in half. In short, the market's pricing in bankruptcy. I don’t see any of those happening.

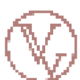
In fact, **we don’t need [illegible] to go right for PAPPEL for us to generate a 3-bagger.**

Why is The Company So Cheap?

What are we seeing that Mr. Market isn’t? I think a few things are to blame. First, the stock is illiquid. It’s ADRs trade less than 2,000 shares a day (~$2,000 daily volume). This makes it impossible for those with larger accounts to establish a position.

Second, management owns over 90% of the business. There’s little float left for outside investors. This means in order for the stock to *really* move, we need insider purchasing, or one large outsider to push prices upwards.

We Don’t Need Growth to Win



If the company remains in steady state, they'd generate over $713M in cumulative after-tax earnings in five years. The current market cap is $347M. That's a near 300% return assuming ï ˘growth.

If we assume even modest 4% top-line growth annually, we end up with $830M in after-tax earnings in five years. At current share price that's a 400% return.

This doesn't include any reduction in leverage over the next five years either. The company's most likely going to pay off *some* debt annually. For example, PAPPEL paid off $70M in long-term debt in 2018. At that run-rate, the business would be debt-free in four years.

Risks

1. Family-run business

There's always the risk that future relatives don't run the business well. Or even run it at all. I like that the family owns 85% of the business, and the CEO's made all the right moves over the last three years.

2. Favoritism with the Mexican President

Mexico is known for its friendly relations between politics and financially incentivized parties. The Cartel seems to run things down South. So far, Rincon's done well. In April he renounced a contract from the government so as not to portray any false favoritism.

3. Other risks

Other risks include an economic slow-down in Mexico. There's also leverage risk and interest coverage. An upwards trend in leverage would hinder our long-term value creation. Finally, we have to mention currency risk. Although it looks like the peso is set to appreciate, we can't be certain.