GANSALO CAPITAL

A framework for identifying strong companies selling at a deep discount to fair value

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It is much easier to determine a bargain price for a company than its intrinsic value…

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It is very difficult to determine, with reasonable confidence, the intrinsic value of a company. To do so requires knowing three things: (1) the book value of the company; (2) the liquidity premium for being readily tradable, if the company is public; and (3) the present value of future cash flow. Of these factors, only book value is deterministic; the others are nearly impossible to estimate. Liquidity premium is the additional cost for the benefit of being able to trade in and out of a public company's stock, relative to a private company. It is the difference between the values of two perfectly similar companies, except that one is private, the other is public. Finding such perfect comparables is nearly impossible. And even if we assume that liquidity premium has a negligible impact on valuation or that it is constant across all public companies, we are left with the difficult task of estimating the present value of future cash flow, which requires an accurate prediction of the growth rate of earnings over the remaining life of the company, the terminal value of the company upon its eventual sale, and an appropriate discount rate that reflects the risk profile of the company throughout its remaining life. A careful attempt at such analysis will yield, at best, a wide confidence range around the value estimate that will render the analysis un-useful.

The book value of a company is a reasonable proxy for the lower end of the company's intrinsic value. A company trading below book suggests the: (a) financial statements are materially inaccurate, (b) company is expected to destroy equity over time, or (c) market undervalues the company. In the US, as well as other advance economies, there are regulatory bodies that guard investors against accounting malfeasance, thus reducing the chance of systemic, material inaccuracies in financial statement reporting. So, investors can be confident about the book value of a company as reported in its balance sheet. The open question will then be whether or not the company will destroy, preserve or grow equity over time. That is far easier to determine with reasonable confidence than the intrinsic value.

A company's *past performance record* on profitability will give insight to its potential ongoing profitability. If the company is unprofitable, it will likely remain unprofitable in the near to medium term, unless business fundamentals, which outsiders cannot know nearly as well as insiders, change. If the company is profitable and *increasingly* so, it is likely to remain profitable in the near to medium term. The chance that such a company will destroy equity is low; and the stock is a bargain if it trades below book. The following questions were designed to help identify such companies:

Question	*Answer*	*Meaning*
Are operating margins stable or widening?	Yes	The company is managing costs down and getting better at it
Are earnings growing?	Yes	The company is increasingly profitable
Are earnings less volatile?	Yes	Volatility of earnings is reducing over time, suggesting that (1) past performance is a good indicator of future performance, and (2) the company has diversified business lines
Does the company have capacity to withstand a 5% shock to revenue?	Yes	SG&A (which is controlled by management) makes up a large proportion of cost, and can be reduced to partially offset revenue shock
Is free cash flow positive?	Yes	The company has enough cash for capital investments, to guard or increase its market share
Is the company invulnerable to interest rate shock?	Yes	The company has little or no debt and is not susceptible to a sudden increase in interest rates

If the answer to majority of the questions is yes, then we can be reasonably confident that the company will continue to be profitable in the near to medium term. We look for such companies trading near or below *tangible book value* (book value less intangible assets like goodwill, trademarks, copyrights, etc.). At that price we would be getting intangibles, liquidity premium, and present value of future earnings all for free!