

# GREENLEA LANE CAPITAL

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# GLCP Investment Strategy

- **Objective:** To minimize the risk of permanent capital loss while achieving a high absolute rate of return—net of fees, expenses, and taxes—to limited partners, over the long term
- **Fundamental beliefs:**
  - Businesses have intrinsic values (DCF)
  - Market prices can deviate from those values (irrational behavior)
  - Over time, prices approximate intrinsic values (reasonable efficiency)
  - Buy at a discount, sell at full value → above-average returns with below-average risk

## GLCP Investment Strategy (cont'd)

- **Look for businesses with:**
  - High return on capital
  - Selling for no more than 2/3 of intrinsic value *and* no more than 10-12x normal earnings power
  - Significant growth prospects
  - Minimal debt
  - Management economically aligned with shareholders

# Magic Formula Investing

- *The Little Book That Beats The Market*
  - By Joel Greenblatt of Gotham Capital, published 2006
  - Legendary value investor and excellent teacher
- Main ideas:
  - High return on capital is indicative of a good business
  - High earnings yield is indicative of a cheap business
  - Buying a basket of good, cheap businesses will produce above-average results over time

# Magic Formula Investing (cont'd)

- Why is high ROIC indicative of a good business?
  - $ROIC = EBIT / (\text{Net Working Capital} + \text{Net Fixed Assets})$
  - ROIC is profit divided by the investment required to produce that profit
  - Microeconomics 101: Competitive pressures push returns on capital toward the cost of capital in the absence of sustainable competitive advantages
  - If a business has a high return on capital, there's a good chance it has a special advantage that will permit high sustainable profitability
  - **High sustainable profitability is the purpose of business**

## Magic Formula Investing (cont'd)

- Why is high earnings yield (low P/E) indicative of a cheap business?
  - Earnings yield =  $\text{EBIT} / \text{Enterprise Value}$  (you can think of it as the reciprocal of a P/E ratio)
  - Earnings yield is your profit divided by what you have to pay to buy that profit
  - **Getting a lot for what you pay is the definition of a bargain**

## Magic Formula Investing (cont'd)

- These rules of thumb are not right every time...
  - ROIC or earnings can be temporarily inflated or accounting can be misleading
- ...But they are right on average and over time
- So → invest in a diversified basket of high-ROIC, high-yielding companies, and stick with the strategy for the long-term

## Magic Formula Investing (cont'd)

- Greenblatt back-tested the magic formula strategy using data from 1988–2004
  - Ranked US companies based on ROIC and earnings yield, based on trailing-12-month numbers
  - Purchased highest-ranking 30 stocks
  - Held basket for 1 year, then rebalanced

## Magic Formula Investing (cont'd)

- Compound annual returns 1988-2004:
  - Magic formula strategy → **30.8%**
  - 3,500-company universe → **12.3%**
  - S&P 500 → **12.4%**

## Magic Formula Investing (cont'd)

- How could such a simple strategy—based on trailing numbers calculated by a computer—work for so long?
- Why doesn't everyone bid up the prices of magic formula stocks, thereby destroying the strategy?
- Answer:
  - Although the magic formula is easy to understand, it's hard to put into practice
  - Along the way to good long term performance, there are significant periods of underperformance
  - Most people can't stick with it through those tough periods

## Magic Formula Investing (cont'd)

- There will be tough periods (emphasis added):

*For one out of every six periods tested, the magic formula did poorly for more than two years in a row. During those wonderful 17 years for the magic formula, there were even some periods when the formula did worse than the overall market for three years in a row!*

## Magic Formula Investing (cont'd)

- Your buy list will often scare you (emphasis added):

*Often the near-term prospects for the companies selected by the magic formula don't look so good. In many cases, the outlook for the next year or two is downright ugly.*

## Magic Formula Investing (cont'd)

- The pressures are greatest if you're a professional investor :

*As a professional manager, if you do poorly while everyone else is doing well, you run the risk of losing all your clients and possibly your job!*

## Magic Formula Investing (cont'd)

- Conclusion:
  - Magic formula investing works
  - But only if you can stick with it through tough periods
  - Most people can't

# Magic Formula Versus GLCP

## Magic Formula

## GLCP

Buy high ROIC companies with high earnings yields	
Good long-term performance with tough periods	
Backward-facing	Forward-facing
No research	Intensive research
Average attributes of group	Specific attributes of individual stocks
Diversified (30 stocks)	Concentrated (10-15 stocks)
Hardly any work!	Invest in best ideas

## Case Study

- **AlarmForce Industries (TSX: AF)**
- Market cap: C\$50M
- Toronto-based home alarm monitoring company with ~90K subscribers
- 20% subscriber CAGR over past decade
- 90% of subscribers in Canada; 10% in US

## Key Investment Points

- High after-tax ROIC → 32%
- High after-tax earnings yield → 13.5%
- Sustainable 15-20% top-line growth with operating leverage
- Competitive advantage is low-cost/low-price business model and strong brand in its markets
- Minimal debt; management is averse to leverage
- Management economically aligned with shareholders

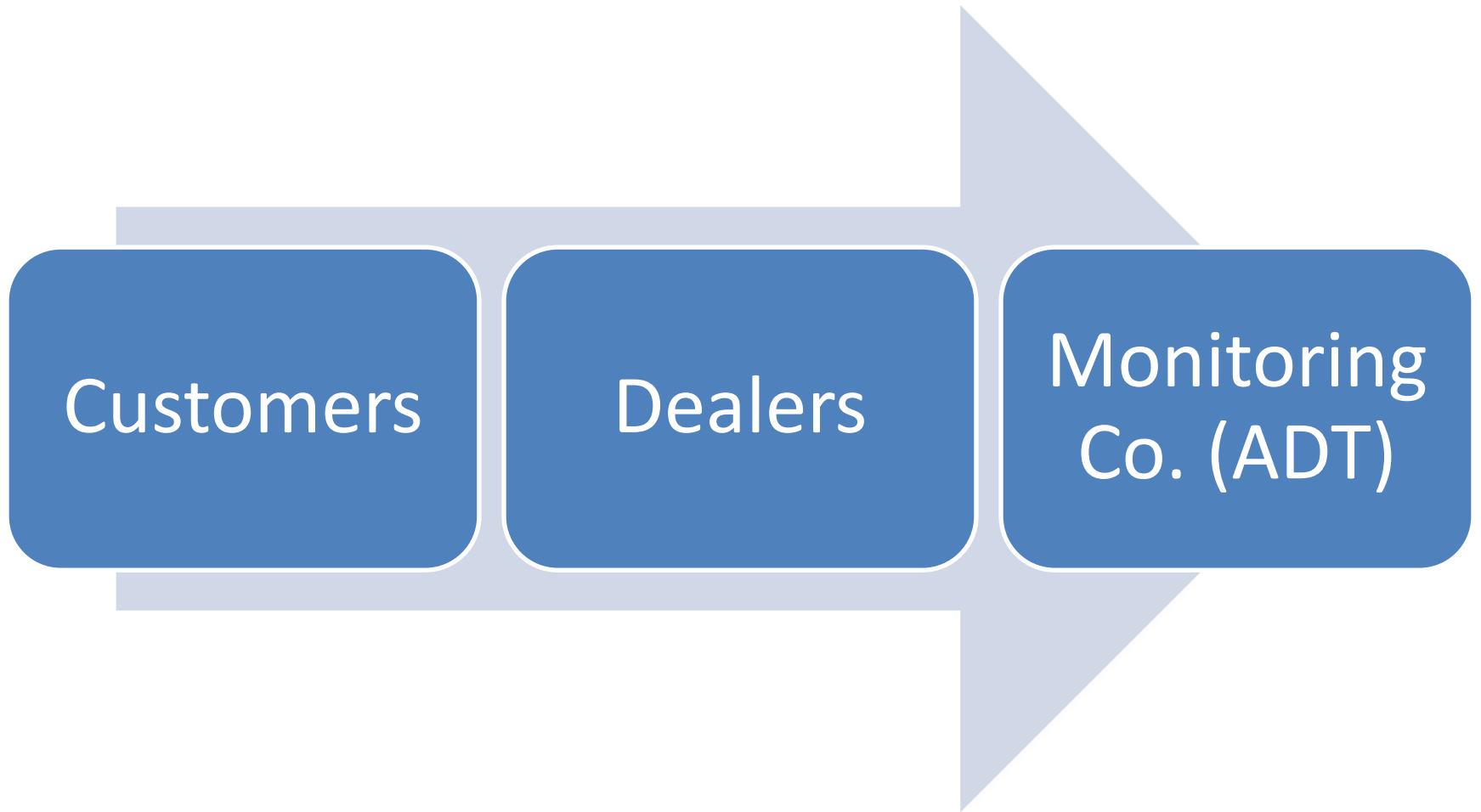
# Home Alarm Monitoring Industry

- Valuable to consumer → reduces chance of break-in, helps in event of break-in, lowers insurance premiums, peace of mind
- Sticky business → 3-year contracts, customers rarely switch
- Low penetration → <20% in US/Canada, many underserved markets
- Defensive → Grow in recession, crime up, ad costs down

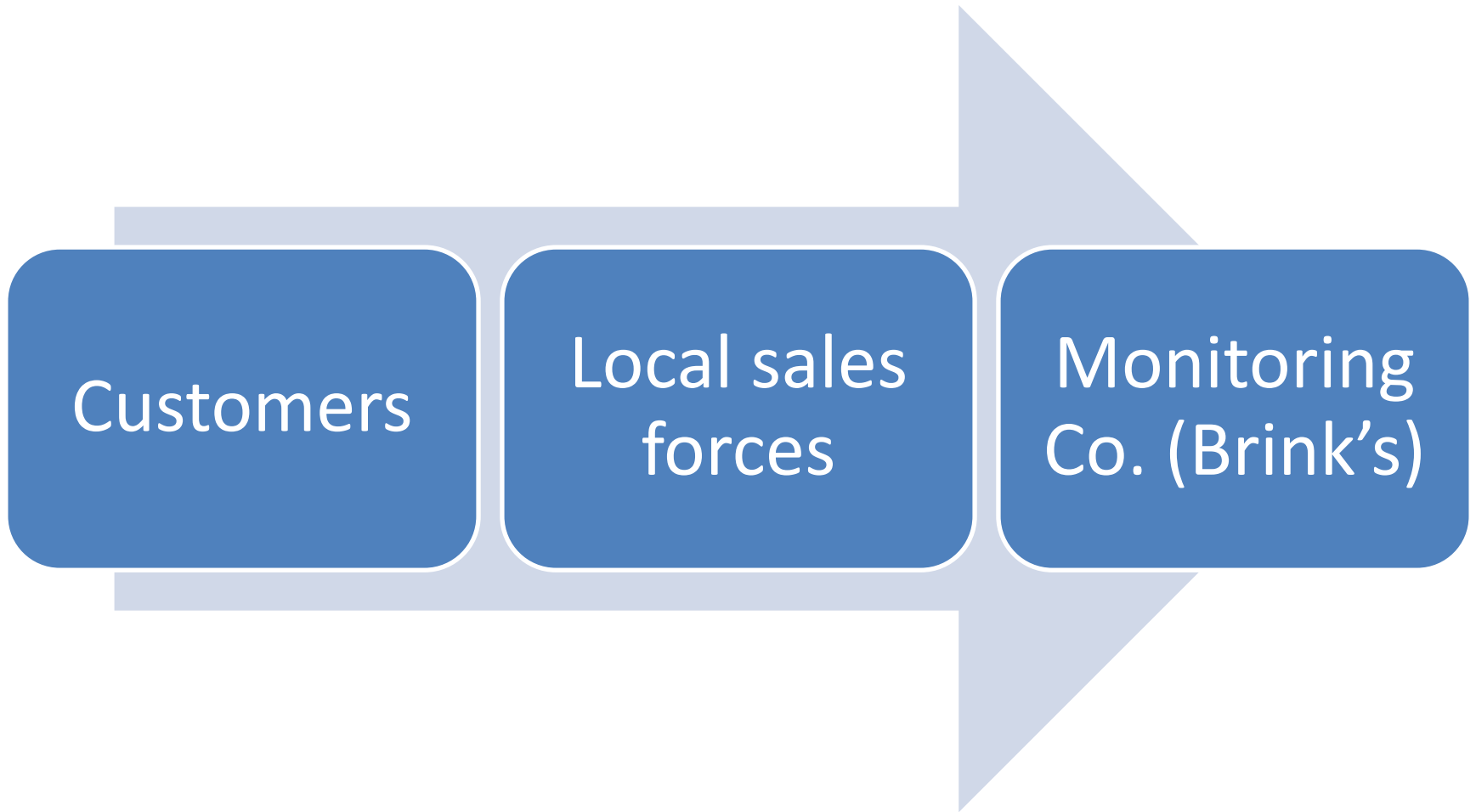
## AF's Strategy: Low Cost Structure / Low Price

- AF's strategy is similar to that of early Wal-Mart:
  - Leverage low cost structure to under-price competitors
  - Gain local economies of scale to entrench position
  - Selectively expand into underserved markets
- AF's low cost structure is based on more efficient means of customer acquisition

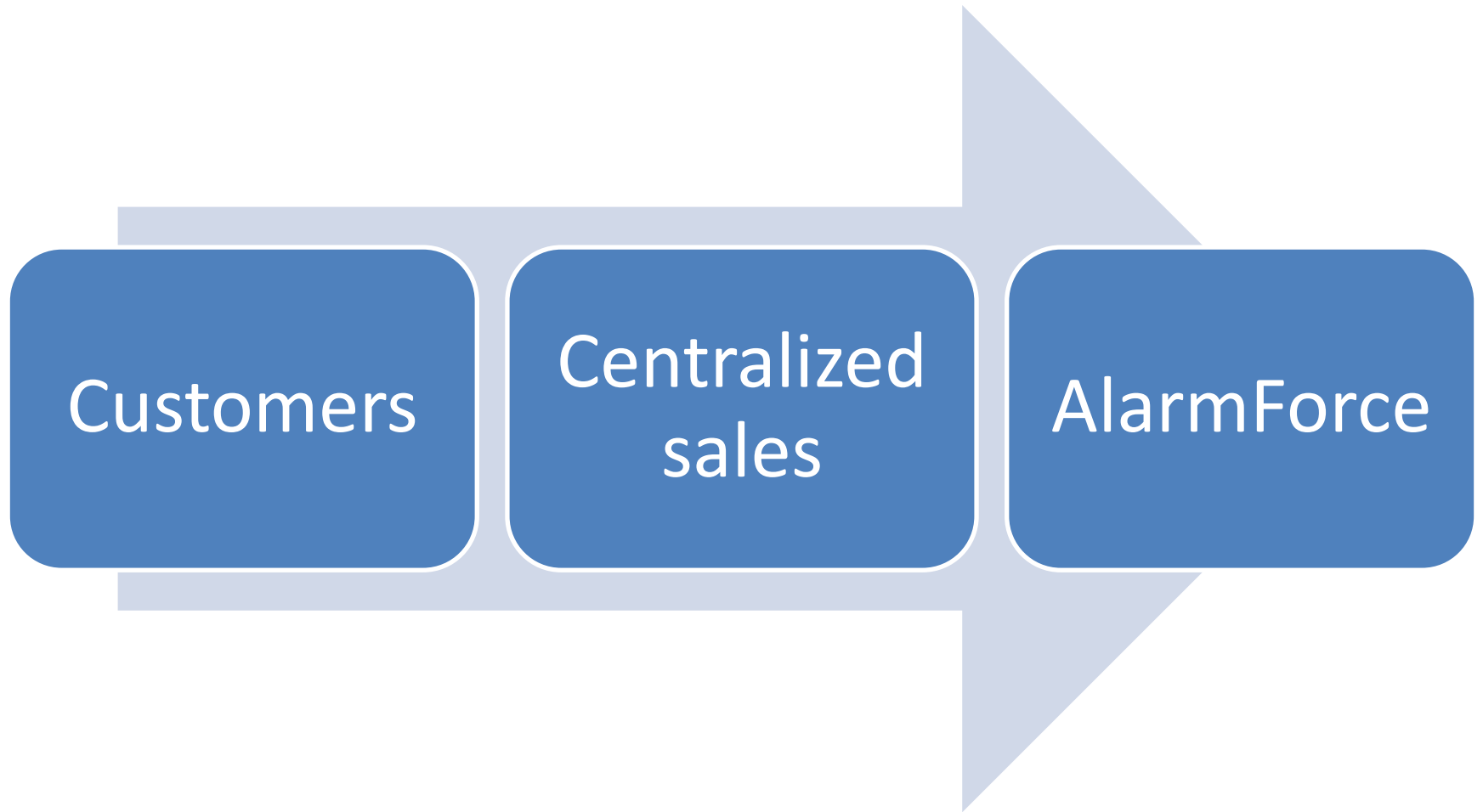
# Customer Acquisition Through Dealers



# Customer Acquisition With Local Sales Forces



# AF: Direct Customer Acquisition



## AF: Low Cost Structure / Low Price (cont'd)

### Subscriber Acquisition Cost Comparison

<b>Company</b>	<b>Account Creation</b>	<b>SAC</b>
ADT	Dealer networks	>\$1,500
Brink's	Local sales forces	~\$1,400
AF	Direct	<C\$800

# AF: Low Cost Structure / Low Price (cont'd)

## Pricing comparison

	<b>ADT*</b>	<b>Brink's**</b>	<b>AF***</b>
Contract term	36 months	36 months	36 months
Installation fee	\$99.00	\$49.00	\$0.00
Monthly monitoring fee	\$33.99	\$29.99	\$25.00
<b>Total cost for contract</b>	<b>\$1,322.64</b>	<b>\$1,128.64</b>	<b>\$900.00</b>
<b>AF discount</b>	<b>-32%</b>	<b>-20%</b>	

\* Installation after \$200 mail-in rebate for internet orders

Lowest available monthly rate

\*\* Lowest available pricing

\*\*\* Universal pricing

# Valuation

- GAAP accounting numbers are misleading
- AF invests heavily in growing subscriber base
- Although growth is highly profitable (40% incremental ROIC), subscribers cost more to acquire than they contribute in the first year
- Growth investment expensed on income statement
- We must add back growth investment to calculate true profitability → *maintenance free cash flow (MFCF)*

## AF Valuation Metrics (C\$ 000s)

Current stock price (C\$)	4.00
Market cap	49,008
Debt	1,529

### **2009 estimated:**

Revenue	32,556
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Net income	2,173
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FCF	2,717
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MFCF	6,644
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EPS	\$0.18
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FCF / share	\$0.22
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MFCF / share	\$0.54
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P / E	22.4x
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P / FCF	18.0x
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P / MFCF	7.4x
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## **Calculation of 2009 estimated "maintenance" free cash flow**

Cash flow from operations (\$ 000s)	6,189
Less: Capex (\$ 000s)	3,472
<b>Free cash flow (\$ 000s)</b>	<b>2,717</b>
<b>Plus: Net growth investment</b>	
Net adds	9,037
SAC - sales and marketing	\$605
Sales and marketing investment after tax (\$ 000s)	3,279
SAC - equipment	\$175
Capital investment (\$ 000s)	1,581
<b>Gross growth investment (\$ 000s)</b>	<b>4,861</b>
ARPU	\$28.69
Net adds - full-year equivalent	4,518
<b>Less: Revenue from new subs after tax (\$ 000s)</b>	<b>933</b>
<b>Net growth investment</b>	<b>3,927</b>
<b>Maintenance free cash flow (\$ 000s)</b>	<b>6,644</b>
<b>Per share</b>	<b>\$0.54</b>

## What Is It Worth?

- Current stock price: C\$4.00
- Sustainable competitive advantage
- Sustainable 15-20%+ MFCF growth
- Should trade for at least 15x-20x MFCF
- This would imply a stock price of **C\$8.50-11.00**
- Represents **113-175% upside**
- AF should be able to double subscriber base over next 5 years; **stock could return 5x** over that time
- 5x over 5 years implies **38% annual returns**

Thank you