Complete Guide to Value Investing

Everything from essential terms to Practical Value Investing Strategies you can use now.

DrWealth
# Table of Contents

What is Value Investing?

Why You Should Not Be Trying To Invest Like Warren Buffett
  Warren Buffett’s advice to the small value investors

2 Approaches to Value Investing

Essential Terms That Every Value Investor Must Know

8 Financial Ratios That Every Value Investor Absolutely Must Know

How Does Value Investing Work In A Nutshell

5 Value Investing Valuation Strategies

How is Value Investing Like?

Useful Resources for the Value Investor

3 Bonus Value Investing Case Studies

About Dr Wealth

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"Buy Low, Sell High'';

This epitome of Value Investing is easier said than done.

While the pros and superstars like Warren Buffett make millions with it, retail investors are left struggling to make it work for them.

This guide was created for you, the individual investor who wants to grow your wealth through investing.

It will give you a complete introduction to Value Investing by covering its genesis, the various Value Investing Strategies that are commonly used, some common terms that you should know as a Value Investor and much more.

This guide is a compilation of the knowledge and wisdom from various iconic and successful value investors.

Now, let’s get into it:
What is Value Investing?

Definition of Value Investing:

“Value Investing is an investment strategy where investors aim to invest in stocks that are deemed to be "undervalued" (aka under priced) by the market.”

Value investors aim to invest in stocks that are deemed to be under priced by the market.

The concept of value investing has been accorded to the brainchild of Graham and Dodd. Since then, many value investing methods have been created and tested by investors around the world.

There are 2 key areas to Value Investing that allow value investors to make profit in the stock market:

1. Stock Analysis: Determine the value of a stock

2. Buy Low and Sell High: Using the results from #1, value investors will buy when the stock price is below the value and sell when the stock price is above the value
This guide will give you a complete introduction to Value Investing by covering its genesis, the various Value Investing Strategies that are commonly used, some common terms that you should know as a Value Investor and much more.

Do note that this guide is a compilation of the knowledge and wisdom from various iconic and successful value investors. None of the information in this guide should be taken as investing advice. Please refer to the disclaimer.
Value Investing was coined in the 1920s by Benjamin Graham and David Dodd and explored in their book, Security Analysis. You can read the entire history of Value Investing here.

It was revolutionary when proposed by Graham and Dodd as investors in the 1920s were selecting stocks mostly by speculation. Graham and Dodd provided methods to research the value of a company. Graham also shares his investing strategies in his subsequent book, *The Intelligent Investor*.

Over the years, value investing had been learnt, practiced and modified by many distinguished investors such as Warren Buffett.
Warren Buffett is largely known as one of the richest men who had made his fortunes from investing. (Interesting facts: The moment when Warren Buffett Became Famous and Warren Buffett’s Journey to Riches)

Because of his reputation, many investors have taken an interest in Value Investing. And because of this increase interest in Value Investing, many have written best-selling books on Warren Buffett and his investing philosophy.

However, it is interesting to note that most of these books were not endorsed nor written by Warren Buffett himself. Despite having this much information around, no one is sure of the exact strategy that Warren Buffett uses.

What we can be sure of is that he has modified his investing strategies from his days under Benjamin Graham. And he admits this directly as he shares about his experience in the 2014 Berkshire Hathaway Shareholders letters:
“My cigar-butt strategy worked very well while I was managing small sums. Indeed, the many dozens of free puffs I obtained in the 1950s made that decade by far the best of my life for both relative and absolute investment performance.

Even then, however, I made a few exceptions to cigar butts, the most important being GEICO. Thanks to a 1951 conversation I had with Lorimer Davidson, a wonderful man who later became CEO of the company, I learned that GEICO was a terrific business and promptly put 65% of my $9,800 net worth into its shares. Most of my gains in those early years, though, came from investments in mediocre companies that traded at bargain prices. Ben Graham had taught me that technique, and it worked.

But a major weakness in this approach gradually became apparent: Cigar-butt investing was scalable only to a point. With large sums, it would never work well.”
Why You Should Not Be Trying To Invest Like Warren Buffett

Warren Buffett has NEVER encouraged investors to invest like him. Neither has he written any official book about investing. The only literature he has written are the shareholders letters that Berkshire Hathaway publishes annually.

This is our warning to all who are still trying to invest like Warren Buffett.

As Warren Buffett’s capital grew, he realised that he had to modify his investing strategy to suit his capital size. Around the same time, he got to know Charlie Munger, his current partner at Berkshire Hathaway.

Charlie Munger is a smart investor who studies the market. Under his influence, Warren Buffett’s investing strategy shifted towards that of Philip Fisher’s.

You can watch this video where Alvin explains the story of Value Investing.
Who is Philip Fisher?

The author of another famous investment book, “Common Stocks and Uncommon Profits”, Fisher is an influential investor of his time. Unlike Benjamin Graham who looks for stocks that are highly discounted on the stock market, Fisher would invest in stocks which he thinks are going to be way more valuable in the future.

Here’s a simple example.

Imagine if you could invest in a big company like Facebook before it was well known.
If you were following Benjamin Graham’s investing philosophy, you would not invest in Facebook because its assets are not ‘valuable’ in your eyes.

If you were following Philip Fisher’s investing philosophy, you may see that it has a potential to grow in the future as more people are open to using digital technology to connect, and the advertising revenue has been growing. Hence, you would likely invest in Facebook.

That being said, you will be taking a huge risk because if Facebook didn’t perform up to expectation, you would lose part of your investment capital.

Instead of looking at growth stocks and projecting their value into the future, Benjamin Graham looks at stocks that are already trading cheaper than the value today.
Warren Buffett’s advice to the small value investors

Don’t lose hope yet.

Because Warren Buffett did share how he would invest if he were a retail investor like us. He shared this key information in a Berkshire Hathaway shareholder meeting. You can watch the video here.

Alvin had decoded Warren Buffett’s reply in this article: “How Would Warren Buffett Invest If He Were You” or watch the video explanation by Alvin here: “How Would Warren Buffett Invest With Less Money”

These are the 3 key points that Alvin had picked up.
If he were a small investor, he would pick Graham type stocks:

“If I were working with small sum, I certainly would be much more inclined to look among, what you might call the classic Graham stocks.”

Buffett acknowledged that he would be more likely to invest in Benjamin Graham’s stock picking principles. These stocks tend to be small companies, in unsexy businesses and may even have problems attached. This is a far cry from the big, glamorous companies with competitive advantage which Buffett as known for investing in.

If he were a small investor, he would have more advantage:

“I would be doing far better percentage wise if I am working with small sums, there are just way too many opportunities.”

The reason to use Graham’s approach was because Buffett would be able to get a higher percentage gains, than he would if he stuck with the big companies he usually invests in. There are a lot more small companies he could buy and make money. But he cannot efficiently invest in small companies when his capital becomes much larger.
If he were a small investor, he would diversify across many stocks:

“I bought a large number of stocks in small amounts, in companies whose names I couldn’t pronounce. But the stocks as a group were so cheap, you have to make money out of it, it was Graham’s kind of stocks.”

Graham’s principle was to invest small amounts in many companies. It doesn’t matter what businesses they are in as you do not need to do in depth research. In Buffett’s words, he didn’t even know how to pronounce the names, lest to say what the companies do. Due to the large number of stocks, it no longer matters if a few of these companies eventually go bust, but there will be some winners that would more than cover the losses. As a group, or as a portfolio of stocks, it would be an overall gain for the Graham investor.

Since Graham and Fisher, there have been various other forms of Value Investing Strategies and philosophy. We will look at some of these in the Value Investing Strategies section.

But first up, let’s cover the fundamentals of Value Investing in the next three sections.
2 Approaches to Value Investing

Not many people are aware of the existence of the two approaches to Value Investing.

Most investors understand the qualitative method, but few have heard about the quantitative method.

It isn't the fault of investors but rather, the success of Warren Buffett that puts the qualitative approach to the fore. Alvin wrote about investing in assets versus investing in earnings previously, this section goes deeper into that discussion.

Benjamin Graham coined the terms "Qualitative" and "Quantitative" approach to investing in his book, "The Intelligent Investor". We quote;
“Our statement that the current price reflects both known facts and future expectations was intended to emphasize the double basis for market valuations. **Corresponding with these two kinds of value elements are two basically different approaches to security analysis.** To be sure, every competent analyst looks forward to the future rather than backward to the past, and he realizes that his work will prove good or bad depending on what will happen and not on what has happened. Nevertheless, the future itself can be approached in two different ways, which may be called the **way of prediction (or projection) and the way of protection.**

Those who emphasize **prediction** will endeavor to **anticipate fairly accurately just what the company will accomplish in future years** - in particular whether earnings will show pronounced and persistent growth. These conclusions may be based on a very careful study of such factors as supply and demand in the industry - or volume, price, and costs - or else they may be derived from a rather naive projection of the line of past growth into the future. If these authorities are convinced that the fairly long-term prospects are unusually favorable, they will almost always recommend the stock for purchase without paying too much regard to the level at which it is selling...
By contrast, those who emphasize **protection** are always especially concerned with the price of the issue at the time of study. Their main effort is to **assure themselves of a substantial margin of indicated present value above the market price** - which margin could absorb unfavorable developments in the future. Generally speaking, therefore, it is not so necessary for them to be enthusiastic over the company’s long-run prospects as it is to be reasonably confident that the enterprise will get along.

The **first, or predictive, approach could also be called the qualitative approach**, since it emphasizes prospects, management, and other non measurable, albeit highly important, factors that go under the heading of quality. The **second, or protective, approach may be called quantitative or statistical approach**, since it emphasizes the measurable relationships between selling price and earnings, assets, dividends, and so forth."
Qualitative Value Investing

• The certainty with which the long-term economic characteristics of the business can be evaluated;

• The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows;

• The certainty with which management can be counted on to channel the reward from the business to the shareholders rather than to itself;

• The purchase price of the business;

• The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor’s purchasing-power return is reduced from his gross return.

Such evaluations definitely require more guesswork and most people will fail terribly at it. Warren Buffett has a knack of getting it right in the businesses he understands. But most retail investors are not Warren Buffett. We do not have his skills and insights to project the future with a certain degree of certainty.
Even our highly intelligent and knowledgeable financial analysts aren’t able to do it well enough.

Without a doubt, the future returns are high with the qualitative approach. However, there is no point fantasizing about mouth-watering returns if we cannot do it accurately enough.

It will often backfire with disappointing returns, even worse than the stock index returns.
Quantitative Value Investing

Quantitative approach entails the analysis of the current state of the business.

While the *qualitative approach* buys a business less than what it is worth in the future, the *quantitative approach pays less than what the business is worth today*.

This requires the use of financial ratios such as Price-to-Book and Price-to-Earnings to evaluate the strength of the company.

Quantitative approach’s risk management *centralises on margin of safety* as well as diversification;

- Buy as low as possible below the value of the company.
- Diversify into many undervalued stocks.
Below is a list of rules that Walter Schloss advocated (not exhaustive, he has more rules than these):

- Diversify into many stocks
- Stocks trading below book value
- Stocks with little to no debt
- Stocks trading at new price lows

Most of these rules are quantifiable.

They are less subjective than the qualitative approach.

Quantitative value investing also doesn’t require the investor to know a company deeply to ascertain her future prospects.

The analysis of a company can be completed within minutes just by the numbers. Hence, the quantitative approach suits the investor with a full-time job, and he is unable to intimately keep up with in depth company research and developments.
Qualitative or Quantitative?

As authors of this guide, we are biased towards the quantitative approach.

It is our opinion that Quantitative Investing is more suited to investors who have not much time and experience, and yet it can yield decent returns of 12-15% per annum.

You will find that the financial ratios and value investing strategies that we share later in this guide are all tilted towards Quantitative analysis of Value Stocks. This is because the quantitative approach allows us to transfer the ability of profitable stock analysis to others.

This is more difficult when it comes to the qualitative approach.

Of course, there is nothing wrong if an investor wishes to pursue the qualitative approach and aims for a higher return than a quantitative approach could. However, the success rate of the former isn’t high.
As you study about Value Investing, you will encounter “technical” terms or lingo that are usually used by Value Investors. Don’t be alarmed, here’s what they mean. We have arranged this list alphabetically.

**Intrinsic value**
This is determined by the perceived value of the company. It could be valued based on the underlying assets or potential earnings. Value investors use a range of financial figures and ratios to determine the intrinsic value of a company. We share some examples of these financial figures and ratios in a later section of this guide.

**Margin of Safety**
Once a value investor determines the intrinsic value based on a set of rules and financial figures, he will compare the intrinsic value with the stock price. This difference is also known as the ‘Margin of Safety’. The wider the positive difference between the intrinsic value and the stock’s current market price, the greater the margin of safety.
**Undervalued or Overvalued**
If the intrinsic value is greater than the market value, the stock is said to be ‘**undervalued**’. Vice versa, if the intrinsic value is lower than the market value, the stock is said to be ‘**overvalued**’.

**Alpha**
The ratio used to measure your investment performance in comparison to market returns. A positive alpha suggests that the investor has outperformed the market that he is comparing against.

**Beta**
The ratio used to measure volatility or systematic risk of your investment in comparison to the market. A beta of 1 suggests that the volatility of your investment(s) is the same as that of the market. A beta of less than 1 suggests that the volatility of your investment(s) is lower compared to the market, and vice versa.

**EBIT**
Abbreviation for Earnings Before Interest and Tax. EBIT is also known as “operating income” or “operating profit”.

It gives investors an idea of the company’s ability to generate profits by ignoring factors such as taxes and interest. You can calculate EBIT by taking Total Revenue – Operating Expenses.
**EBITDA**
Abbreviation for Earnings Before Interest, Taxes, Depreciation and Amortization.

On top of Interest and Taxes, EBITA looks at the earnings of a company by ignoring additional debt related factors.

**CAPEX**
Abbreviation for Capital Expenditure.

This refers to the company’s expenses used to upgrade or purchase physical assets which include equipment, properties or industrial buildings.

CAPEX gives investors a rough idea of how much the company’s newly acquired asset cost.
Common Terms Used in Financial Statements

As a value investor, you will need to refer to annual reports or financial statements to analyse a stock. Here are the common terms that are found in annual reports.

You will find these terms in the **Income Statement** of a financial statement:

**Revenue or Sales**
Amount of money earned by the company.

**Expenses**
Cost of running the company and business.

**Profits**
Difference between revenue and expenses

You will find these terms in the **Balance Sheet** of a financial statement:

**Current assets**
Assets that the company can use up or liquidate within the year of assessment. Non-current assets are the opposite.
Current liabilities
Debts that the company needs to return within the year of assessment. Non-current liabilities are debts that the company takes more than the current assessment year to pay back.

Equity
Difference between total assets and total liabilities. Also known as the book value or net asset value.

Paid in capital
The amount of money raised during the company’s Initial Public Offering.

Retained earnings
Cumulative profits earned by the company after subtraction of dividends payouts.

You will find these terms in the Cash Flow Statement of a financial statement:

Cash flow from operations
Cash generated from the company's core business.

Cash flow from investments
Cash spent on capital investment or other activities in investment vehicles.

Cash flow from financing activities
Record of activities involved in debts, loans and dividends.
8 Financial Ratios That Every Value Investor Absolutely Must Know

There are too many financial ratios available and this leads to “paralysis by analysis”. Here are 8 essential financial ratios that value investors should focus on.

#1 – Price-Earnings (PE)

PE ratio is the most common financial ratio to investors. The numerator is the price of the stocks while the denominator is the earnings of the company.

This shows how many times of earnings you are paying for the stocks. For example, if the PE is 10, it means that you are paying 10 years’ worth of earnings.

*The lower the PE, the better.*

Let’s use an example to illustrate this. You saw a house selling for $1m and the owner said it is tenanted. The owner tells you the rental is worth $5k a month. After you have factored all the costs in owning and maintaining the house, your net profit is $2k a month or $24k a year. So the PE ratio for the house will be about 42. It will take 42 years for you to get back the worth of the house through a positive cashflow of $2k per month.
Although PE is a favourite ratio, it is ever changing.

Firstly, price can change. No one can predict how high the stock prices can go and although the PE can be high in your opinion, it can continue to go higher beyond your imagination.

The other factor that causes PE to change is the significant rise and fall in earnings. A company can be making a lot of money for the past 10 years but because of competition, they may lose market share and suffer a decline in earnings.

Hence, PE ratio is at best a view of the company’s and its stock’s historical performance. It does not tell you the future.

You would need to assess the quality aspect of the company – Can it sustain its earnings? Will the earnings grow?
#2 – Price / Free Cash Flow (FCF)

There is a belief that while it is possible to fake the income statement, it is harder to fake cash flow. Hence, besides looking at the PE ratio, you can examine the P/FCF Ratio.

FCF is calculated based on the values from the cash flow statement, which is the statement that shows the movement of money in and out of the company. FCF is defined as, Cash Flow from Operations – Capital Expenditures. If the number is positive, it tells us that the company is taking in money even after expenditures on replacing or buying more equipment.

**PE and P/FCF should tell the same story.** You can use either or use both to detect any anomaly/divergence.
#3 – Price Earnings Growth Rate (PEG)

We recognise the deficiency of PE ratio; it is plainly historical performance. Is there a better way to look into the future to get a sense if the company is a good buy?

The house example assumed the rental does not grow over time. But you and I know that it is not totally true. Rental may go up due to inflation. Likewise, growing companies are likely to increase their earnings in the future.

One of the ways to factor this growth is to look at PEG ratio. It is simply PE / Annual Earnings Per Share (EPS) Growth Rate. Yes, it is a mouthful.

Let’s break it down.

EPS is simply earnings divided by the number of shares. But we need to look at the growth of earnings. So we have to average out the growth in EPS for the past few years.

For example, if the company has been growing at a rate of 10% per year, and its PE is 10, the PEG would be 1. **In general, PEG ratio less than 1 is deem as undervalued.**
However, it is important to understand that we are **ASSUMING** the company would continue to grow at this rate. No one can forecast earnings accurately.

Warren Buffett is smart in this area because he buys into companies with competitive advantage. Only this way, he can be more certain that the earnings will continue to grow, or at least remain the same.

#4 – Price-to-Book (PB) or Price-to-Net Asset Value

PB ratio is the second most common ratio. Some people call it price to net asset value (NAV) instead. Net asset is the difference between the value of the assets the company possessed and the liabilities the company assumed.

Let’s revisit the house example. Your house is worth $1m dollars and you owe the bank $500k, so your net asset value of the house is $500k.

If the stock’s PB ratio is **less than 1**, it means that you are **paying less** than the net asset value of the company – think along the lines that you can buy a house below market value.
There is a word of caution when you look at NAV. These numbers are what the companies report and they may overstate or understate the value of assets and liabilities. In fact, not all assets are equal.

For example, a piece of real estate is more precious than product inventory. Rising inventory is a sign the company is not making sales and earnings may drop. Hence, rising assets or NAV may not always be a good thing.

You have to assess the asset of the company. The worst assets to hold are products with expiry, like agricultural crops etc. Also, during property booms, the assets may go up significantly as the properties are revalued. The NAV may tank if the property market crashes.

#5 – Debt-to-Asset or Debt-to-Equity

Sometimes you wondered if you should be looking at Debt-to-Asset (D/A) or Debt-to-Equity (D/E) ratios. Either one of them is fine because both are just trying to measure the debt level of the company.

Most importantly, use the same metric to make comparisons. Do not compare a stock’s D/A with another stock’s D/E!
Let’s go back to the example of your $1m house and remember you still owe the bank $500k, what would your D/A and D/E look like? Your D/A will follow the formula, Total Liabilities / Total Assets, which will give you a value of 50% in this case (assuming you only have this house and no other assets or liabilities for the sake of this example). Your D/E, which is defined as Total Liabilities / Net Asset Value, will give you a value of 100%. Hence, for D/A at 50%, it should mean something like this to you: 50% of my house is serviced through debt. And for D/E at 100%, you should read it as: if I sell my house now, I can repay 100% of the debt without having to top up.

As you can see, it is just a matter of preference and there is no difference to which ratio you should use.

Most importantly, the value of D/A or D/E is to understand how much debts the company is assuming. The company may be earning record profits but the performance may largely be supported by leverage. You should not be happy to see D/A and D/E rising. Leveraged performance is impressive during the good times. But during bad times, companies run the risk of bankruptcy.
#6 – Current Ratio or Quick Ratio

Long term debts usually take up the majority of the total liabilities. Although the company may have a manageable long-term debt level, it may not have sufficient liquidity to meet short term debts. This is important as **cash in the short term** is the lifeline of a business. One way to assess this is to look at the Current Ratio or Quick Ratio.

Again, it doesn't really matter which one you are looking at. In investing and in life, nothing is 100% accurate. Close enough is good enough.

Current Ratio is simply **Current Assets / Current Liabilities**.

‘Current’ in accounting means less than 1 year. Current assets are examples like cash and fixed deposits. Current liabilities are loans that are due within one year.

Quick Ratio is, Current Assets – Inventory / Current Liabilities, and it is slightly more stringent than Current ratio. Quick ratio is more apt for companies that sell products where inventory can take up a large part of their assets. It does not make a difference to companies selling a service.
A company can do two things to their earnings: (1) distribute dividends to shareholders and/or (2) retain earnings for company’s usage.

**Payout ratio is to measure the percentage of earnings given out as dividends.**

You will understand how much the company is keeping the earnings and you should ask the management what they intend to do with the money.

Are they expanding the business geographically or production capacity? Are they acquiring other businesses? Or are they just keeping the money without having knowing what to do with it? There is nothing wrong for the company to retain earnings if the management is going to make good use of the money.

Otherwise, they should give out a higher percentage of dividends to shareholders. This is a good ratio to question the management and judge if they really care about the shareholders.
#8 – Management Ownership Percentage

This is not a financial ratio per se but it is important to look at.

It is unlikely the CEO or Chairman would own more than 50% of a large corporation. Hence, this is more applicable to small companies. Some investors prefer to buy into small and profitable companies where their CEO/Chairman is a majority shareholder. This is to ensure his interests are aligned to the shareholders. It is natural for humans to be selfish to a certain extent and if you have the CEO/Chairman having more stake in the company, you are certain he will look after you (and himself).
There are several characteristics or assumptions that Value Investors will have to understand and make. These characteristics help to explain why certain stocks are said to be undervalued while others are not. Here, we list 5 key characteristics that value investors should know.

**Irrational Market**

We believe that the market is made up of irrational investors. Hence, prices on the stock market do not accurately reflect the true value of a stock.

A stock may be underpriced or overpriced mainly due to its investors’ sentiments. And this creates opportunities for value investors who look to invest in undervalued stocks.

**Intrinsic Value**

As value investors, we believe that every stock has its intrinsic value. This is the value of the stock and it is not related to the price that it is currently trading at.
We aim to look for stocks that are trading at a price below its intrinsic value. Pretty much like going into a store to look for items sold at a bargain.

If our research and analysis are done right, there is a chance for the stock price to rise to its intrinsic value over time.

**Margin of Safety**

There is risk involved in any type of investing. It is no different in Value Investing.

No matter how in-depth your analysis is, you can never guarantee that a stock’s price will move in the way you’d predict it to. Especially because of #1, some stocks’ true value will just never get realised on the stock market.

Hence, to minimise our potential loss, value investors always look for a margin of safety; which is determined by the difference between its intrinsic value and its current price in the market.

Basically, we want a wider gap between the stock’s intrinsic value and its current price in the market. For example, Benjamin Graham was known to only invest in stocks that were trading at 2/3 of their intrinsic value.
Time and Effort

This is not exactly the characteristic of Value Investing. However, all value investors who want to do well in value investing must be prepared to spend some time and effort.

To determine a stock’s intrinsic value, value investors carry out analysis based on their strategy. This process requires time and effort (and more patience and nerves).

Many value investors make use of fundamental factors to evaluate stocks, and there are little to no good fundamental stock screeners available. Even with a stock screener, value investors would still need to carry out their own due diligence to look beyond the numbers.

The market is irrational. It could take a while for a stock’s true value to be realised in the stock market. A value investor may need to wait for months or years before a stock can realise its true value for a positive return.

The waiting time for a positive ROI is something that most average investors find difficult to adhere to.
Contrarian

As mentioned, the market is irrational and it is driven by investors’ sentiments. This means that the price you see on the stock market and the performance of a stock in the market reflects how investors feel about the stock.

Value investors tend not to make investment decisions according to what everyone else is doing. In fact, we believe that you have to be a contrarian to succeed as a value investor.

And it is not easy.

To buy when the rest of the market is selling (i.e. *when the market is plummeting*), or to sell when the rest of the market is buying (i.e *when the market is booming*)

This process can be eased if you have a strategy with clear buy and sell guidelines.
How Does Value Investing Work In A Nutshell

In short, the aim of Value Investors is to “Buy Low, Sell High”. Most people would have heard of this age old advice. But implementing it is not as straightforward.

“What price is considered low?” and “What price is considered high?” These are the two key questions that every investor seeks to answer.

In value investing, we use the ‘intrinsic value’ to determine if a stock price is considered ‘high’ or ‘low’.

Ultimately, this is what we want to do:

![Diagram showing Price vs Time with 'Buy' and 'Sell' points at Intrinsic Value level.]

Figure 2: What Value Investors aim to do
We want to identify the intrinsic value or true value of a stock. And then, buy when the stock price is below the intrinsic value and sell when the stock price goes above its intrinsic value.

The greater the difference between the buy and sell points, the better because this difference is your return on investment.

In the next section, we share several methods that value investors use to determine the intrinsic value of a stock.
Value Investing is a large field. There are many groups of value investors using different valuation methods in their attempts to determine the intrinsic value of a stock. Most of the time, the different valuation methods do not agree on the intrinsic value.

However, each of these valuation methods have their pros and cons, and tend to work better for a smaller subset of value stocks.

It is wise for a value investor to be well-equipped with different valuation methods before deciding if he should stick to any one method.

In this section, we list the different valuation methods that value investors use.

One important rule to remember when investing using any one method is that you should use the same method to make the buy and sell decision for any 1 investment.

i.e. If you decide that stock A is worth investing using method 1, you should be using method 1 to decide when you should be selling stock A subsequently.
Net Net Strategy (Benjamin Graham’s Investing Strategy)

Benjamin Graham invested during the dark days of the Great Depression where many companies were going bankrupt each day. To enhance his possibility of success in the stock market, the Net Net Strategy was designed with a focus on safety.

Graham had to ensure that even if the company he invested in were to go bust, he would still ‘win’. He looked for companies with excess liquid assets that could cover all their liabilities and still payout to their shareholders, even if they were to go bust. Hence, Graham used ‘Current Asset’ instead of ‘Total Asset’ when looking for Net Net stocks.

With that in mind, the value of a Net Net Stock is determined by this formula:

\[ \text{Stock Price} < \frac{2}{3} \times \frac{\text{Current Assets} - \text{Total Liabilities}}{\text{no. of shares}} \]

You would want to take profit once your gains hit 50% or cut loss after 2 years regardless of the stock price.
Some features of Net Net Stocks we have noticed:

- **Unfamiliar stocks:** As they are unfamiliar, most investors shun them. Hence, they tend to be undervalued.

- **Low liquidity:** Insufficient sellers too, hence discourage buyers to participate.

- **Small company:** Most Net Net stocks are small companies and investors generally view them as risky. However, some of them could be debt free and financially stronger than bigger companies.

- **Problems:** Net Net stocks are usually companies which are facing short term issues that lead to a drop in their prices. Once the issue is resolved, we would expect the stock price to increase.

To learn more about Net Net Investing, watch our in-depth interview with Evan Bleker, founder of NetNetHunter. He uses the principles of Benjamin Graham’s Net Net strategy to find undervalued stocks in any market today.
Net Asset Value (NAV) Valuation

The Net Asset Value (NAV) method is less conservative compared to Graham’s Net Net Strategy. NAV or the book value is commonly used by many investors to get an idea of a company’s worth.

Net Asset Value of a stock can be determined by the following formula:

\[
\frac{(\text{Total Assets} - \text{Total Liabilities})}{\text{no. of shares}}
\]

Discounted Cash Flow (DCF) Valuation

With the Discounted Cash Flow (DCF) method, investors discount future cash flow projections to get an estimated present value of a stock.

To get the Discounted Cash Flow value of a stock, use this formula:
We do not prefer this valuation method as there are 2 vague variables that we find difficult to determine; predicting future cash flow and determining a discount rate many years into the future.

However, DCF valuation remains widely used. Many investors tend to get their estimates from professional analysts. It is easier to use DCF to evaluate companies with consistent free cash flow.

Concepts similar to DCF, one example is the Discounted Earnings Per Share (EPS).

For a quick video explanation of Discounted Cash Flow, watch this video: Discounted Cash Flow: How it works

To help you with DCF calculations, we have created an intrinsic value calculator. You can download it here.
Price/Earnings to Growth (PEG) Ratio (Peter Lynch's Investing Strategy)

Made popular by Peter Lynch, author of the book ‘One Up on Wall Street’.

This valuation is useful for growth stocks. Peter Lynch mentioned that "the P/E ratio of any company that's fairly priced will equal its growth rate."

The Price / Earnings to Growth (PEG) ratio is depicted as:

\[
\frac{\text{Price} / \text{Earnings}}{\text{Annual EPS Growth}}
\]

A stock with a PEG ratio of 1 is said to be fairly valued. Below 1 is undervalued and above 1 is overvalued.
Conservative Net Asset Value (CNAV) (Dr Wealth’s Investing Strategy)

We share about the CNAV strategy and our performance here: The CNAV Strategy.

The CNAV strategy is a form of value investing strategy, focusing on stocks with their price trading below their asset value (less liabilities). It is a quantitative method to keep our biases at bay in the process of stock selection. The strategy consists of two key metrics and 3-step qualitative analysis.

Metric 1: Conservative Net Asset Value (CNAV)

We focus on the asset value of a stock and aim to pay a very low price for a very high value of assets.

Hence, we only count the full value of cash and properties, and half the value for equipment, receivables, investments, inventories and intangibles (income generating intangibles such as operating rights and customer relationships. Goodwill and other non-income generating intangibles are excluded).
This means that the CNAV will always be lower than the NAV of the stock. This additional conservativeness adds to our margin of safety.

It is easy to find many stocks trading at low multiples of their book value but many of them deserve to be due to their poor fundamentals. Hence, we need to further filter this pool of cheap stocks to enhance our probability of success.

**Metric 2: POF Score**

A 3-point system based on Dr Joseph Piotroski’s F-score to find fundamentally strong low price-to-book stocks that are worth investing into.

**Profitability**

While we emphasised on asset-based valuation, we look at earnings as well. The company should be making profits with its assets, indicated by a low Price-To-Earnings Multiple. Since we did not pay a single cent for earnings, the earnings need not be outstanding. Companies making huge losses would definitely not qualify for this criteria.
Operating Efficiency
We have to look at the cash flow to ensure the profits declared are received in cash. A positive operating cash flow will ensure the company is not bleeding cash while running its business. The operating cash flow gives us a better indication if the products and services are still in demand by the society. If not, the business should not stand to exist. A negative operating cash flow would mean that the company needs to dip into their cash to fund their current operations, which lowers the company’s NAV and CNAV. The company may even need to borrow money if their cash is insufficient and this raises further concerns for the investors.

Financial Position
Lastly, we will look at the amount of debt assumed by the company. We do not want the company to have to repay a mountain of debts going forward, especially if interest rate rises, it may dip into their operating cash flow, or worse, depleting their assets. Equity holders carry the cost of debt at the end of the day and hence the lower debt the better.
3-Step Qualitative Assessment

Step 1 – Check announcements and corporate actions since the data of Annual Report

Each annual report is dated and usually only available to investors three to four months after the reported date. The delay is to facilitate the auditing of the financial statements.

The figures of the company could have changed in a big way during the time difference between the day you look at the financial data and the date the statements were reported. Hence you need to go through the company announcements to ensure nothing major event has happened that could change your calculations.

Some of the key events that will affect CNAV calculations are:

- Changes in number of shares (rights issue or convertibles that dilutes shareholders’ interests)
- Large dividend distribution (significant cash is removed and lowers CNAV + NAV)
- Large acquisition (above NAV) or divestment of assets (below NAV)
- Issue of debt securities like corporate bonds (increase debt and lowers NAV)
Step 2 – Determine the major assets that you are buying

As our focus in CNAV strategy is to buy assets cheaply, it is thus important to know what assets we are actually buying.

The calculation of CNAV would classify the assets into the following 6 types, shown in the diagram below:

After you have determined the assets that you are buying, dig further into the details of these assets. For example, if it is properties that you are buying, find the locations of these properties and note the valuation dates. If the valuation of these properties coincide with a property boom, you may want to discount these properties further.

If the company has high receivables, it is good to question whether they have an issue chasing their customers to pay. It is also crucial to make sure if a company has lots of inventories, they should not have short lifespan like perishables.
Bottomline, this step is to check if the assets are justifiable as the numbers presented them to be.

**Step 3 – Establish the Trustworthiness of the Management**

Our investment decisions hinged on the calculations and our calculations depend on the accuracy of the numbers reported in the annual reports. Hence, by inductive reasoning, our investment success depends on the management’s honesty in reporting these numbers.

This is a difficult item to measure and the best way we have found is to evaluate the management’s ‘Skin in the Game’. This simply means that we would check the management’s ownership of the company. A significant ownership in the company speaks louder than the words in their letters and their interest should be more aligned with shareholders since they are the biggest shareholders if they own more than 50%.

However, there have been cases whereby owner-cum-management short changed the minority shareholders by offering a very low price to buy up the remaining shares and delist the company. To minimise this risk is to consider a controlling shareholder who does not own more than 70% of the company.
How to get started?

Now that you have a basic understanding of how Value Investing works, all that is left is to take action and start looking for undervalued stocks in the market.

The Most Common Mistake of an average Investor

In investing, there are many strategies that work.

Some of these strategies work better in certain market conditions. Some strategies work better for certain types of stocks. (i.e. the CNAV strategy is efficient at finding undervalued stocks)

Most investors find themselves shopping for strategies from various mentors. And at the end of the day, have invested in a bunch of stocks that were analysed using different strategies.

Their portfolio ends up like a messy patch work of stocks.

And when the market drops as a whole, they are not able to determine which stocks to sell or keep.
#1 rule of thumb

When investing in stocks, always make sure that your buying and selling decisions are made using the same strategy.

Because the same stock can appear to have ‘Great Potential” using strategy A while appearing to be a “Bad buy” using Strategy B if the philosophy behind these 2 strategies are different.

Learn a complete value investing strategy and stick to it

The CNAV strategy that we use is just one of many value investing strategies that work. Dr Wealth does not believe in using leverage as it increases risk as well.

Instead, we aim to become functional ‘part-time’ investors who are able to pick undervalued stocks and grow our portfolio at a consistent rate of 10-15% every year.

This means that we free up a lot of our time – since there is no need to constantly monitor the stock market - to be able to go on with our daily lives.
Thus far, the Conservative Net Asset Value (CNAV) strategy has allowed us to beat the market since 2014 by tapping into stocks with Value and Size ‘factors’.

We share more about our Value Investing Strategy at our FREE live course. We run these courses occasionally, you can check the latest availability here.

It doesn’t cost thousands of dollars to gain the ability to invest successfully. In fact, our Introductory Investing Course is free and was created to give new beginners an overview of successful value investing and investing in general.
Value investing is not all roses. It is not likely for a stock price to immediately surge the moment you invest in it. Some stocks take years to realise their true value.

Here’s a case study of our experience in value investing. You can find more of these case studies at www.drwealth.com/blog.

This is ‘How Value Investing Felt Like, before a 67% Gain’.
Buy stocks cheap and sell them dear.

How difficult can it be?

Simple doesn’t mean it is easy.

Value stocks are very uncomfortable to buy. An unprepared investor would have a lot of self-doubt and might lose confidence when bad events arise.

The case in point revolves around TSH, a stock listed on the Catalist (the secondary board of the SGX). TSH’s market capitalisation was about S$30 million when we first looked at the stock in 2014. It was a very small cap stock which most professionals would not even take a glance at.

Though a small company, TSH had 4 business streams.

Homeland security arm served the Defence sector, disposing ammunition and constructing civil defence shelters. This business segment also supplied and choreographed fireworks displays.

Consumer electronics arm designed headphones, earphones, speakers and accessories for mobile phones and tablets. These products were made in China and sold in the U.S. through a distributor.

The property arm developed properties in Australia.
Lastly, the consulting arm organised sports event such as POSB PAssion Run for Kids, PAssion Fun Around the Bay, Home TeamNS-New Balance REAL Run, Orange Ribbon Walk, Run for Hope, Green Corridor Run, Jardine’s MINDSET Challenge (Vertical Marathon), and Love Your Heart Run.

It appeared to me that the Company was not focused. A small company shouldn’t be doing so many unrelated businesses because there weren’t enough resources to do everything well.

**Why Invest?**

We practise a version of value investing known as the Conservative Net Asset Value (CNAV) strategy. The approach focused on buying companies below their asset value, as opposed to valuing companies based on their earnings.

Slightly more than 2 years ago, the Net Asset Value (NAV) of TSH was $44.6m. The assets included $23.8m cash and a freehold building worth $8.8m.

Market capitalisation was only $30m, less than the NAV of $44.6m. An undervalued stock indeed.

Graduates of our course would understand that TSH had a CNAV2 discount of 19% and a POF Score of 3. We bought some TSH shares at S$0.124 on 31 Jul 2014.
A String Of Negative Events

An undervalued stock doesn’t mean it can only go up in price.

On the contrary, the share price fell after we invested in TSH.

We had a paper loss of 30% as the share price dropped to $0.086.

What happened?

What should we do?

Some investors may panic. Some may be in denial.

We actually added our position in TSH on 15 Feb 2015 because the assets were still intact and the shares just got cheaper. Moreover, the CEO of TSH added a large position in Dec 2014. We do not usually average down though and we believe most investors shouldn’t do it.

The annual report for FY14 was released in Apr 2015. Operating cash flow was negative and we should have cut loss given our quantitative criteria. We analysed the situation and decided not to because the operating cash flow was impacted by a one-off large purchase of development property. Without this, the operating cash flow would remain positive.
On 4 Aug 2015, TSH invested $5m into an oil & gas company listed on the Bursa Malaysia. The Company was Hibiscus. It was a bad timing as we know that the crude oil prices tumbled in end-2015.

It was not easy for most investors to swallow one bad news after another. It would be normal to start thinking that you have made a mistake and indulge in self-blame for not identifying the risks in advance. How many investors would have given up hopes on the stock and suffer in silence?

The series of events are plotted on the following stock chart after the investment was made.

![Stock Chart](https://via.placeholder.com/150)

**Figure 4: Sequence of events after TSH investment. Stock chart from ShareInvestor.com**

### The Change Of Fortune

Somehow, all of a sudden, the management seemed to be enlightened and took a series of actions that benefitted the shareholders.
On 23 Dec 2015, the management sold away all the Australian properties and decided to close down this business segment. They made a small loss from this.

This kicked off the liquidation of other businesses and assets of TSH, unlocking value for the shareholders. The management declared a $0.03 dividend per share, which was a 27% dividend yield based on our average buy price of $0.108.

Of note, the homeland security business was sold to the CEO of TSH and the consumer electronics was sold to a third party. The freehold building was sold for $16m at the prevailing market value. The gain was around $7m.

TSH became a cash company without any business operations. The management declared a special dividend and capital reduction of $0.1232 per share. This would return 82% of the NAV to the shareholders. With such a large distribution, I believe it is unlikely the management is going to buy a business and stay listed. Eventually all the money would be returned to the shareholders.

The revised NAV per share was S$0.15 and we decided to sell off at this price with a total percentage gain of 67%.

Below is the summary of asset disposal and value unlocking sequence.
Value investing is unnatural. You have to go against the herd. Most of the really cheap stocks are small caps and many would find them uncomfortable to buy. It is also counter-intuitive to buy into problems. But it is the presence of problems that resulted in cheap stock prices.

To make it even tougher, the stock price may continue to disappoint after you have invested in a value stock and result in a large loss, albeit on paper. It makes you doubt your investment position. You need a lot of confidence and conviction to stick to your investment process. One day, things might just turn rosy and allow you to sell for a handsome profit.

It is true not all stocks would turn out as well as TSH. Some may become a permanent loss. Hence, we must manage our portfolio properly – diversify sufficiently, cut loss when necessary. Having a time stop to exit is also important to avoid value traps.
Useful Resources for the Value Investor

This section lists additional useful resources that are catered for the value investor. All resources are listed alphabetically. For more investing and trading resources from financial commentary, economic data to charting tools, download our Ultimate Investing Resource.

Company Announcements

**Singapore**
https://www.sgx.com/securities/company-announcements

**Malaysia**
https://www.bursamalaysia.com/market_information/announcements/company_announcement

**Hong Kong**
https://www.hkexnews.hk/index.htm
Stock Screeners

**Acquirer’s Multiple**
https://acquirersmultiple.com/

Deep Value Stock Screener.

**Dr Wealth’s App**
https://app.drwealth.com/discover

We made our own app to discover more stocks.

**FINVIZ**
https://finviz.com/screener.ashx

Stock screener for investors and traders, financial visualizations.

**GuruFocus**
https://www.gurufocus.com/screener/

The All-In-One Guru Stock Screener. The screener now has more than 120 filters for you to screen your favorite stocks.
**Jitta**
https://www.jitta.com

Rank stocks based on Jitta Score and Jitta Line to give you the opportunity to “Buy a Wonderful Company at a Fair Price”.

**Share Investor**
https://www.shareinvestor.com/sg

Get real-time stock quotes, stock charts, company fundamentals, financial results and market moving financial news.

**Stockopedia**
https://www.stockopedia.com/

Comes with a free 14 days trial. You can screen stocks using the strategies from different gurus inside Stockopedia.
The Intelligent Investors Immersive Introductory Course is a live, free course that will equip you with:

• How we marry 2 contrasting investing strategies to build a balanced portfolio that’ll grow while paying us dividends, at the same time.

• The insights to finding Undervalued and Growth stocks in today’s market - post Covid-19.

• How to use a free stock screener to identify opportunities in today’s market (and how it can be done within a couple of clicks)

• 7 key financial figures to focus on, so that you can cut through the fluff of annual reports and analyse companies within 15 minutes.

• 2 main criteria that’ll help you pick safe Growth stocks with huge potential (we’re looking at at least 100% growth).

The Intelligent Investors Immersive Introductory Course is free and we run it occasionally, check this page for latest updates.
At Dr Wealth, we invest our own money using our Conservative Net Asset Value (CNAV) strategy covered above. We use it alongside a dividend investing strategy as part of our Investing methodology.

Factor-Based Investing allows us to exploit proven stock profit factors like Value, Size and Profitability to pinpoint stocks that are more likely to give us higher returns.

After all, it’s a no-brainer that we’d want to put our money only in stocks that can give us better and higher returns.

Here are 3 case studies of stocks analysed using the CNAV strategy.

We hope that you’ll become more familiar with the stock analysis and thought process of a value investor, through these case studies.

For newer case studies, follow our blog!
Case Study #1: Can A Metal Stamper Bring Significant Profits to Your Portfolio?

All data accurate as of Nov 2016.

Why does this stock deserve our attention?

A CNAV2 discount of 44% and POF score of 2, that’s why.

Miyoshi (SGX:M03) has numerous properties and land in Asia. We believed the value is much higher today as many of these owner-occupied properties were quoted at cost in the balance sheet.

During our meetup with the management, the key office holders have shown their drive in creating value for the business by investing in new growth areas, and diversifying away from the reliance on a declining but still profitable Hard Disk Drive market.
What Does The Company Do?

Miyoshi Precision Limited was established in Singapore in 1987 starting as a mere tool-and-die and metal stamping company. 4 years later, Sin Kwong Wah, Andew joined the Company as CEO and Chairman. Since then he has been the driving force behind Miyoshi’s growth and expansion.

In Dec 2014, Miyoshi Precision Limited changed its name to Miyoshi Limited. They dropped the word “Precision” as a recognition that they have to do more than just providing metal stamping service in order to survive in a tough engineering market. Hence, they positioned themselves to provide an integrated engineering solution to fit the market demands.

They have also changed their Company’s logo from its previous Japanese looking design as a pragmatic move to avoid possible antagonising customers in China.

Today, Miyoshi is headquartered in Singapore with 900 employees in manufacturing plants across Asia.
Core service
Miyoshi provides Integrated Engineering Services (IES) for manufacturers which includes product design and prototyping for precision components and assemblies in the data storage, consumer electronics and automotive markets. And also precision metal stamping, progressive cold forging, mechanical joining/laser welding, electroplating, manual assembly and testing.

Their key markets are data storage, Hard Disk Drive (HDD), consumer electronics, photocopiers, scanners and printers manufacturers.

What Are The Assets?
Properties represent the largest pie followed by Investments which comprised 15% stake in Coal Power (Fujian) and others, and receivables. The Properties were made up of $7.5 Million in investment properties and $19 Million in Land and Building.

Land and Building
The Singapore building is located at No.5 Second Chin Bee Road and is where Miyoshi is headquatered. It used to be their core metal stamping operation for the HDD market which was a major revenue contributor in its heyday. The management decided to close down the Singapore manufacturing plant in 2014 due to poor business viability.
The property is a leasehold two-storey factory cum office building. In 2014, they extended the leasehold by another 30 years.

$20 million worth of land and buildings in the balance sheet was quoted at cost less depreciation. Given that the plants are in good working condition it is likely that the valuation has increased over time.

**Investment properties**
Miyoshi built two industrial buildings on the empty land in the Philippines and turned it into investment properties. The rental yield was 10% based on the past 12 months August 2016 quarterly report. This is one of the examples in which the management has been trying to create value with existing assets and expand the streams of income.

**Receivables**
The Company has approximately 44% out of $14 million in Trade and other receivables that have passed due. The amount is significant but not alarming. As we have sufficient buffer through discounting the value by 50%.
Why is the stock undervalued?

In hindsight, Miyoshi was barely profitable over the past 5 years and even had a few years of losses. During profitable years, their net profit margin was a meagre 1 – 2%. Their factories and supply chain have also been damaged and disrupted from the flood in Thailand and the earthquake in Japan. The declining HDD market further pressured Miyoshi’s business performance and stock price.

The market tends to price stocks based on their earnings and growth prospect. For the case of Miyoshi, earnings have dropped significantly and a boring industry like metal stamping meant that it is likely to be neglected and priced pessimistically by the market.

What are the main risks for this stock?

Data Storage and Consumer Electronics are the main revenue contributors. However, the latter was not profitable and was loss-making for the past 3 years. Data Storage and Automotive segments were profitable but with profit margin of 10% and 3%, respectively.
The main risk for Miyoshi is probably whether they would be quick enough to diversify their declining Data Storage segment to other market segments like Automotive, Microshaft and others.

The venture in Light Electric Vehicle (LEV) via Core Power would unlikely be a major contributor to Miyoshi’s earnings in future, mainly, it was a 15% investment. Hence, it does not add to her revenue.

Secondly, even if the venture proves to be a success, Miyoshi would still require to increase her stake to leverage on the growth, which could be refused by Core Power. Even if we assumed that Core Power is willing, Miyoshi would still face financing constraints. Due to this the Company does not have significant cash to make bigger investments.

What are the positive signs for this stock?

Although revenue in the HDD market is falling and their days are numbered. Metal stamping continues to play an important role in making metal components for industries like consumer electronics, medical devices, automotive and etc. Hence, there is a chance for Miyoshi to turn around a loss-making business if they manage to secure more contracts in these areas. The Chairman mentioned that there are fewer players now and competition has eased. In fact, Miyoshi is rejecting businesses if they do not bring in sufficient profit margin.
Their investment in Light Electric Vehicles may turn out to be a success and create value for the Company. They could also shut down some of the less profitable plants and turn it into investment properties to unlock value.

The market seemed to react positively on their recent dividend announcement, the price has almost doubled. The dividend yield is around 9% at today’s price.

**Does the management have skin in the game?**

Sin Kwong Wah Andrew is the largest shareholder of Miyoshi with a total interest of 31.79%. He is the Group’s CEO and Chairman.

Masayoshi Taira holds 15.36% indirect interest in Miyoshi. He is the Group’s Non-Executive Director and also the general manager of Miyoshi Industry Co., Ltd., Japan, where Miyoshi was originally from.

Pek Yee Chew is the wife of Sin Kwong Wah Andrew. Collectively, the family owns approximately 30% of Miyoshi. A healthy level as it is not too high or low but just good enough to have sufficient skin in the game.
There is also bound to have some sentimental value for Andrew as he has spent over 25 years in building the Company. He also showed willingness to share profits with the shareholders as dividends.

**Conclusion**

Miyoshi is an undervalued stock in a boring industry. During our visit, Chairman Andrew shared that the metal stamping business has become increasingly tough. The market demands higher quality work at lower prices which eats into their profit margin.

It may seem risky to invest in such a stock. As value investors, we invest in stocks that are trading cheaply below their assets valuation and wait for positive events to happen for the value to be unlocked. There are some potentials given the possible earnings turnaround and the investment in LEV. Miyoshi certainly qualifies for that.

Investors should not expect Miyoshi to distribute dividends every year as the management has told us that they would try to distribute dividends when they managed to generate $3 – 4 million of free cash flow which they have not been able to in the past 5 years.
Case Study #2: Local Steel Trader Available at a Steal

All data accurate as of Oct 2016.

Why does this stock deserve our attention now?

Sin Ghee Huat (SGX:B7K) was trading with a CNAV2 discount of 25% and POF score of 2. The share price has dropped from $0.26 (2014) to $0.19 (Oct 2016) due to depressed steel and commodities price. The stock deserved our attention because the CNAV discount has increased to 25% and cash level has risen after some of the investment bonds were sold.

The potential profit is approximately 100% based on the NAV of $0.39. It is also a net-net stock with 14% discount. In other words, Sin Ghee Huat is trading below its liquidation value.

What does the company do?

See Ghee Huat machines, processes and supplies stainless steel to various business sectors. Trading and machine processing contributed 73% of the revenue.
What are the assets?

As a metal trading firm, it is normal to have a large inventory which accounted for almost half of the total assets. There is also a significant amount of cash and trade receivables which constituted 29% and 12% of the total assets respectively.

<table>
<thead>
<tr>
<th></th>
<th>Inventory</th>
<th>Cash</th>
<th>Receivables</th>
<th>Properties</th>
<th>Investments</th>
<th>Intangibles</th>
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<td>%</td>
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<td>29%</td>
<td>12%</td>
<td>7%</td>
<td>6%</td>
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<td>$38.8m</td>
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<td>$10.8m</td>
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Why is this stock undervalued?

The business performance has been weak over the past 5 years, mainly dragged down by the weak global steel market, which is suffering from weak demand, over-capacity and excessive inventories.

Falling Profits and Dividend Pay Outs

The Company has been distributing the majority of their net profit as dividends over the past few years. As the earnings have not improved, the ability to distribute higher dividends was hampered. In April 2016, the Company issued a profit guidance in anticipating a 3rd quarter loss.

The state of affairs for steel and its gloomy outlook are affecting the way investors are valuing the steel industry, including this company.
What are the main risks for this stock?

There is a significant amount of inventory held by the company, which may be subjected to write-down risks. The table below shows the inventory levels and write down amounts by year.

The inventory levels have always been stable, ranging from 34% to 47%. This shows the ability to maintain the inventories despite changing demands in steel. The write down in FY16 was not excessive, as compared to FY09 and FY10. If history is indicative of the future, Sin Ghee Huat’s inventory should not pose a big risk since write downs have been manageable.

The second risk revolves around the uncertainty of steel price recovery. Could this be a prolonged period of low steel prices such that this stock becomes a value trap? This is possible and we have a time stop of 3 years, should nothing positive come out of it during this period.

As the share price is undervalued at this point, and considering that the Kua family is a majority shareholder (67%) of Sin Ghee Huat, there is a chance the Family would make an offer to delist the Company. It would rather be easy to accumulate enough shares to meet the delisting criteria given their level of ownership. The rest of the shareholders may have to give up the shares at undervalued prices.
Does the management have skin in the game?

As mentioned above, the Kua family owns the majority and some of the members serve as directors and managers of the Company. There is definitely sufficient skin in the game for the Kua family. But shareholders may be shortchanged if a delisting scenario unfolds. The positive sign was that the Management distributes most of the profits as dividends, and it is a sign that they treat shareholders fairly.

Conclusion

Sin Ghee Huat share price has been beaten down because of their exposure to the weak steel market. This is not the first time the Company has experienced this as the management has navigated the Company’s survival for nearly 3 decades of steel cycles. The Company currently has the cash and resources to tide through more years and hopefully a steel recovery is in sight in the near future.

Regardless, it is important that investors practice diversification, and make investment decisions that are aligned to the individual’s investment horizon and risk appetite.
Case Study #3: Best Value Stock – 3 Undervalued Companies for the Price of 1

*All data accurate as of Jul 2017.*

Why does this stock deserve our attention?

Great Eagle (HKSE:0041) is trading at a CNAV2 discount of 46%, POF 3, P/E 10, and is generating positive net operating cash flow over the past two years. We chose this stock because of her globally diversified properties, stable growth and enterprising management.

Furthermore, two of her Hong Kong listed subsidiaries, Champion REIT and Langham Hospitality Investments are also traded below their CNAVs.

Besides having capital gain potential, Great Eagle also pays dividends of around 1.8% yield. The yield isn’t impressive but the stock presents an opportunity to receive some returns while waiting for capital gain.
What Does The Company Do?

The Great Eagle Group is one of Hong Kong’s leading property companies. They manage and own an extensive international hotel portfolio branded under “Langham” and other affiliate brands.

The group also develops, manages and invests in high quality residential, office, retail and hotel properties in Asia, North America, Australasia and Europe.

The company was founded by the late Lo Ying-Shek in 1963 and subsequently listed in Hong Kong Stock Exchange in 1972. Today, they are headquartered in Hong Kong and run by the second generation of Lo’s family. The third son of the late Lo Ying-Shek, Dr. Lo Ka Shui, is the Chairman and CEO of the Group. He is also in the Forbes’s billionaire list.

Operating Segments
The Group derives their earnings largely from three main areas –

1) Hotel management under the hotel franchises Langham

2) Distribution from her three subsidiaries (Champion REIT, Langham Hospital Trust and U.S Fund) and,

3) Managing fee income from Champion REIT.
It might not be obvious how each of these segments contributes to the revenue and earnings of Great Eagle since their numbers are consolidated in the parent company. In terms of the geographical revenue (bottom right table), we can see that 46% of the earnings are diversified outside of Hong Kong, minimising the concentration risk in one country.

**Two Subsidiaries**

![Diagram showing the composition of earnings with percentages and segments]

- **[66%]**
  - ChampionREIT
    - Three Garden Road (office)
    - Langham Place Office Tower
    - Langham Place Mall

- **[62%]**
  - Langham Hospitality Investments
    - The Langham, Hong Kong
    - Cordis, Hong Kong
    - Eaton, Hong Kong

*Note: 15 overseas hotels largely come from the brand ‘Langham.’ See below table for the breakdown.*
Great Eagle holds 66% and 62% stakes in Champion REIT and Langham Hospitality, respectively. The subsidiaries are spinoffs from the Great Eagle’s property portfolio. This is beneficial since properties are capital intensive assets and the Group’s capital could be freed up by selling part of these spinoffs to other investors. The management can in turn use the capital for other property development projects while retaining control of the assets (more than 60% of the voting rights in each of the subsidiaries).

Secondly, the Group is also entitled to the dividends and property income distributed by their subsidiaries so that they retained majority of the profits from the spun-off properties. Moreover, they could also retain the lucrative property manager role in the subsidiaries. You would have noticed the trend when property managers such as CapitaMallAsia and ARA Asset Management were delisted while the REITs they managed remained listed.

What Are The Assets?

Over 80% of the total assets come from properties.

Great Eagle owns over 21 asset properties globally, 5 of them belong to Champion REIT and Langham Hospitality. And the remaining properties are held under Great Eagle either through direct holding or partnership. Most of the hotels are run under the brand name ‘Langham.’
Champion REIT owns the largest pie followed by Great Eagle and Langham Hospitality. We will start with Great Eagle first.

**Great Eagle**
Below is an overview of Great Eagle overseas’ portfolio and properties under development (under ‘Pipeline hotels’). On top of these properties, they also own an apartment building and Great Eagle Centre in Wanchai, Hong Kong.

Champion REIT’s portfolio includes two grade-A office towers and one shopping mall. The REIT was listed in 2006 with Three Garden Road as the initial portfolio. Subsequently, they acquired Langham Place Office Tower and Langham Place Mall in 2008 from the Group. Two of which are located in Mongkok.
The REIT pays an average 3% – 4% dividend yield and is a CNAV stock with 42% discount. Their net operating cash flow was positive over the past three years and has a POF score of 3.

The share price has risen by 39% from the bottom in early 2016 due to improved earnings from higher occupancy rate and positive rental reversion from Three Garden Road, Langham Place Office Tower and Langham Place Mall.

**Langham Hospitality (HKSE:1270) | Ownership: 62%**

Langham Hospitality is a stapled security consisting of a REIT and a Business Trust. Their property portfolio includes two High Tariff A hotels also known as ‘5-star’ hotels (The Langham and Cordis) and one High Tariff B hotel (Eaton).

The Business Trust is trading at a CNAV2 discount of 41% and distributed a rather high dividend yield of 7% – 9% over the past three years. Net operating cash flow was positive in the past 3 years with a POF score of 2.
Why Is The Stock Undervalued And What Are The Main Risks

The share price has doubled from $20 to $40 since early 2016 but it is still a distance away from the NAV per share of $82. It could be a sign that the stock is reverting to its value but the possibility seems slim as we do not see any catalyst happening.

The undervaluation could be due to the family tussle as investors tend to avoid such stock with the fear of uncertainty. Besides that, it is important to understand that we could only make educated guesses and may never know the real reason. One human tendency or bias is to seek an explanation about why stock prices move in a certain way and neglect that not every price movement has a reason other than randomness.
We know from experience and empirical evidence that undervalued stocks tend to revert to fundamentals over time and that is good enough for us to make profitable investing decisions. Furthermore, our downside will be limited so long we do not overinvest in a few stocks and maintain adequate diversification.

**What are the main risks for this stock?**

They are heavily exposed to the global tourism market as the majority of their income is derived from hotel related activities. Furthermore, they are also at the mercy of the property market cycles since they have property development projects in the U.S, Japan and China.

It is also worth noting that their debt to equity ratio of 60% is quite high. But this is understandable as they are in a capital-intensive business which is perhaps the reason for spinning off their properties to the REIT and Business Trust. They should be able to refinance the loan given their well-located properties but it would be at higher interest rates, which would decrease their profits.

In addition, the Lo’s family owns approximately 60% of the shareholding in Great Eagle Holdings, giving them considerable power to place their interests ahead of shareholders if they desire to.
What Are The Positive Signs For This Stock?

Great Eagle Holdings (HKSE:0041)

<table>
<thead>
<tr>
<th>Great Eagle (HKD '000)</th>
<th>Dec-12</th>
<th>Dec-13</th>
<th>Dec-14</th>
<th>Dec-15</th>
<th>Dec-16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>135,528</td>
<td>7,454,764</td>
<td>8,405,748</td>
<td>8,438,565</td>
<td>8,704,467</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>1,385,111</td>
<td>3,000,541</td>
<td>3,278,975</td>
<td>3,022,455</td>
<td>3,368,624</td>
</tr>
<tr>
<td>Gross profit Margin</td>
<td>27%</td>
<td>40%</td>
<td>39%</td>
<td>36%</td>
<td>39%</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>3,551,830</td>
<td>2,399,472</td>
<td>2,115,101</td>
<td>3,312,335</td>
<td>2,769,792</td>
</tr>
<tr>
<td>Net profit Margin</td>
<td>69%</td>
<td>32%</td>
<td>25%</td>
<td>39%</td>
<td>32%</td>
</tr>
<tr>
<td>Net Operating Cash Flow</td>
<td>1,934,025</td>
<td>2,442,950</td>
<td>-13,341</td>
<td>1,566,368</td>
<td>2,120,905</td>
</tr>
</tbody>
</table>
The Group’s revenue, earnings and net operating cash flow has been quite stable over the past 5 years. Dec-14 saw a negative in net operating cash flow but that was due to an acquisition of a property for development. Likewise, her two subsidiaries have stable earnings.

The management has also proven to be enterprising by expanding to overseas projects, achieving considerable success in building the Langham brand globally and spinning off her asset properties to create value for the Group.

<table>
<thead>
<tr>
<th>Champion REIT (HKD '000)</th>
<th>Jun-12</th>
<th>Jun-13</th>
<th>Jun-14</th>
<th>Jun-15</th>
<th>Jun-16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>-</td>
<td>2,208,570</td>
<td>2,288,113</td>
<td>2,288,766</td>
<td>2,556,820</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>-</td>
<td>1,203,961</td>
<td>1,245,180</td>
<td>1,221,523</td>
<td>1,412,615</td>
</tr>
<tr>
<td><strong>Gross profit Margin</strong></td>
<td>-</td>
<td>55%</td>
<td>54%</td>
<td>53%</td>
<td>55%</td>
</tr>
<tr>
<td>*<strong>Net Earnings</strong></td>
<td>-</td>
<td>2,198,654</td>
<td>1,928,563</td>
<td>3,305,013</td>
<td>3,181,582</td>
</tr>
<tr>
<td><strong>Net profit Margin</strong></td>
<td>-</td>
<td>100%</td>
<td>84%</td>
<td>144%</td>
<td>124%</td>
</tr>
<tr>
<td><strong>Net Operating Cash Flow</strong></td>
<td>-</td>
<td>1,221,354</td>
<td>1,278,752</td>
<td>1,212,118</td>
<td>1,387,142</td>
</tr>
</tbody>
</table>
Langham Hospitality Investments Ltd (HKD '000)

<table>
<thead>
<tr>
<th></th>
<th>Dec-12</th>
<th>Dec-13</th>
<th>Dec-14</th>
<th>Dec-15</th>
<th>Dec-16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>1,623,459</td>
<td>476,918</td>
<td>771,051</td>
<td>691,517</td>
<td>708,296</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>843,922</td>
<td>399,546</td>
<td>643,397</td>
<td>572,696</td>
<td>595,629</td>
</tr>
<tr>
<td><strong>Gross profit Margin</strong></td>
<td>52%</td>
<td>84%</td>
<td>83%</td>
<td>83%</td>
<td>84%</td>
</tr>
<tr>
<td>*<strong>Net Earnings</strong></td>
<td>397,491</td>
<td>445,275</td>
<td>557,063</td>
<td>1,442,191</td>
<td>409,609</td>
</tr>
<tr>
<td><strong>Net profit Margin</strong></td>
<td>24%</td>
<td>93%</td>
<td>72%</td>
<td>209%</td>
<td>58%</td>
</tr>
<tr>
<td><strong>Net Operating Cash Flow</strong></td>
<td>498,677</td>
<td>208,491</td>
<td>665,168</td>
<td>448,802</td>
<td>482,327</td>
</tr>
</tbody>
</table>

*The years which have higher net earnings than revenue was due to fair value gain in property.*
Does The Management Have Skin In The Game?

The Lo’s family collectively owns 60% stake in Great Eagle Holdings through a family trustee. The Annual Report did not indicate the exact breakdown of each family member’s ownership.

We could only estimate that the Group’s Chairman and CEO, Lo Ka Shui, owns the largest proportion. In addition, the Group is currently run by the second and third generation of Lo’s family. Hence, we could assess that the management has sufficient skin in the game.
Conclusion

Comparison Between Parent And Subsidiaries

<table>
<thead>
<tr>
<th></th>
<th>(HKSE:0041)</th>
<th>(HKSE:2778)</th>
<th>(HKSE:1270), biz trust</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Great Eagle</td>
<td>Champion Real Estate Investment Trust</td>
<td>Langham Hospitality Investments Ltd.</td>
</tr>
<tr>
<td>CNAV2</td>
<td>46%</td>
<td>41%</td>
<td>41%</td>
</tr>
<tr>
<td>Net. OCF</td>
<td>++-</td>
<td>+++</td>
<td>+++</td>
</tr>
<tr>
<td>PE</td>
<td>10</td>
<td>9</td>
<td>17</td>
</tr>
<tr>
<td>Potential Profit</td>
<td>109%</td>
<td>72%</td>
<td>70%</td>
</tr>
<tr>
<td>Div Yield</td>
<td>1.80%</td>
<td>4.50%</td>
<td>7.70%</td>
</tr>
<tr>
<td>Free Float</td>
<td>33.68%</td>
<td>31.25%</td>
<td>30.21%</td>
</tr>
<tr>
<td>Mkt Cap (M)</td>
<td>$26,760,058,483</td>
<td>$29,397,063,248</td>
<td>$6,881</td>
</tr>
</tbody>
</table>

66% owned by GE 62% owned by GE

Among the three stocks, we think Great Eagle offers the greatest value to investor for a couple of reasons:

CNAV2 & Potential Profit

Great Eagle has the highest CNAV2 discount of 46% compared to the two subsidiaries of 41% representing greater margin of safety. Great Eagle has a potential gain of 109% while Champion REIT has 72% and Langham has 70%. hence, Great Eagle is evidently the winner. The potential profit is measured from current price to the NAV.
**Diversification**
Both subsidiaries were incorporated and listed as part of Great Eagle’s expansion strategy. Champion REIT focuses on high quality office and commercial property. Whereas Langham Hospitality concentrates on luxury hotels. Both focus on the Hong Kong market solely, which can be advantageous if the property market sees a boom. On the flip side, their property portfolios could also become heavily exposed to the volatile Hong Kong tourism industry. We think Great Eagle is more robust mainly because of the majority property assets located worldwide. Besides that, their controlling stake in the two subsidies allows Great Eagle to still benefit from its subsidiaries’ growth.

**Higher probability of catalytic events**
Events that may unlock value include their overseas expansion in the U.S and China which may lead to a new earnings record and potential spinoff from their existing property portfolio.

All factors considered, Great Eagle Holdings offers the greatest value among the three companies in this analysis.
Discover How to Get Even More Returns in Today’s Market

Value Investing is great, it allows any investor to find profitable stocks in any market. But, it takes time, and most investors want dividends alongside growth.

We’ve incorporated our CNAV strategy into our Factor-Based Investing methodology which allows us to pinpoint stocks using proven profit factors as determined by over 40 years of scientific research.

We share more about the CNAV strategy and the Factor-Based Investing methodology regularly at our live workshop. Grab a seat here.
We are an investor-centric platform providing investor education and portfolio management tools. We have conducted classes and workshops for close to 4,000 attendees in the past few years.

The topics include value investing, dividends, REITs, bonds, angel investing and other personal finance matters. These lessons were delivered from the perspective of a Do-It-Yourself investor.

We changed our name from BigFatPurse to Dr Wealth in 2017 after an acquisition of Doctor Wealth Pte Ltd. This marked a new milestone as we embark on developing an app for DIY investors to track their investments conveniently and enhance their stock picking process.

Learn more here: Who is Dr Wealth?