

Three Conflicts for Value Investors

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Investing Conference
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Introduction – About Me

Greek-American, born Germany, based in France

Philosopher by training

Equity analyst since 1999

Founded Quo Vadis Capital in 2017

Kenyon College & University of Oxford

Wall St. Journal “Best on the Street”

Introduction – About Quo Vadis Capital

Founded 2017

Provide single-stock research to professionals

Manage separate accounts for individuals

Focus is consumer sector

Today's Agenda

*Identify **sources of error** in value investing using three analogies*

*Review Quo Vadis Capital **process** for evaluating stocks & portfolio management to evade these problems*

Have fun

Conflict #1

*The Birmingham
Screwdriver*



Conflict #1

An unfair slur on residents of the British Midlands, the Birmingham Screwdriver = A Hammer

The Value Investor Birmingham Screwdriver is overusing valuation filters in stock selection

Conflict #1

*The impact of overuse of P/E, EV/ EBITDA, P/B or other measures is often **a source of error***

Most famous example is Buffett passing on Amazon

Margin of safety is not found (only) in paying a low multiple

Conflict #1

Instead, our approach is based on segmenting businesses, identifying economic drivers

*Conduct valuation analysis & look for margin of safety after determining future drivers of cash flow and earnings **which may be hidden***

Conflict #1

*An example: 2020 IPO Academy Sports (ASO)
\$4B market cap*

*Using Value Investor Birmingham Screwdriver
ASO screens cheap but can we go further and
demonstrate how cheap it really is?*

Conflict #1

We will use a Quo Vadis proprietary unit-level valuation approach

- 1. Break out the **current cash flows of existing businesses**, and assign a value*
- 2. **Estimate future cash flows from growth**, which we value using a unit-level DCF*
- 3. **Evaluate market value vs. our estimates of core + growth***

Conflict #1

Step 1. Value of ASO'S existing Biz = After-tax EBIT + D&A – Maintenance Capex

	FCF per share	Value per share on 12% yield
Steady State	\$8.08	\$67.33
Grows 5%	\$8.48	\$70.70
Decreases 25%	\$6.06	\$50.50

Shares currently ***trade below \$50***, pricing in 25% decline in profitability

Conflict #1

Step 2. To value ASO'S Growth (~90 New Stores over 5 years) we run a unit-level DCF

Quo Vadis Capital - Discounted Cash Flow Store-Level Valuation Calculator

Academy Sports

\$ million, unless otherwise noted

Inputs		Notes	
Valuation Date	9/29/2022	The store level valuation tool estimates the value of individual stores based estimated cash-flows at the store level over 10 years and without allocating any corporate or distribution related expenses. It assigns value of zero to the terminal value.	
Operating Inputs (\$M)			
First Year Revenue (\$M) 2023 EST.	\$18.7		
Capex Per Store (\$M)	\$2.3		
EBITDA (store-level CF margin)	21.5%		
Depreciation	\$0.2		
Amortization	\$0.0		
Maintance Capital Expenditures	\$0.1		
Working Capital (1x)	\$2.3		
Rate Inputs (%)			
Interest Rate (Discount Rate)	8.50%		
Short Term Revenue Growth Rate (immature)	4.91%		
Long Term Revenue Growth Rate (at maturity)	2.90%		
Tax Rate	24.00%		
		Outputs	
		Store Value (\$M)	\$24.7
		Store Value / 2022 Revenue	1.3x
		Store Value / 2022 EBITDA	6.1x
		Value Creation (Multiple to Capex)	11.0x

Yields a \$2.2B or \$26 per share value for growth

Conflict #1

Step 3. Compare to market value of Academy Sports (ASO) at \$45 per share

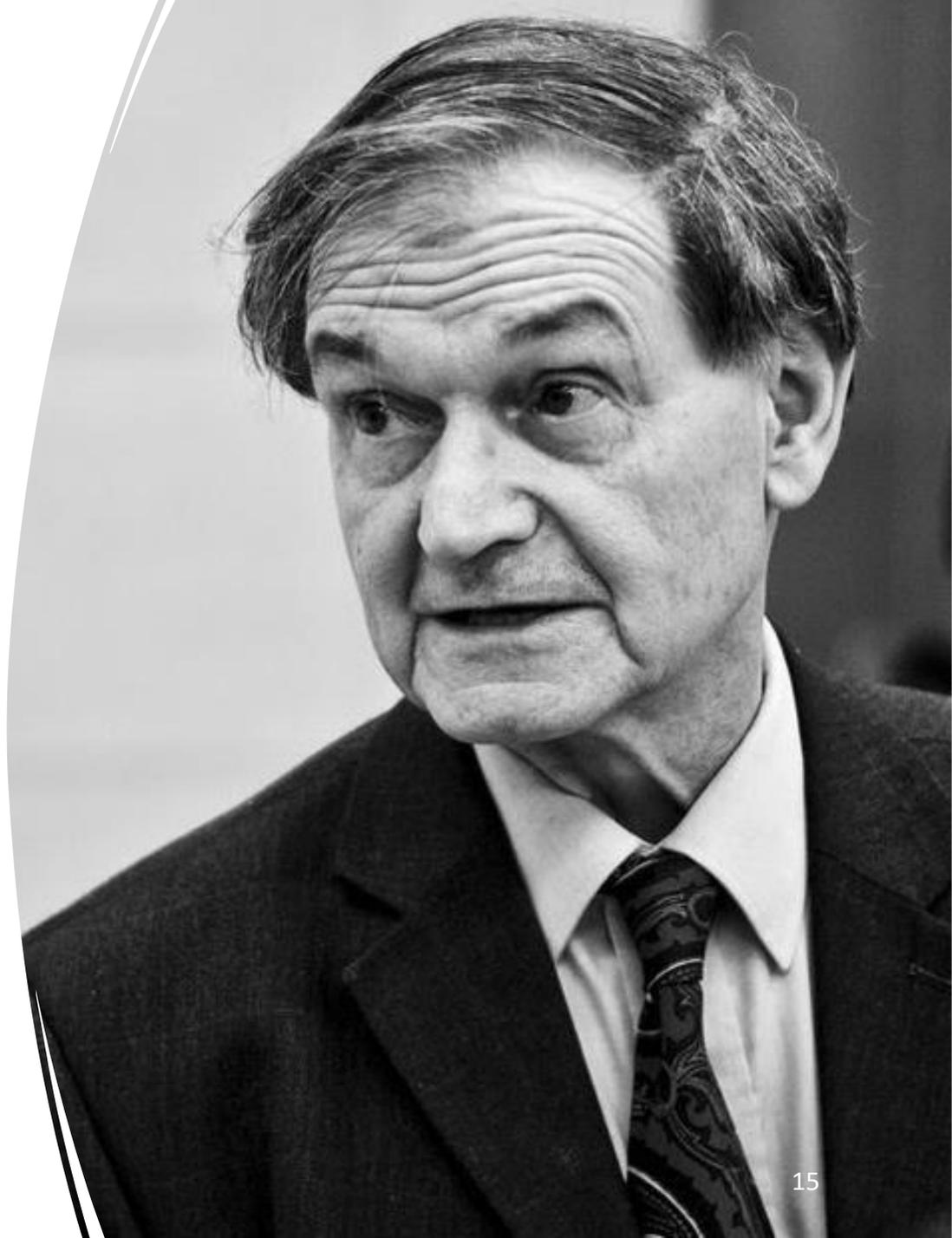
*Market is focused on **risk to existing business** & pricing in large decline*

***Nothing is being factored in for growth,** based on our analysis*

Significant valuation moat in the stock

Conflict #2

The Penrose Heuristic

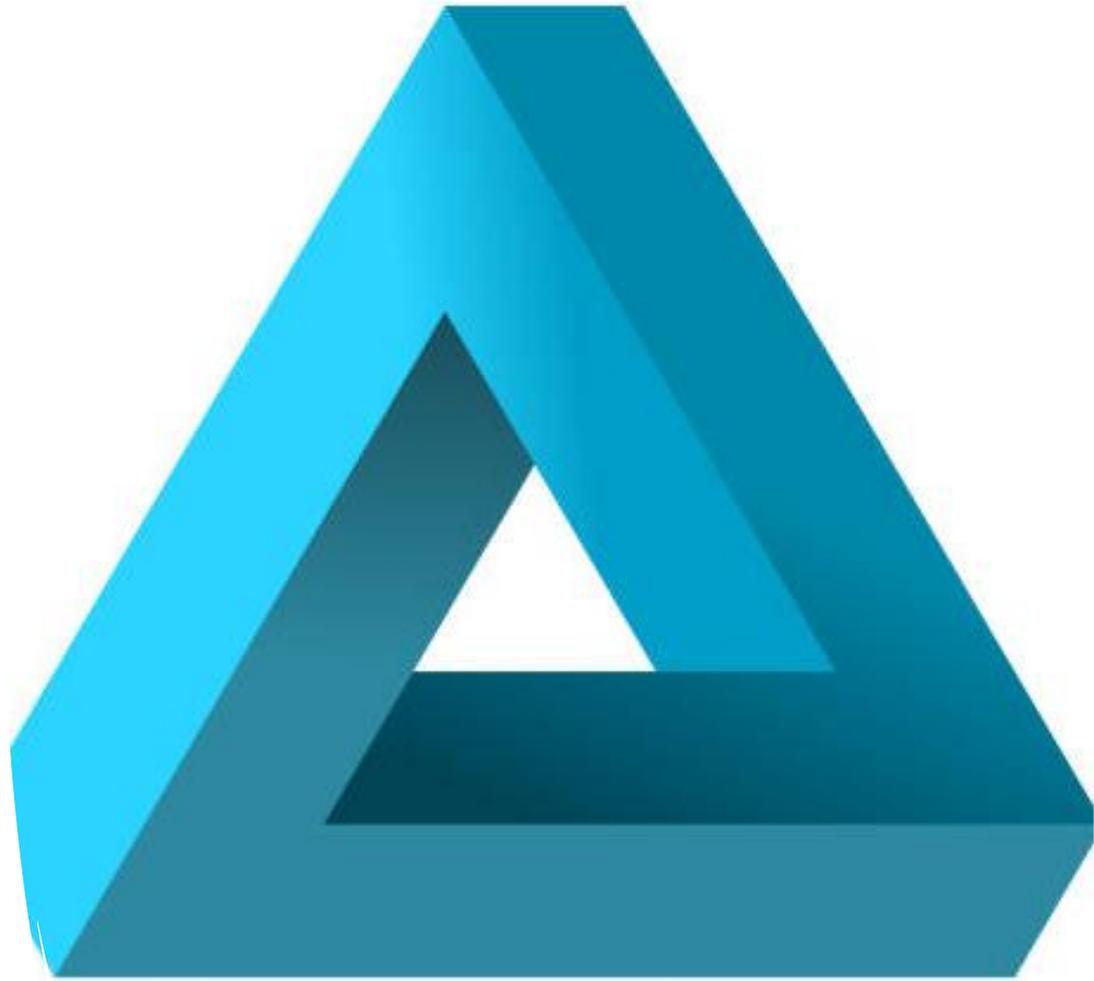


Conflict #2

Sir Roger Penrose is a mathematician, physicist & philosopher, awarded the Nobel prize in 2020

Among his many achievements and discoveries, he published, in 1958, together with his father, an “Impossible figure”

The Penrose
Triangle



Conflict #2

A heuristic is a shortcut – the substitution of a simple process that generates an approximate result for a more complicated & precise analysis

*Value Investors use a “Penrose Heuristic” when they **analyze a stock via comparison** to a similar case (turn around the triangle)*

Conflict #2

*Our view: analysis via comparison is tempting
but a significant **source of error***

*Instead, our approach: treat every company &
every situation as if it were unique*

Conflict #2

Quo Vadis Capital approach to stock analysis is based on unit level economics

Evaluate business models by breaking them apart into segments & solving for the economic drivers

Conflict #2

An example: Recent IPO Dutch Bros. Coffee (BROS) \$6B market cap

Using the Penrose Heuristic (analysis by comparison) it appears to be an early-stage high ROIC compounder (i.e. Next Starbucks)

Conflict #2

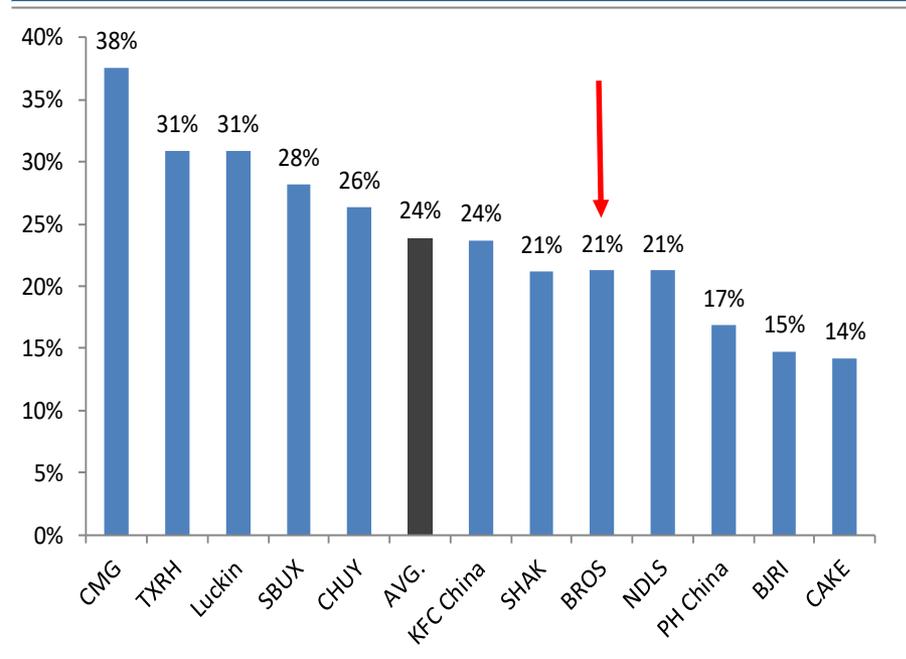
Our work segmented profit drivers of franchisee revenues and company-operated stores, solving for unit level ROIC

*We found nearly all profit coming from franchisees and **below-average ROIC** at company operated stores*

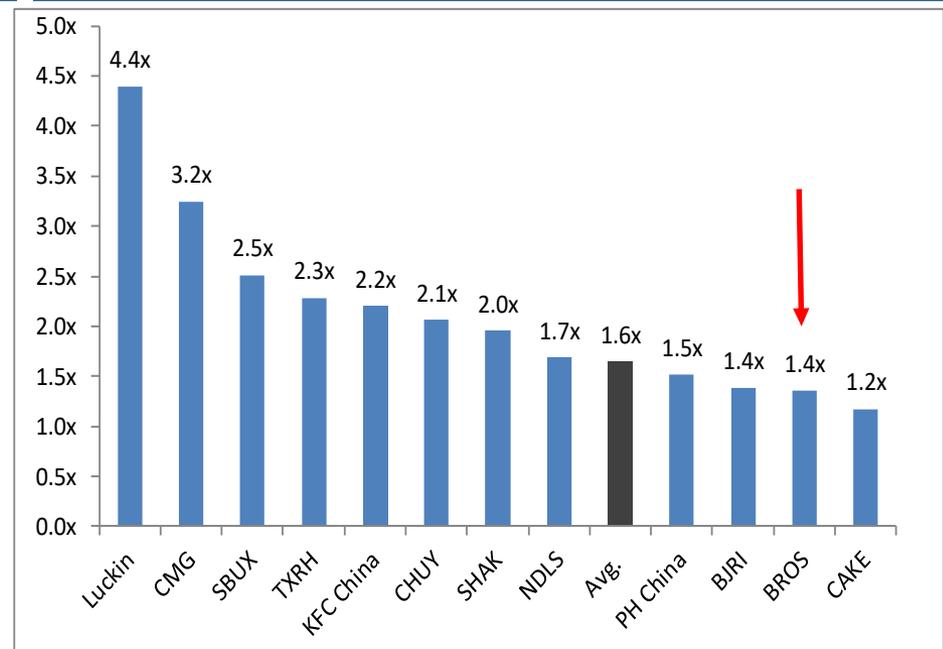
Conflict #2

BROS unit economics (red arrow) screen below average (black bar) and well below SBUX...

LEASE-ADJ. UNIT LEVEL ROIC



RATIO OF UNIT SALES TO INVESTMENT



Source: Company reports & Quo Vadis Capital, Inc. estimates, based on 2022 figures

Conflict #2

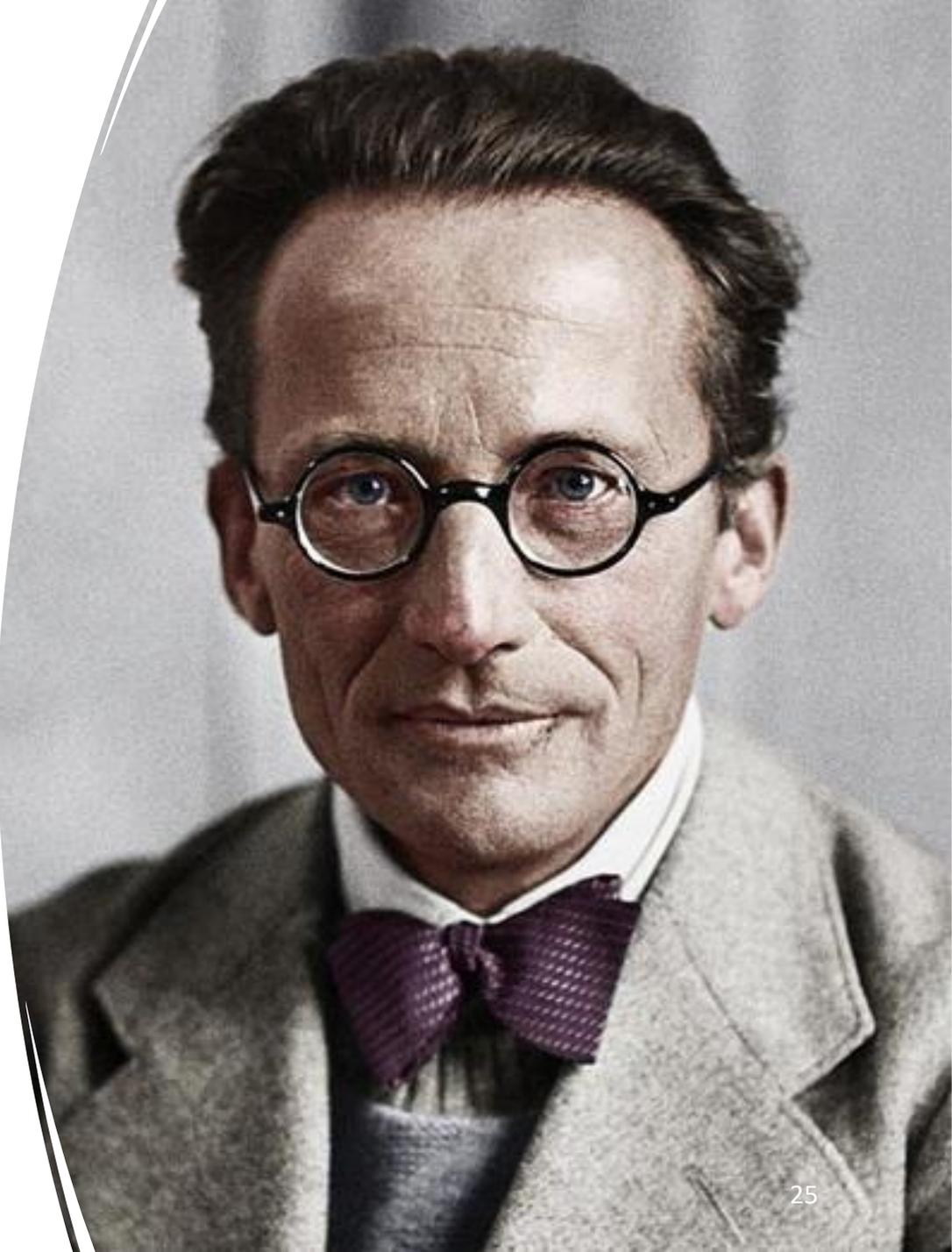
With a precise view on profit drivers & peer compare

Conclude that BROS is not exceptional high-ROIC compounder

*Significant **valuation premium is unwarranted***

Conflict #3

Schrödinger's Cat



Conflict #3

Erwin Schrödinger was an Austrian physicist and philosopher & awarded the Nobel Prize in 1933

He did not like cats

Conflict #3

Schrödinger set up an experiment with cat in a box and a poison gas pellet that would be triggered by a random event



Conflict #3

*The cat experiment is one view about **uncertainty in outcomes** – resulting in a Paradox (cat's alive & dead at the same time)*

Little known subvariant: Value Investor Schrodinger's Cat Uncertainty Paradox

Also about uncertainty

Conflict #3

The Value Investor Schrodinger Cat subvariant Paradox

Arises when value investors conflate uncertainty in the present with uncertainty in the future

*A belief that the **quantity of uncertainty in the future can change** is a significant source of error*

Uncertainty in the financial markets

Climate finance

Uncertainty Grips Markets As Optimism Wanes

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The Stock Market: Beyond Risk Lies Uncertainty

How to Manage Feelings of Uncertainty About the Future



BUSINESS

Uncertainty in the financial markets centers on inflation

By Sarah McCammon Oct 13, 2020

January 25, 2022 · 5:10 AM ET
Heard on Morning Edition

Conflict #3

*Our view: **Uncertainty in the future does not come from current conditions**, it comes from Rumsfeld's "unknown unknowns"*

Instead, our approach based on the view that uncertainty is constant not variable

Conflict #3

We 1) stick with a consistent valuation framework and 2) remain fully or near-fully invested

*Invest in durable business models, with solid balance sheets and **capable management teams that we trust to navigate future challenges***

Don't try to manage uncertainty with exposure or keep the cat alive & dead

Summary – Three Sources of Error

- 1. Value Investor Birmingham Screwdriver: Overuse of valuation screens resulting in missed opportunities*
- 2. Penrose Heuristic: Analysis by similar case rather than treating each situation as unique*
- 3. Value Investor Schrödinger's Cat subvariant Paradox : Conflating future uncertainty with current conditions*

Summary – Quo Vadis Capital approach

- 1. Break businesses into existing and growth components and compare value of cash flows to market value*
- 2. Focus on unit level economics, identify & evaluate drivers of value*
- 3. Acknowledge uncertainty in future is constant, not variable & position accordingly*

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ΤΕΛΟΣ

