
PARADIGM CAPITAL
„THE FUTURE OF ACTIVE VALUE INVESTING“

25 APRIL 2018
BEN GRAHAM CENTRE'S 2018
VALUE INVESTING CONFERENCE
TORONTO

HOW DO WE CREATE AN EDGE AS VALUE INVESTORS...

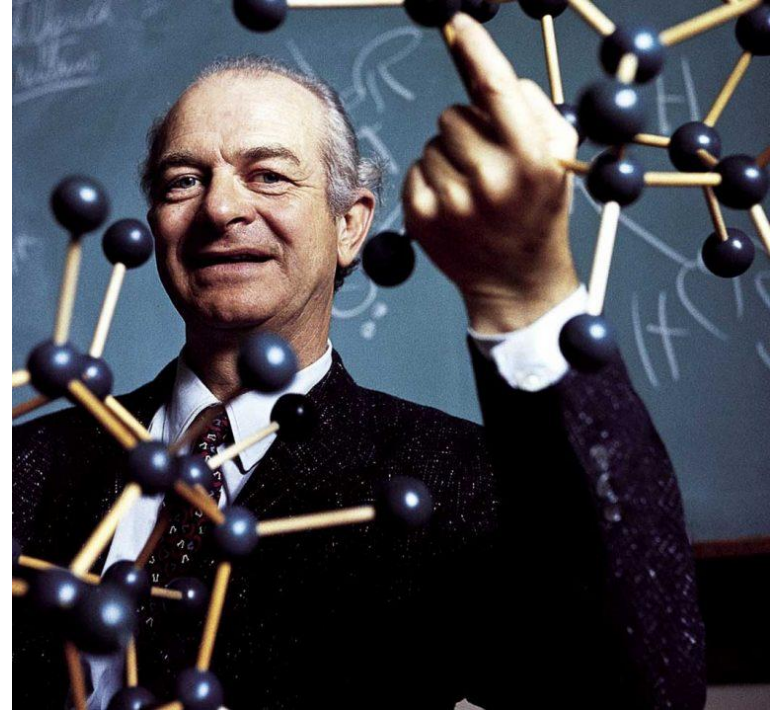
- Imperfect space...
- Deep fundamental research...
- Concentrated portfolio...
- Hedging...

SPECIALISATION IS ESSENTIAL...



Ester Ledecká
Czech Republic

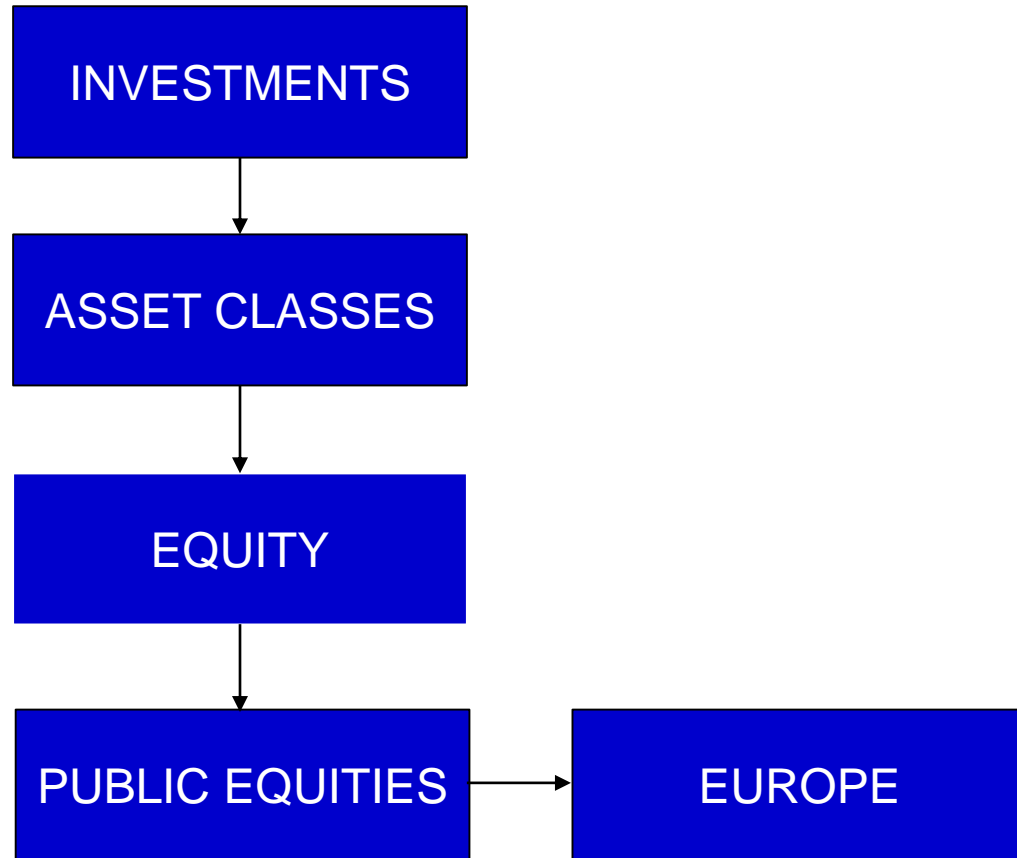
At the 2018 Winter Olympic Games in Pyeongchang Ledecká won gold medals in the super-G in alpine skiing and in the parallel giant slalom in snowboarding



Linus Pauling
USA

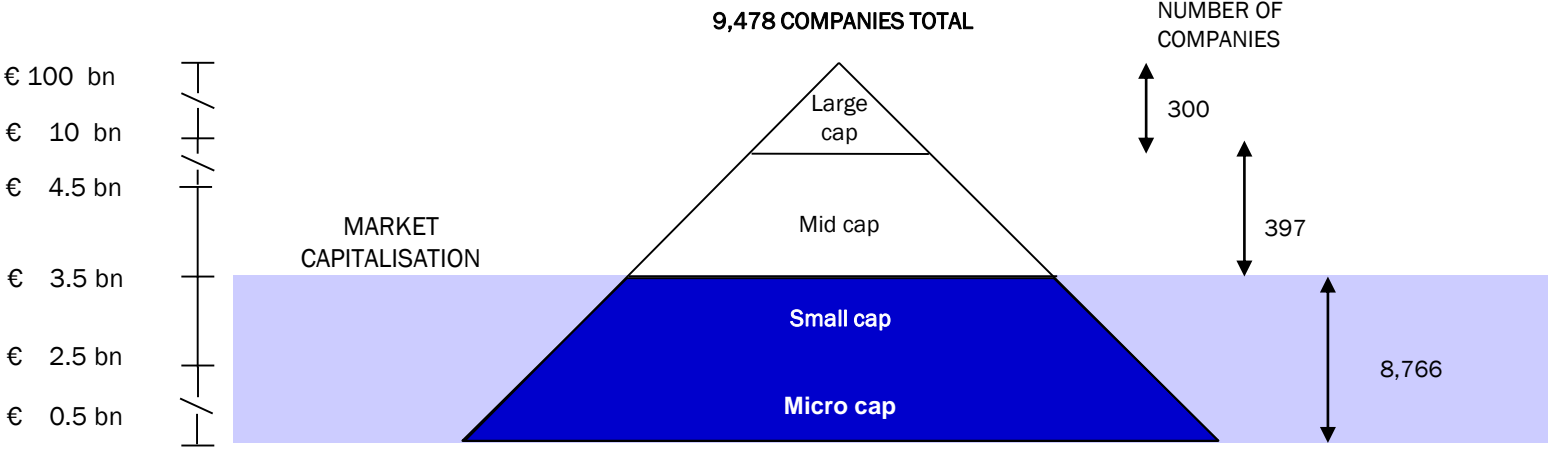
Pauling won the Nobel Prize in Chemistry in 1954 and the Nobel Peace Prize in 1962

HOW DO WE START OUR JOURNEY TOWARDS SPECIALISATION...



A FOCUS ON PUBLICLY LISTED COMPANIES IN EUROPE OFFERS CLOSE TO TEN THOUSAND COMPANIES TO ANALYSE...

Approximately 700 mid and large caps account for more than 80% of the total European market cap but only for 7% of all companies.



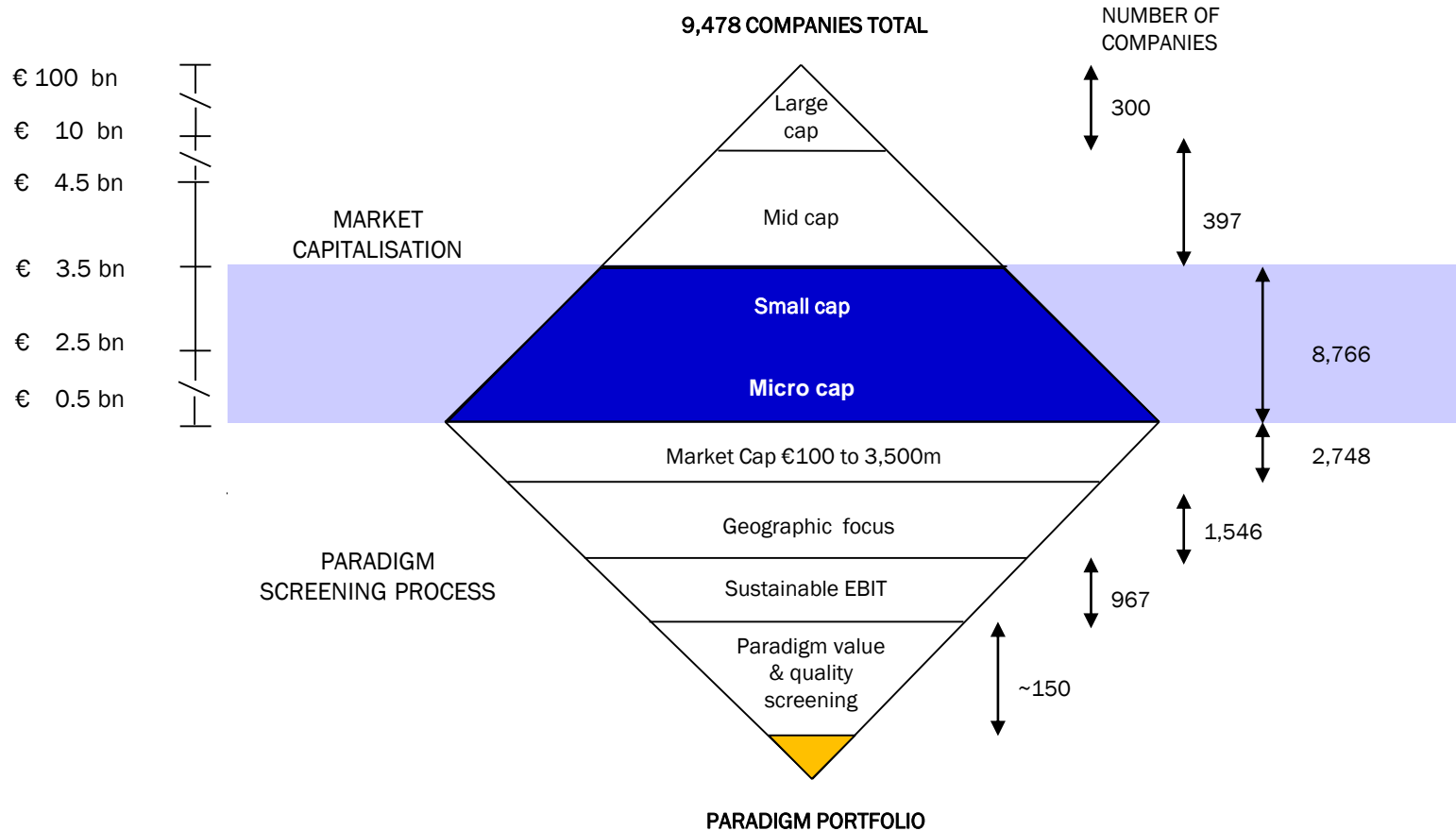
Sources: Bloomberg and Paradigm Capital

**BEING AN ACTIVE VALUE INVESTOR IN EUROPE WE NEEDED TO HAVE
ADDITIONAL SELECTION CRITERIA...**



SIZE AND GEOGRAPHY WERE ADDED TO THE LIST...

Approximately 700 mid and large caps account for more than 80% of the total European market cap but only for 7% of all companies.



Sources: Bloomberg and Paradigm Capital

THE SEARCH PROCESS GENERATES MORE SUCCESS WHEN BEHAVIORAL ASPECTS ARE COMBINED WITH SPECIALISATION...

Value Premium- Behavioral Finance

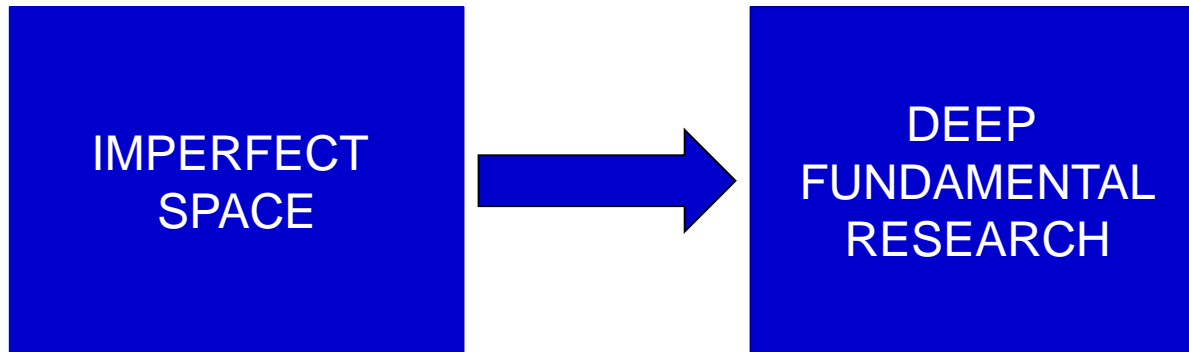
- Lottery Preference
- Ugliness Aversion
- Overconfidence/Uncertainty

Specialisation

- Geography
- Size
- Industry
- Model



HAVING DEFINED WHAT WE THINK IS AN IMPERFECT SPACE WE MOVE TO DEEP FUNDAMENTAL RESEARCH...



VALUATION IS THE MOST CRITICAL SKILL FOR ANY VALUE INVESTOR...

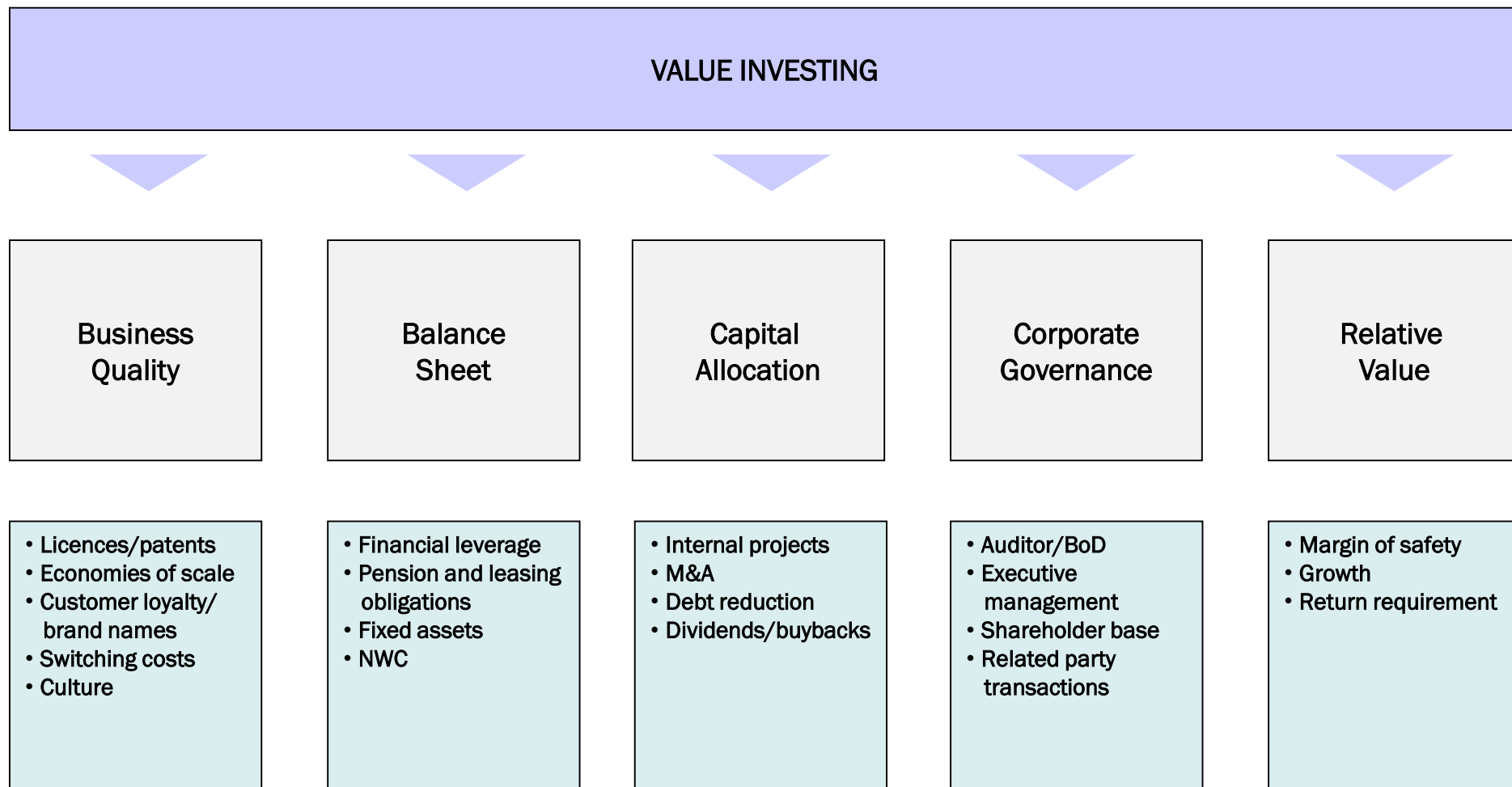
- **One Size Does Not Fit All**

- **Valuation Approach Depends On:**
 - Quality of Different Kinds of Information
 - Horizon Over Which Events Affect Value

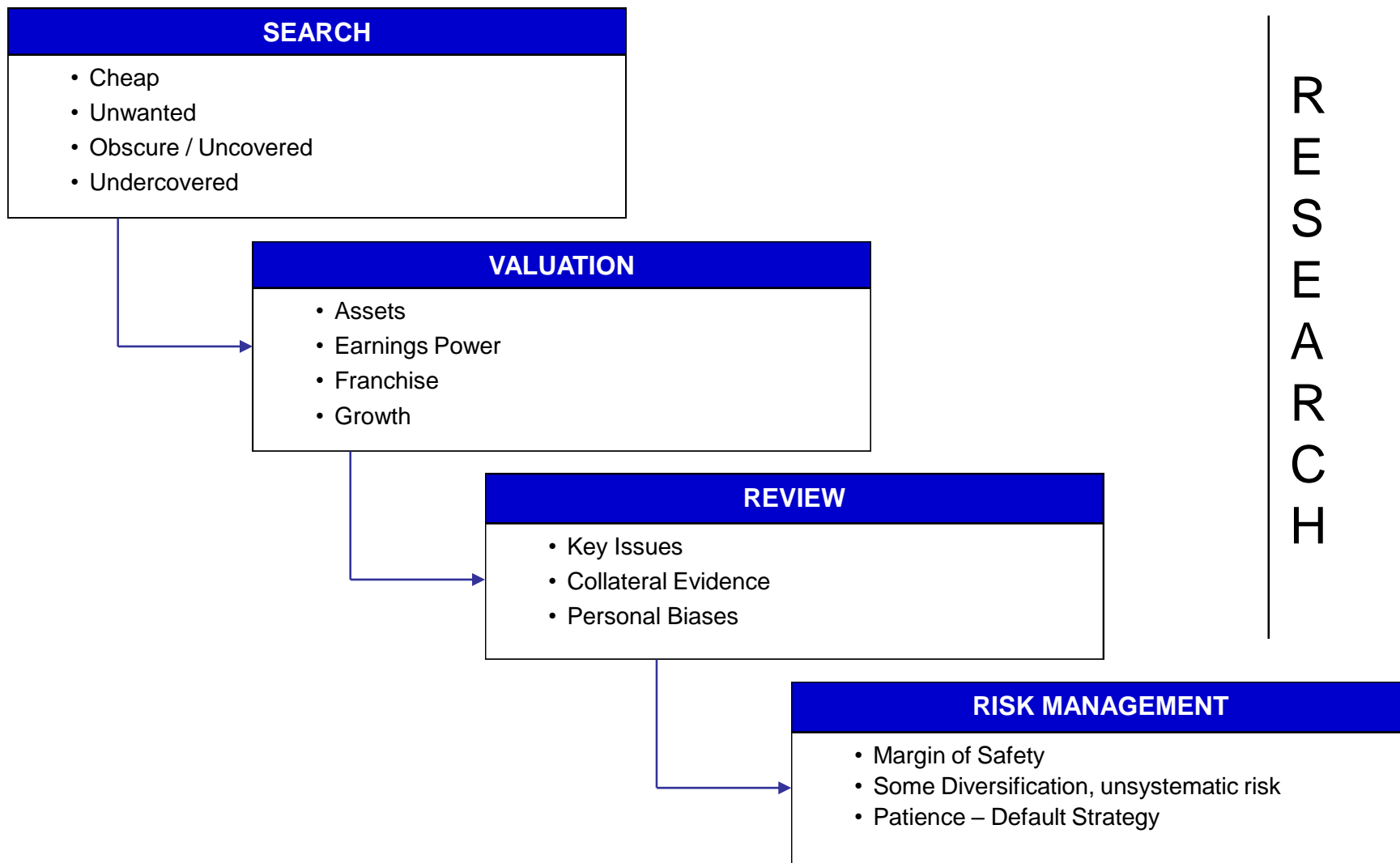
- **Four Basic Horizons:**
 1. Distressed Debt / Short Term Fixed Income
 2. Real Assets / Competitive Businesses
 3. Franchise Businesses
 4. Growth



WE USE FIVE PILLARS WHEN VALUING SECURITIES...



NOW THE VALUE INVESTING PROCESS STARTS...



SHORTCOMINGS OF NPV APPROACH IN PRACTICE...

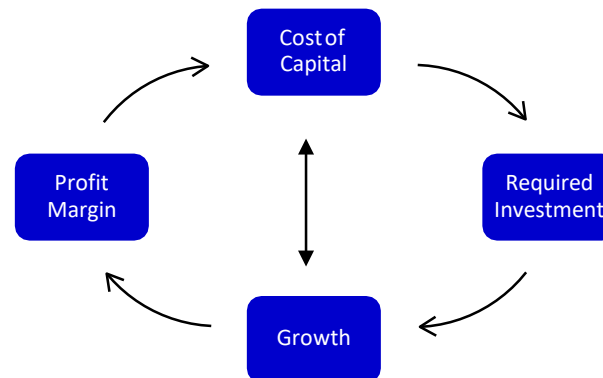
1. Ignores Information – Balance Sheet
2. Method of Combining Information

$$\text{NPV} = CF_0 + CF_1 \left[\frac{1}{1+F} \right] + \dots + CF_{20} \left[\frac{1}{1+R} \right]^{20} + \dots$$

Good Information (Precise) Bad Information (Imprecise)

= Bad/Imprecise Information

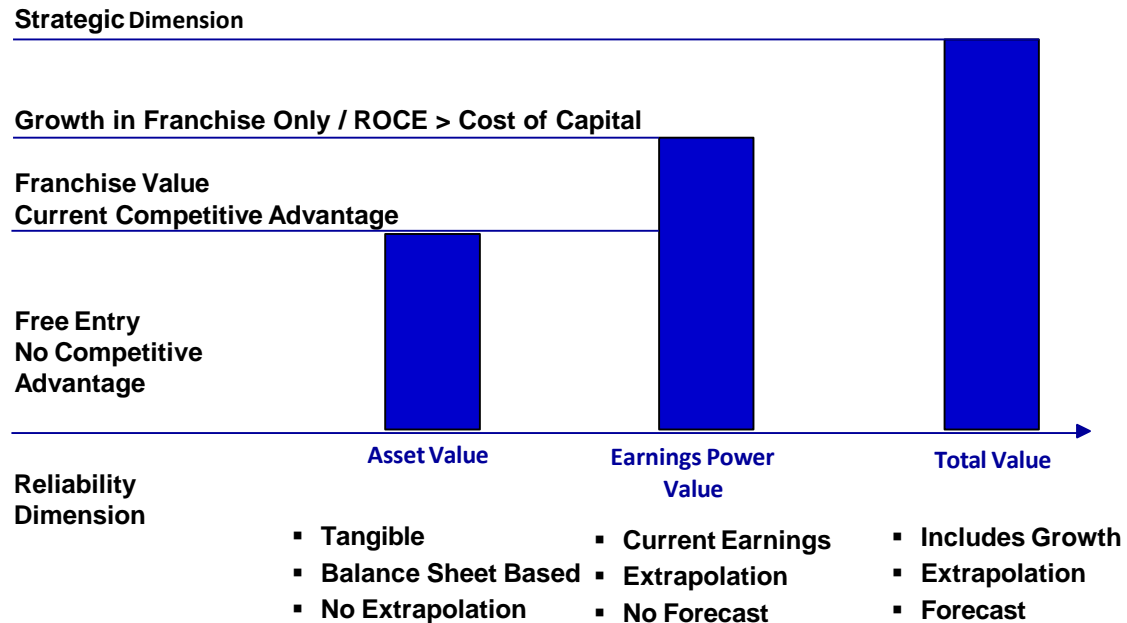
3. Sensitivity Analysis is Based on Difficult-to-Forecast Parameters, which co-vary in fairly complicated ways



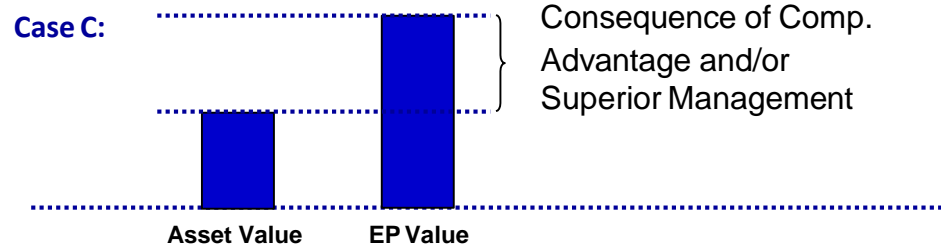
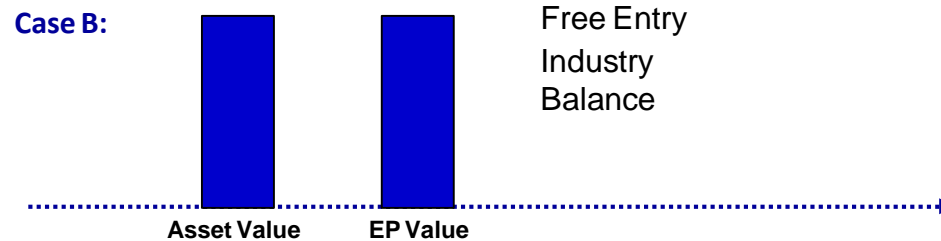
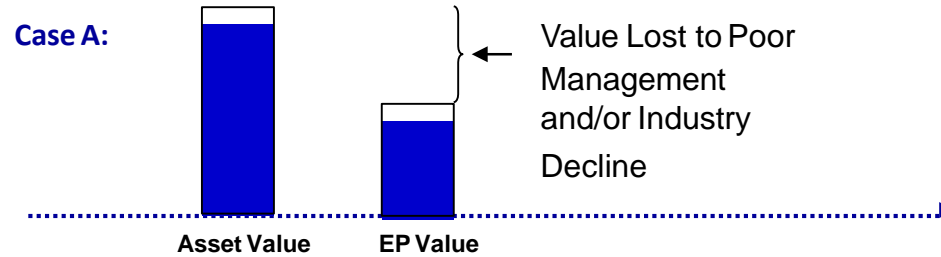
FIXED INCOME VALUATION...

- **Positive Growth Does Not Matter**
 - Growing Franchise – No Distressed Debt
- **Asset Value**
 - Earnings Power Limited by Contracts
- **Scenario Based Valuation**
- **Priority**
- **Timing**

BASIC ELEMENTS OF VALUE...



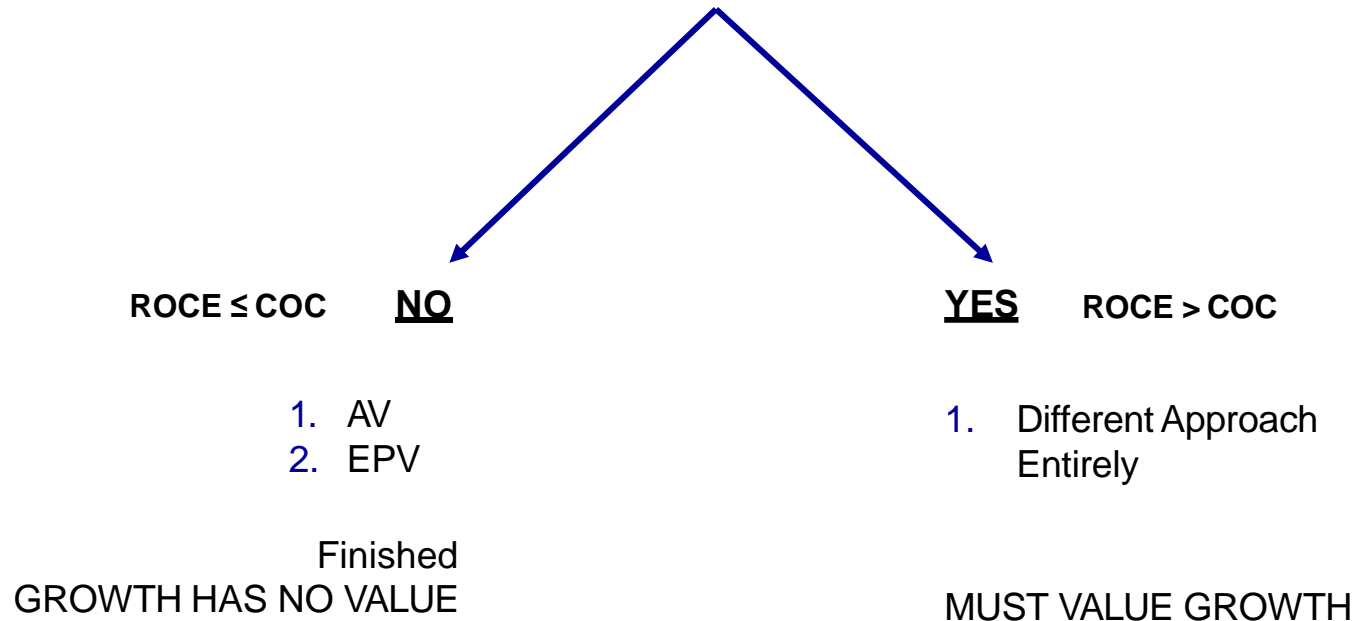
COMPETITIVE BUSINESSES, EARNINGS POWER AND ENTRY BARRIERS...



“Sustainability” depends on continuing Barriers-to-Entry

VALUATION IN PRACTICE...

- Is this a company with significant competitive Advantages / Barriers-to-Entry?



TOTAL VALUE INCLUDING GROWTH...

- Least reliable
 - Forecast change not just stability (Earnings Power)
- Highly sensitive to assumptions
- Data indicates that investors systematically overpay for growth. Why comes later and at lower rate!
- Orthodox value investors want growth for “*Free*”
 - (Market Value < Earnings Power Value)

VALUING GROWTH BASICS...

- Growth at a competitive disadvantage destroys value and capital
- Growth on a level playing field neither creates nor destroys value
- Only franchise growth (at industry rate) creates value



UNDERSTANDING THE CONCEPT OF COST OF CAPITAL AND RETURN ON CAPITAL IS AN ESSENTIAL STEP IN OPERATING A BUSINESS AS WELL AS BEING A GOOD INVESTOR ...

Investment: \$100 million

Cost of Funds: 10% (R) = \$10M

Return on Investment (%)	5%	10%	20%
Return on Investment (\$)	\$5M	\$10M	\$20M
Cost of Investment	\$10M	\$10M	\$10M
Net Income Created	(\$5M)	0	\$10M
Net Value Created	(\$50M)	0	\$100M
Qualitative Impact:	Value Destroyed	No Value	Value Created
Situation:	Competitive Disadvantage	Level Playing Field	Competitive Advantage

VALUE IMPLICATIONS OF BARRIERS TO ENTRY...

Factor	No Barriers-To-Entry	Barriers-To-Entry
Organic Growth	Attracts Entrants - No Value Margins Flat to Down	Creates Value Operating Leverage - Margins Up
Cost-Reducing Tech	Raises Profits in Short Run Attracts Entrants Eliminates Earnings Benefit – No Value	Creates Value - Targeted Price Reductions - Lower Costs - Share of market growth organically
New Investments	Returns Limited by Entry Earn Cost of Capital, at best, no Value	Creates Value if Properly Focused
Growth Options	Beneficial Opportunities Attract Entrants Eliminates Profit – No Value	Potentially Create Value

CALCULATING RETURNS: A SIMPLE EXAMPLE...

Sustainable Revenue	\$3,000M
Sustainable Net Margin	8%
Earnings Power	\$240M
No Debt, No Excess Cash	-
Distribution (DIVS, BBs)	50%*
Cash Distribution	\$120M
Retained (Reinvested)	\$120M
Market Value	\$4,000M
Earnings Return (240/4000)	6%
Cash Return (120/4000)	3%
Reinvested (120/4000)	3%

*History, Policy

TOTAL RETURN...

Cash	3.0%
Organic Growth	3.5%
Active Investment	3.6%
<hr/> <u>Total</u>	<hr/> <u>10.1%</u>
<hr/> <u>Market Return</u>	<hr/> <u>6.0%</u>
<hr/> <u>Margin of Safety</u>	<hr/> <u>4.1%</u>

Fade/Erosion?

ACTIVE RESEARCH...

- **Research Coverage**
 - Local Research/ Focused Research
 - Collateral Evidence
 - Personal Bias

- **Management Assessment**
 - Cost Efficiency
 - Understand Value Creating Growth
 - Proper Financing/ Distribution
 - Human Resource Mgt.

- **Detailed Local Sources**
 - Community
 - Full Range of Media
 - Industry Contacts

RISK MANAGEMENT: MEASURING RISK...

- **Not Variance**
 - Value investors do not define risk as volatility, but view portfolio composition as critical when measuring risk
 - Serial Correlation
 - Upside-Downside Asymmetry
- **Permanent Impairment of Capital**

RISK MANAGEMENT: PERMANENT IMPAIRMENT...

- **Central Management**
 - **Situational Risk (at Purchase) – Margin of Safety**
 - General Risk is Usually Idiosyncratic
 - Diversification
 - **Basic Risk Profiles**
 - Fixed Income
 - Real Assets/Basic Businesses
 - Franchise Businesses
 - **Insure Overall Risks**
 - Safe Assets
 - Selective Shorts
 - Derivatives
- Inflation risk
Deflation risk
Protected risk

SINCE INCEPTION, PARADIGM CAPITAL'S VALUE INVESTING STRATEGY SHOWS A SUBSTANTIAL OUTPERFORMANCE...

Performance	H2 '07	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD March 2018
Paradigm Capital (Net)	-5.2%	-15.8%	12.5%	43.8%	2.9%	7.2%	3.7%	6.1%	30.0%	22.3%	19.1%	-2.8%
STOXX Europe 50 (Gross)	-5.7%	-40.7%	29.9%	3.9%	-4.3%	13.9%	17.9%	6.7%	7.0%	1.2%	9.7%	-5.8%

