CUHK Workshop 1:
Searching for Ideas

Feb 2024

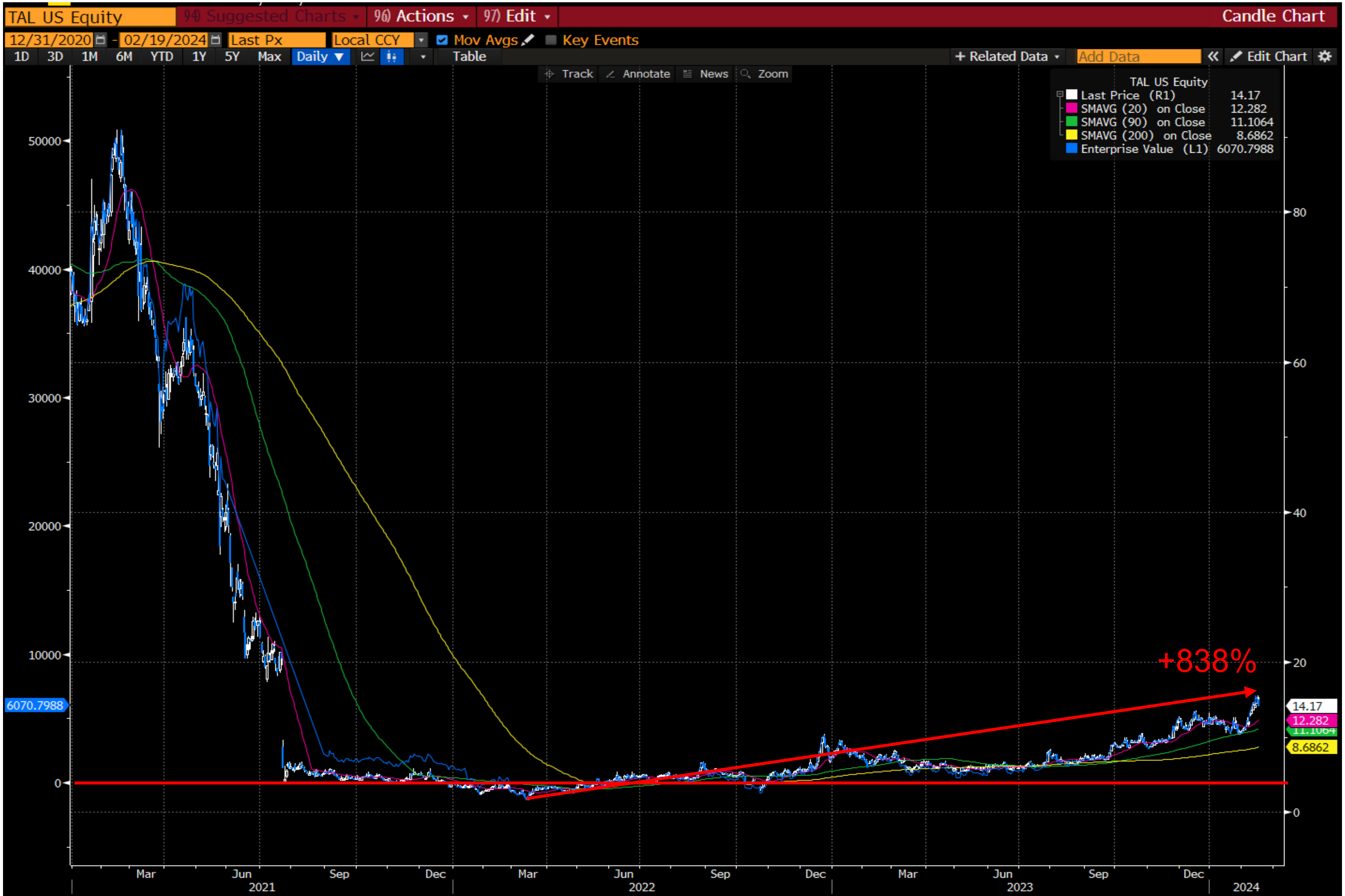
THE OVERLOOK PARTNERS FUND, L.P.

Define the Target

Value Investing

- **A Simple Definition from *Investopedia***
  - "Value investing is an investment strategy that involves picking stocks that appear to be **trading for less than their intrinsic value**"
- **Deep Value – "Cigar Butt Investing"**
  - *Buying a Dollar for Much Less Than Its Worth*
  - Relatively Easy to Screen: Price < Liquidation Value
    - Cheap Valuation, e.g., Negative Enterprise Value
  - Be Mindful of Value Traps!
  - Things to Consider:
    - Reason(s) Behind the Cheap Valuation
    - Catalyst(s) to "Unlock the Value"
    - Time Horizon

Example: Negative Enterprise Value – 1



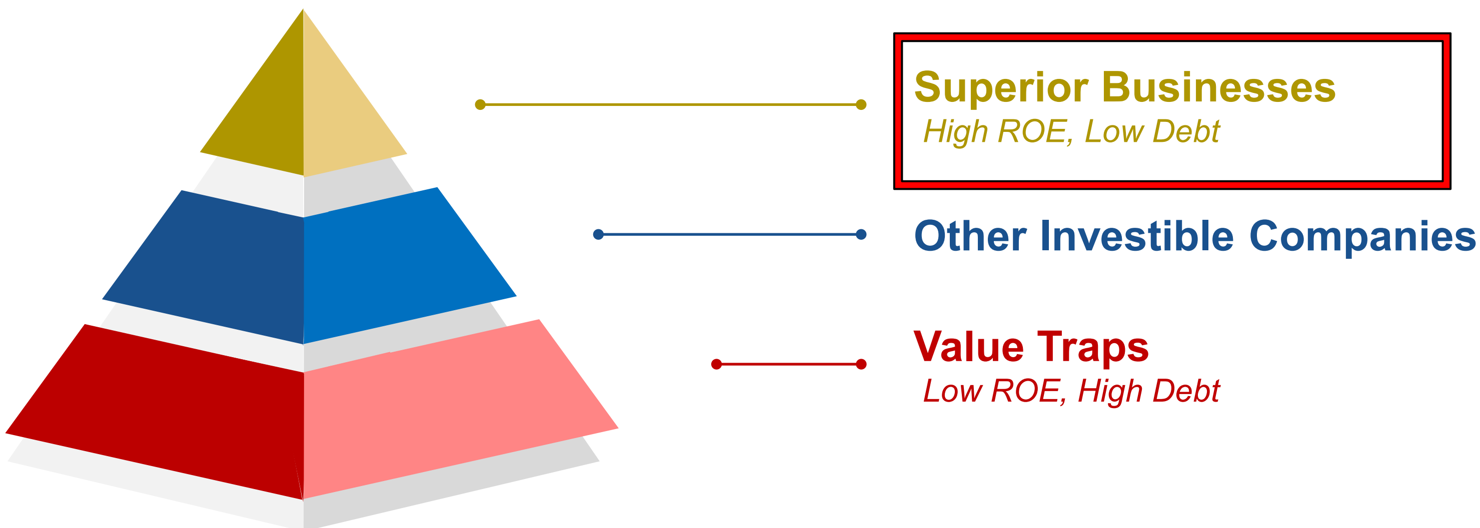
Example: Negative Enterprise Value – 2

Value Investing

- **A Simple Definition from *Investopedia***
  - "Value investing is an investment strategy that involves picking stocks that appear to be **trading for less than their intrinsic value**"
- **Deep Value – "Cigar Butt Investing"**
- **Cyclical Companies – Buy Low Sell High**
  - Screening Tends Not to Work Well for These Companies
  - Earnings and Ratios Often Unreliable
  - Low Valuation at Cyclical Peaks, High Valuation at Troughs
- **"GARP" – Growth at a Reasonable Price**
  - Find A Superior Business and Pay A Reasonable Price
  - Growth is Essential

The Overlook Pyramid

- **Drive Portfolio to Top of the Pyramid**
  - Keep Portfolio at the Top



- **Caveats**
  - Execute Disciplined Financial Analysis
  - Avoid Badly Overpaying

Draw the Roadmap

Characteristics of Superior Businesses

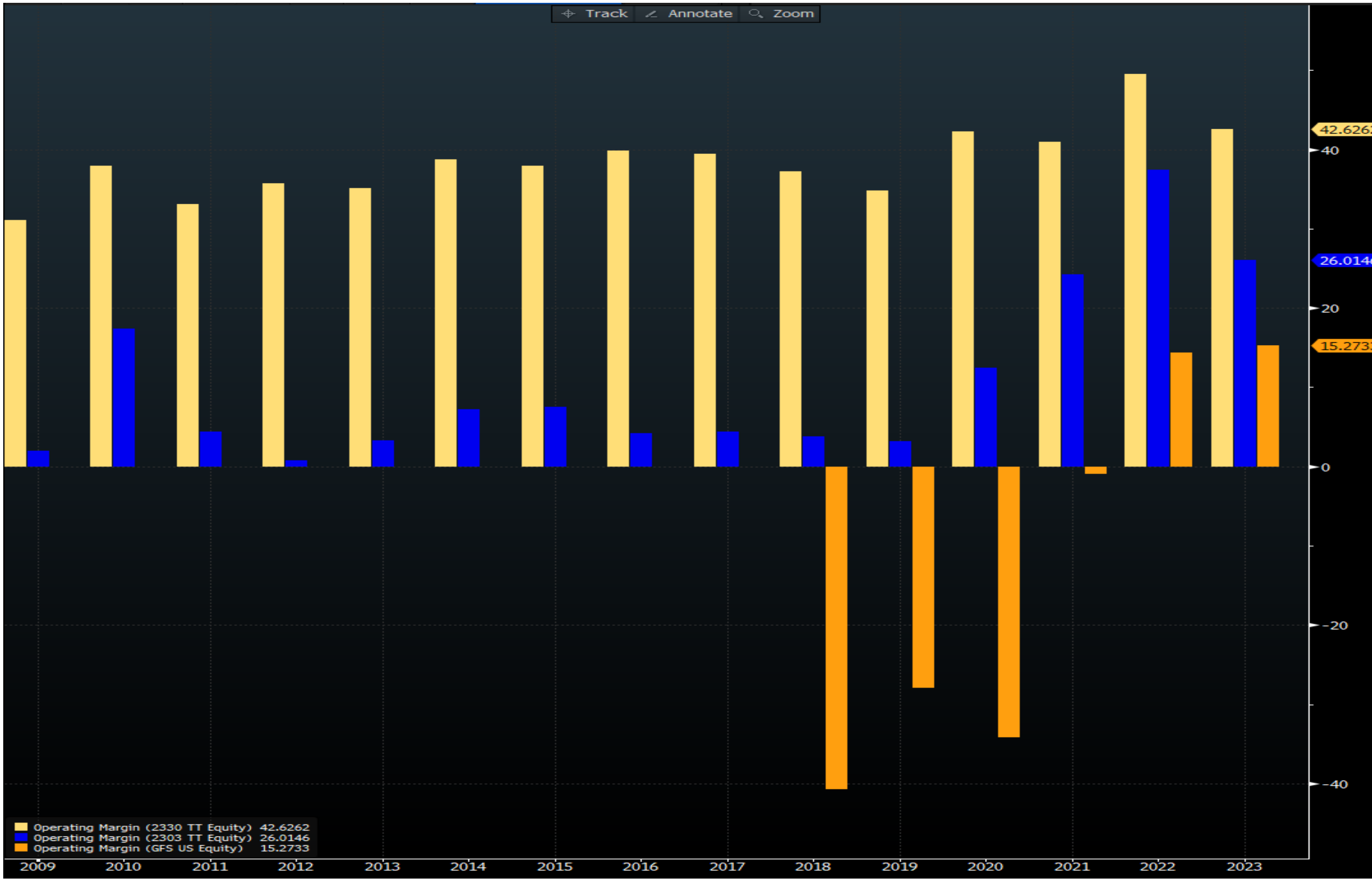
Comes In All Shapes and Sizes, But Tends to Share Some Common Characteristics:

- Dominant Market Share
- Pricing Power
- Consistent Generation of Free Cash Flow
- Self-Financed Growth
- High Rates of Return
- Superior LT EPS Performance
- Returns for Shareholders

Further Elaboration of the Characteristics

- **Dominant Market Share**
- **Pricing Power**
  - To Be Revealed
  - Hint: If A Company Has Strong Pricing Power, It Can Adjust Pricing to Protect It Against Cost Fluctuation
- **Market Shares Are Usually Measured by Revenue**
  - But Profits Are More Important than Revenue
  - For Superior Companies with Dominant **Revenue** Market Share, They Tend to Have **Even Higher Profit Market Share**
    - i.e. Superior Profitability

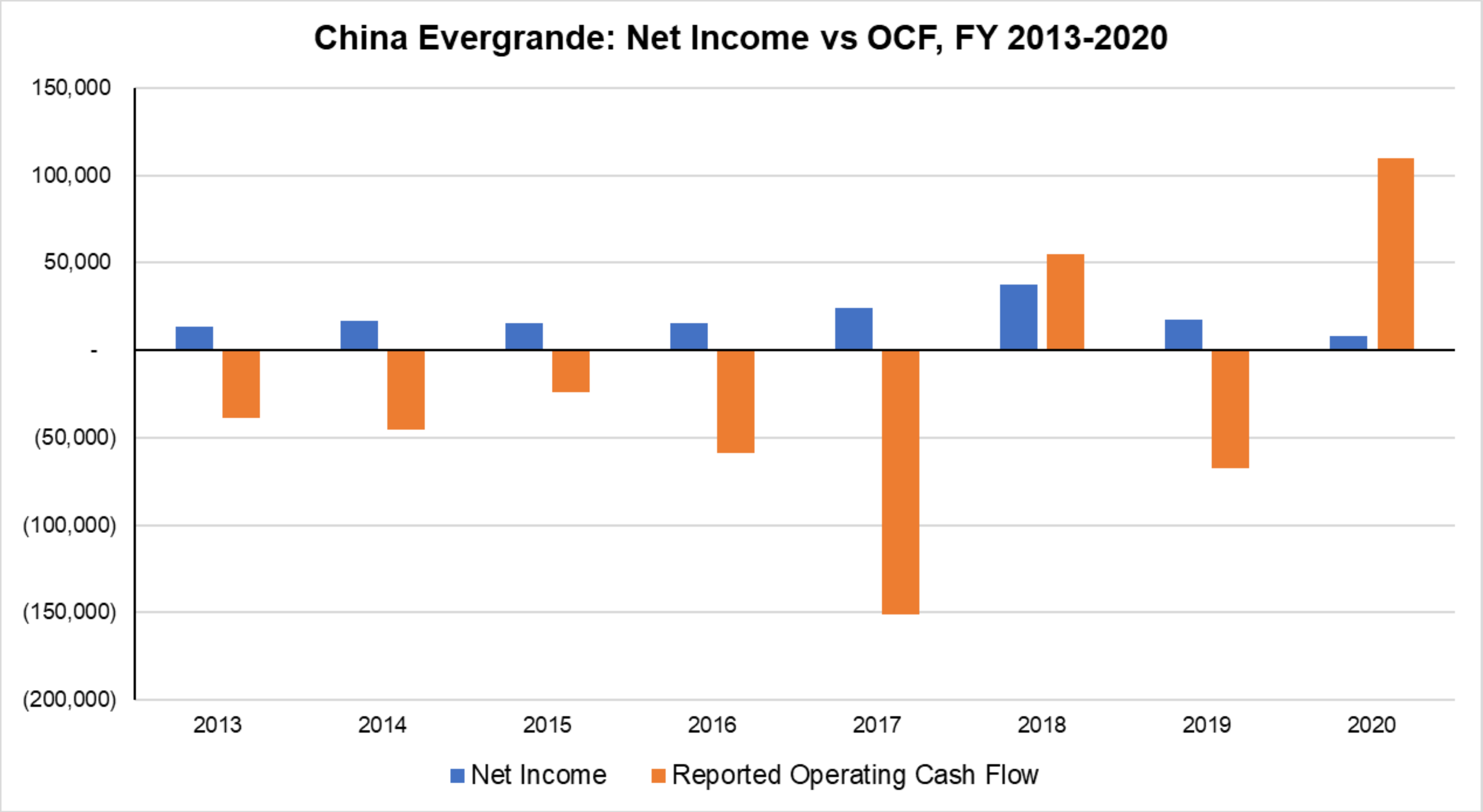
OPM: TSMC vs UMC vs GlobalFoundries



Further Elaboration of the Characteristics

- **Consistent Generation of Free Cash Flow**
- **More Important to Focus On Cash Flow than Accounting Profits**
  - Security Values Are Determined by Future Cash Flows
  - Day-to-Day Operations Are Run on the Cash-Flow Basis
  - Shareholder Returns Are Driven by (Residual) Cash Flows

Example: China Evergrande



THE OVERLOOK PARTNERS FUND, L.P.

Further Elaboration of the Characteristics

- **Consistent Generation of Free Cash Flow**
- **More Important to Focus On Cash Flow than Accounting Profits**
- **Some Definitions of Cash Flows**
  - Reported Cash Flow from Operation
  - Free Cash Flow to Firm (FCFF) & Free Cash Flow to Equity (FCFE)
  - Owner Earnings
    - NI + DA ± Non-Cash Items ± Chg in WC – Maintenance Capex
    - Maintenance Capex Need to Be Estimated Subjectively; Depreciation Might Be Used As a Crude Approximate

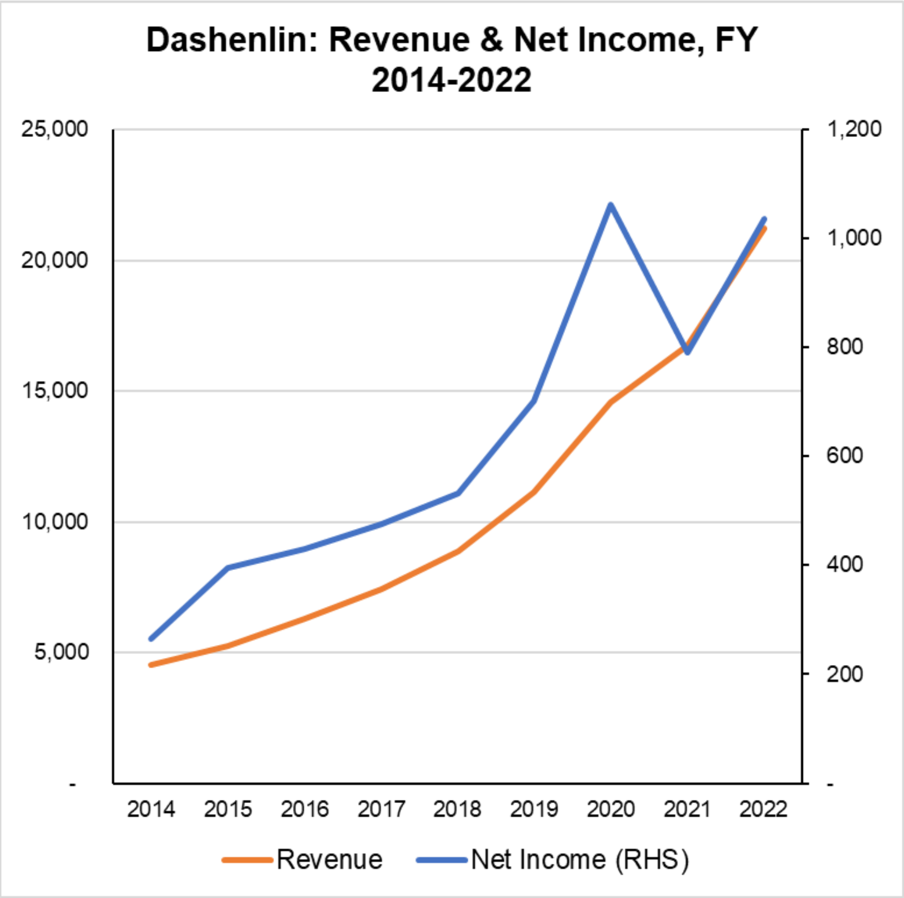
Further Elaboration of the Characteristics

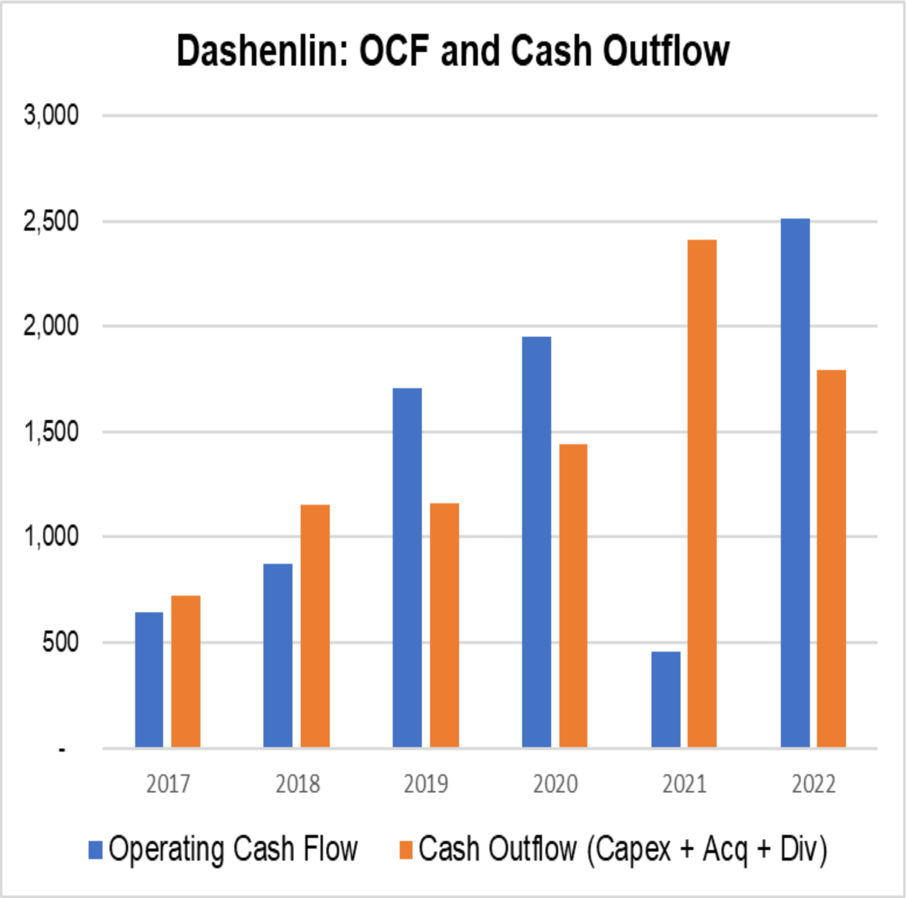
- **Consistent Generation of Free Cash Flow**
- **More Important to Focus On Cash Flow than Accounting Profits**
- **Some Definitions of Cash Flows**
- **Measuring “Consistent Generation”**
  - Cash Flow Conversion Ratio: Cash Flow / Net Income
  - Cash Flow Margin: Cash Flow / Revenue
  - Cash Flow Growth

Further Elaboration of the Characteristics

- **Self-Financed Growth**
  - Ability to Fund Its Growth with Cash Generated Operationally
- **To Generate Growth, Companies Need to Invest, Which Leads to Cash Outflows**
  - Main Usages of Cash Flows:
    - Capex & Working Capital
    - Operation: R&D, Marketing, Employees, Rents, etc.
    - M&As
  - External Financings Needed If Cash Generated < Cash Required
  - As a Result, Existing Shareholders Will Be Diluted
    - New Share Issuance => Direct Dilution
    - Debt Issuance => Profit Shared with Creditors

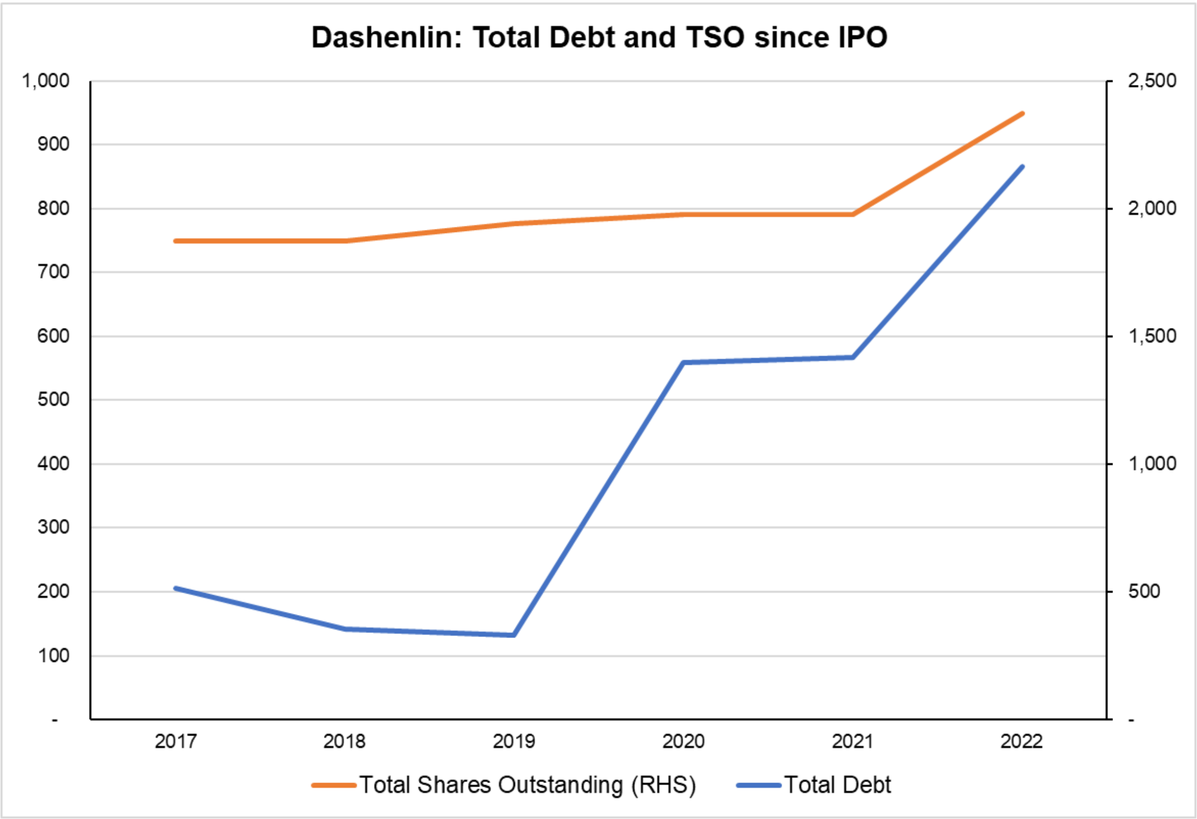
Example: Dashenlin Pharmacy





THE OVERLOOK PARTNERS FUND, L.P.

Example: Dashenlin Pharmacy

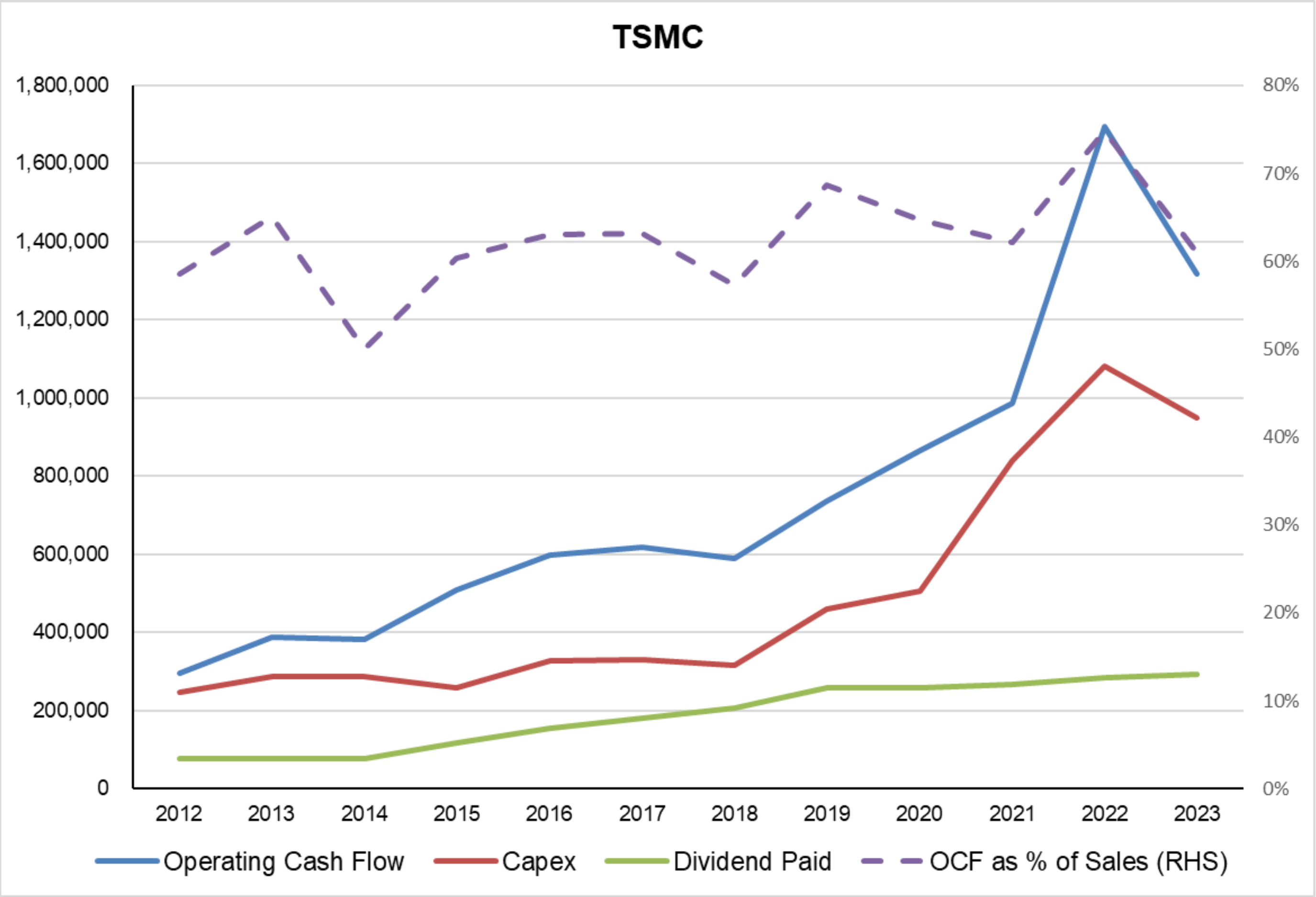


THE OVERLOOK PARTNERS FUND, L.P.

Further Elaboration of the Characteristics

- **Self-Financed Growth**
  - Ability to Fund Its Growth via Self-Generated Cash Flow
- **Some Favorable Traits to Look For**
  - High Cash Flow Generation
    - As Mentioned in “Consistent Generation of Free Cash Flow”
  - Negative/Low Working Capital
    - Net Working Capital = Account Receivable + Inventory – Account Payable
    - Net Working Capital Days = AR Days + Inv Days – AP Days
  - Low Capex Intensity
    - Capex as % of Sales

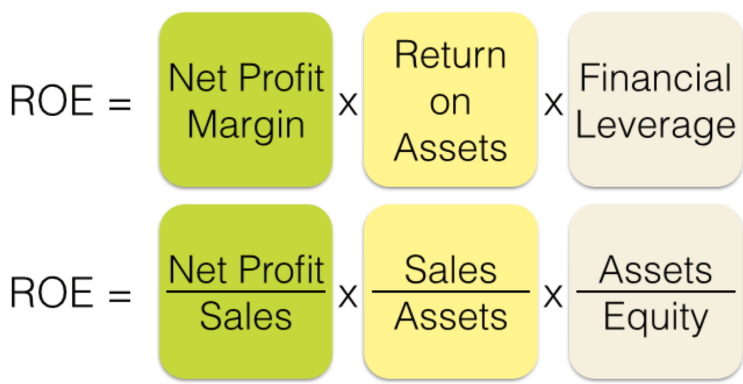
Example: TSMC

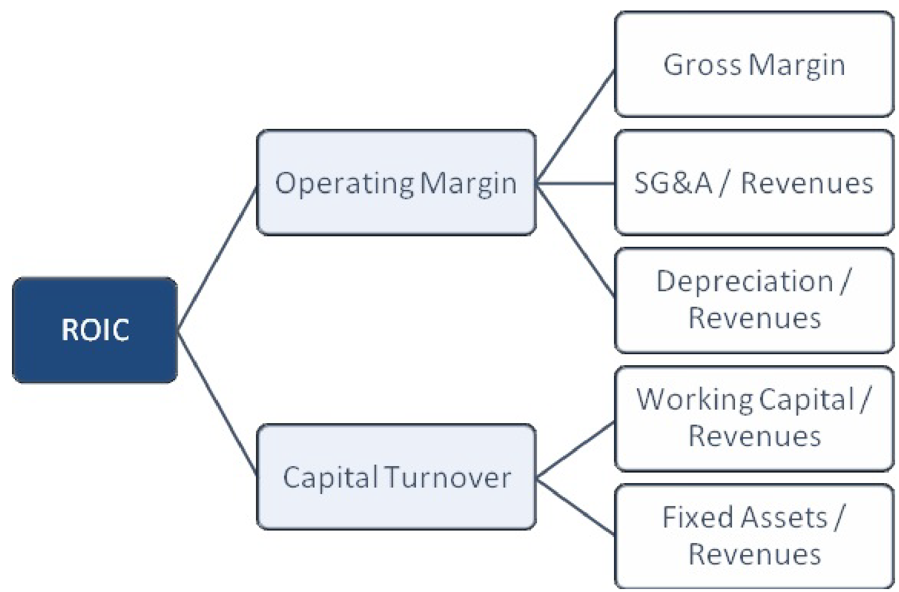


THE OVERLOOK PARTNERS FUND, L.P.

Further Elaboration of the Characteristics

- **High Rates of Business Returns**
- **Two Important Returns**
  - Return on Equity (ROE)
  - Return on Invested Capital (ROIC)
- **Further Breakdown of the Returns Provides More Insights**
  - ROE: DuPont Model
  - ROIC Tree





Picture credit: Meaden&Moore, Founders Advisors

Example: DuPont Model

- **Two Companies Both with High ROEs**

YE = Dec In CNY mn	2018 A	2019 A	2020 A	2021 A	2022 A
Return on Equity	21.7%	25.5%	28.3%	31.1%	33.3%

YE = Mar In USD mn	2019 A	2020 A	2021 A	2022 A	2023 A
Return on Equity	14.6%	16.8%	31.2%	47.5%	30.4%

Example: DuPont Model

- **The High ROEs Are Driven by High Profit Margins**

YE = Dec In CNY mn	2018 A	2019 A	2020 A	2021 A	2022 A
Return on Sales	26.7%	29.3%	36.1%	38.5%	41.3%
Asset Turnover	0.62x	0.61x	0.52x	0.53x	0.53x
Return on Assets	16.5%	18.0%	18.8%	20.3%	21.9%
Leverage (Assets/Equity)	1.32x	1.42x	1.50x	1.53x	1.52x
Return on Equity	21.7%	25.5%	28.3%	31.1%	33.3%

- **The High ROEs Are Driven by High Leverages**

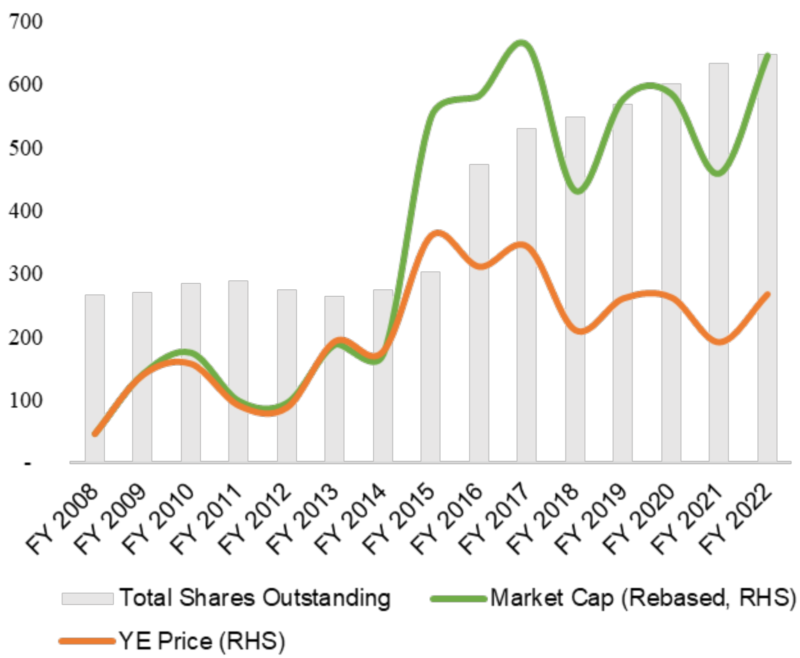
YE = Mar In USD mn	2019 A	2020 A	2021 A	2022 A	2023 A
Return on Sales	1.3%	1.4%	2.0%	2.8%	2.6%
Asset Turnover	1.75x	1.63x	1.73x	1.74x	1.48x
Return on Assets	2.2%	2.3%	3.5%	4.9%	3.9%
Leverage (Assets/Equity)	6.57x	7.24x	9.05x	9.65x	7.89x
Return on Equity	14.6%	16.8%	31.2%	47.5%	30.4%

Which One Do you Prefer?

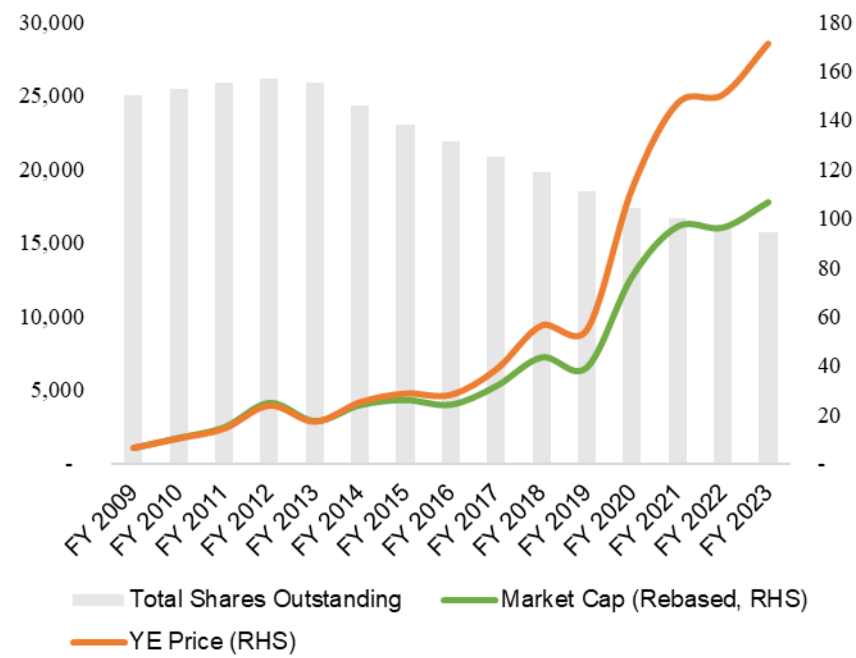
Further Elaboration of the Characteristics

- **Superior Long-Term EPS Performance**
- **Important to Focus on EPS Rather Than Total Earnings**
  - Takes Share Dilution Into Account
  - Sources of Dilution: External Financing, ESOP

Trip.Com: YE Market Cap vs YE Price



AAPL: YE Market Cap vs YE Price

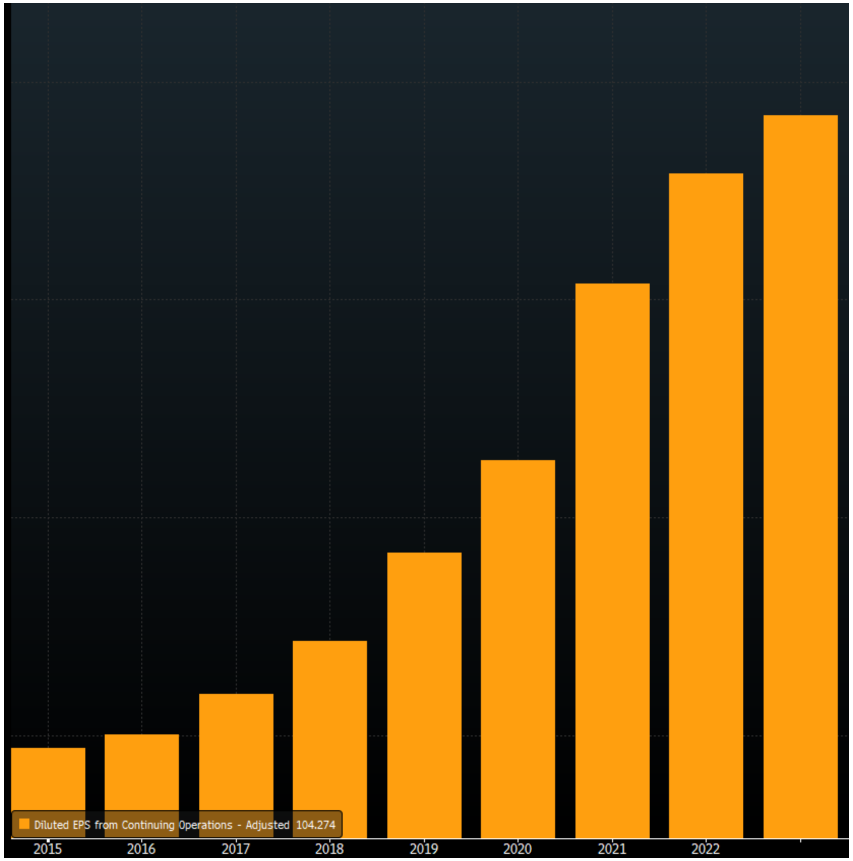


Further Elaboration of the Characteristics

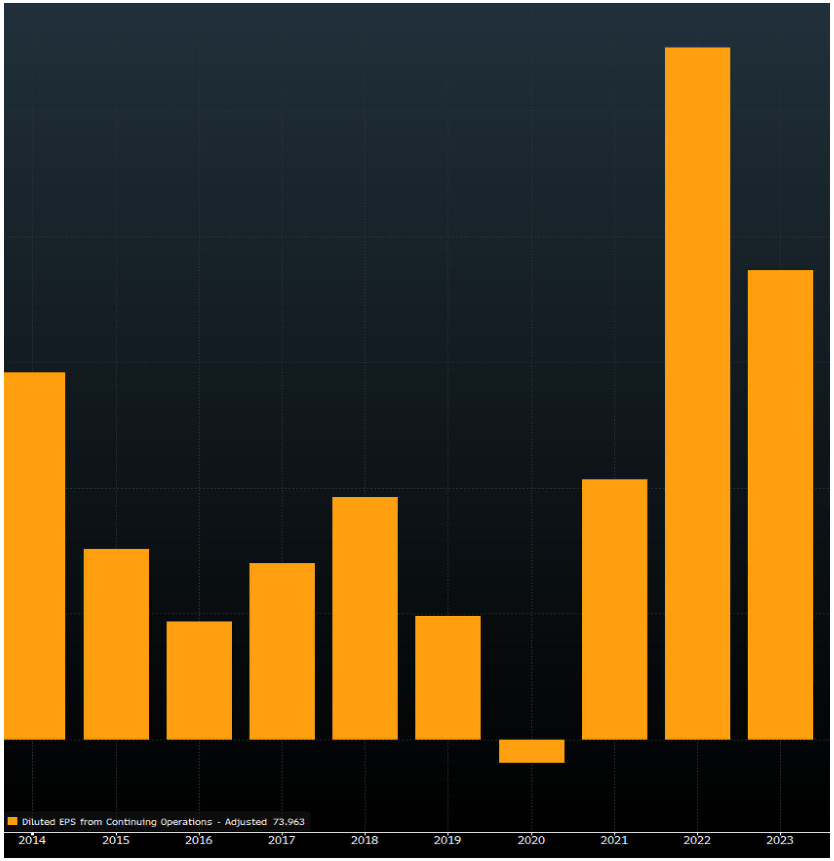
- **Superior Long-Term EPS Performance**
- **Important to Focus on EPS Rather Than Total Earnings**
  - Takes Share Dilution Into Account
  - Sources of Dilution: External Financing, ESOP
- **Examples of Superior Performances**
  - Stability/Consistency of Growth
    - Predictability of EPS
  - Long-Term Compounder

Example: Consistency of Growth

Microsoft



Exxon Mobil



Which One Is Easier to Forecast?

The Overlook Partners Fund, L.P.

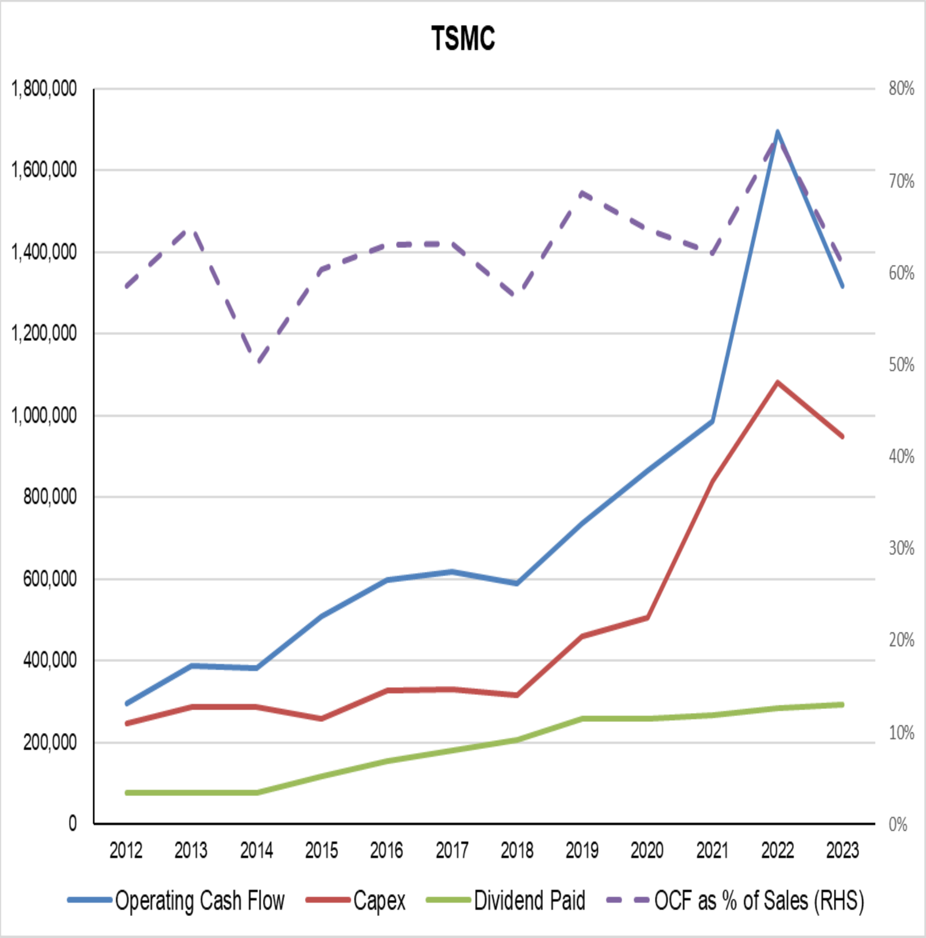
Further Elaboration of the Characteristics

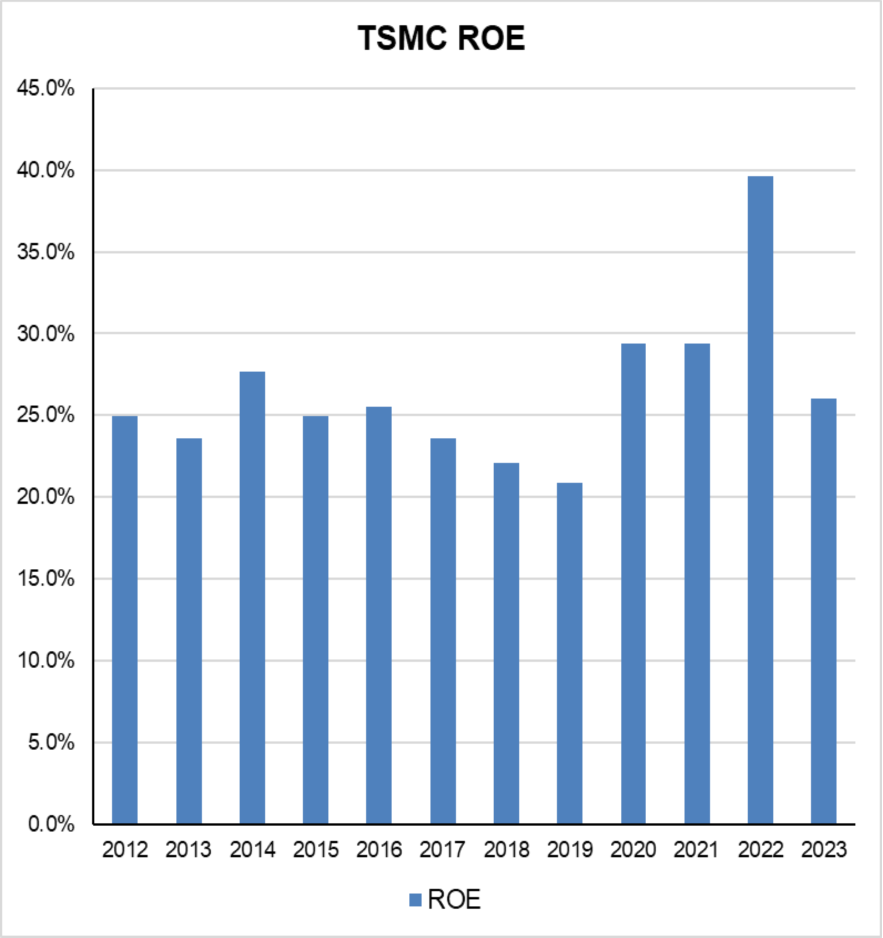
- **Superior Long-Term EPS Performance**
- **Important to Focus on EPS Rather Than Total Earnings**
  - Take the Dilution Into Account
  - Sources of Dilution: External Financing, ESOP
- **Example of Superior Performances**
  - Stability/Consistency of Growth
    - Predictability of EPS
  - Long-Term Compounder
- **Potential Measures to Use**
  - Volatility of Growth (Std Dev, Range)
  - # of Negative Growth in Past X Years
  - Multi-Year EPS CAGR

Further Elaboration of the Characteristics

- **Returns for Shareholders**
- **Superior Businesses Can Generate Good Cash Flows**
- **But Shareholders Can Only Benefit When Those Cash Flows Are Allocated Wisely**
  - Spend on Growth ("Self-Financed Growth")
    - Internally: On Projects that Can Generate High-Enough Returns
    - M&A: Improvement for Core Business (Synergy), Reasonable Valuation
  - Returns Excessive Cash to Shareholders
    - Dividends and Buybacks

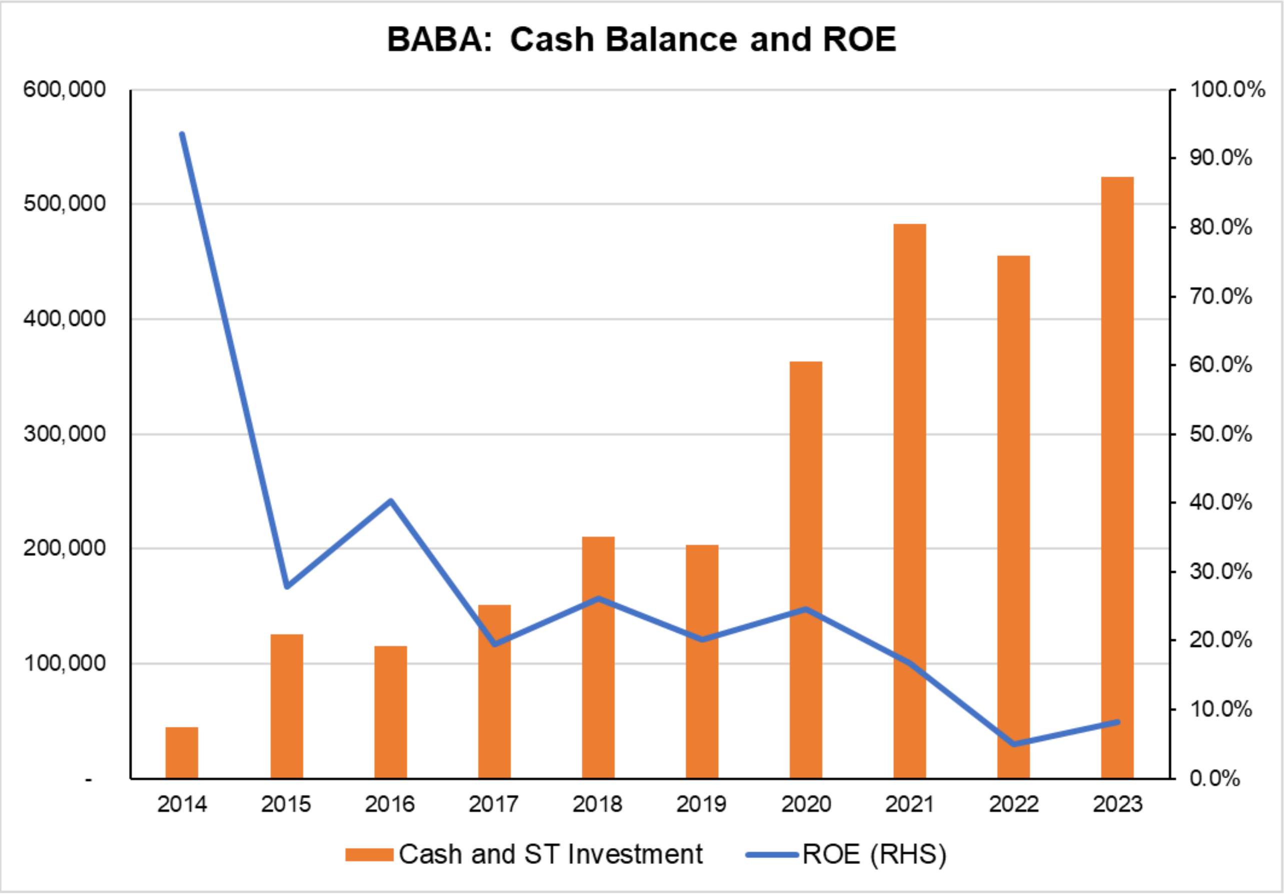
Example Revisited: TSMC





THE OVERLOOK PARTNERS FUND, L.P.

Example: Alibaba



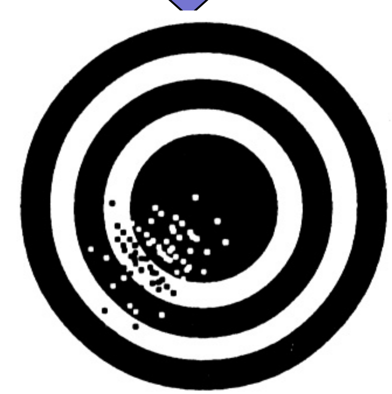
Idea Generation: Rifle vs Shotgun

Bottoms-Up Approach

- Begin with Single Stock or Subsector in Mind
- Build up Knowledge Base & Understanding
- Go deep

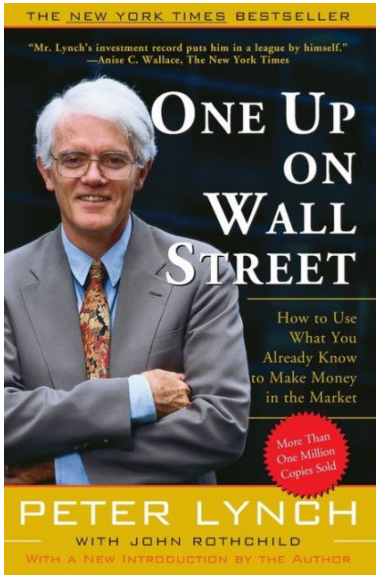
Top-Down Approach

- Start with Wide Investible Universe
- Narrow Down Based on Multiple Criteria
- Can add Macro Overlay
- Output = Short list



RS FUND, L.P.

Bottoms-Up



- **"If you like the store, chances are you'll love the stock" – Peter Lynch**
  - Technology Stocks: AAPL, MSFT, Spotify
  - Brands: Lululemon, Nike, Adidas
- **Individual Investors Can Have an Edge over Professional Fund Managers**
- **Start with A List of Companies You Like, and Use the Characteristics as A Reference Check List**
  - Great Products ≠ Great Companies/Investments
  - Important to Go Back to Financial Numbers

Top-Down: Stock Screening

- **Pick the Desired Criteria**
- **Start From the Whole Investable Universe, Or Pick A Few Industries that You Are Familiar With**
- **Time-Series Perspective**
  - Consistency / Stability, e.g., Std Dev of 5-Yr Margins
  - Improvement / Growth, e.g., 5-Yr EPS CAGR
- **Cross-Sectional Perspective**
  - Across the Investable Universe, e.g., top 10% OPM
  - Industry Neutral, e.g., Top 20 Companies with Highest OPM from Each Industry

In Summary…

- **“Top-of-Pyramid” Companies Tend to:**
  - Have Dominant Market Shares and Pricing Power
  - Strong Cash Flow Profile
  - Generate Good Business Returns
- **Together, With a Good Management Team, Can Lead to Superior EPS Performance and Investment Results**
  - Without Badly Overpaying
- **Find a High-Quality Company Trading At a Cheap / Reasonable Price**
  - Bottom-Up / Top-Down

Overlook Believes Stock Returns Are Driven by:

Earnings & Dividends Growth

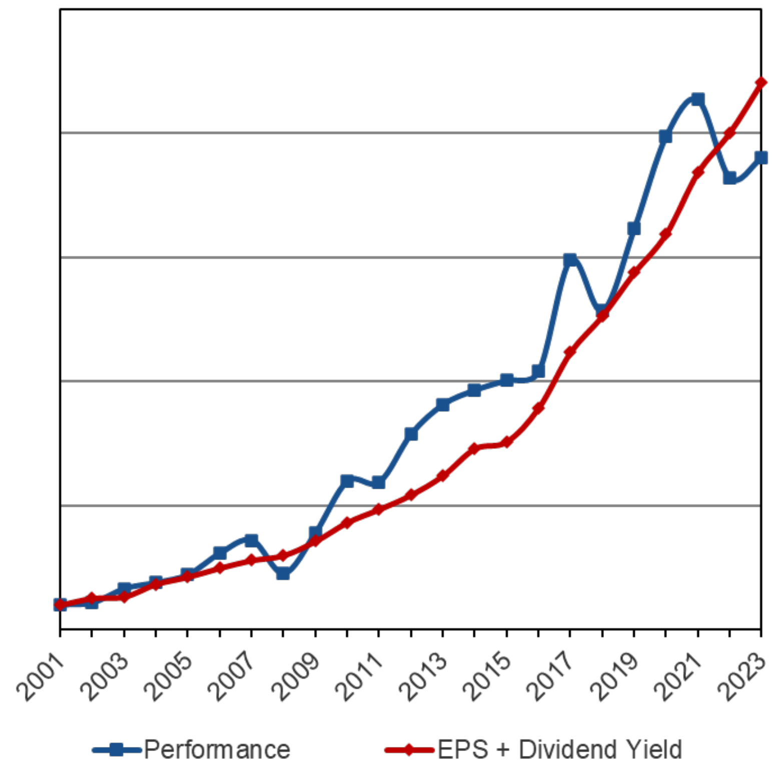
+

Dividend Yield

±

Valuation Re-/De-Rating

Performance vs. EPS + DPS Yield



Thank You

THE OVERLOOK PARTNERS FUND, L.P.