Columbia Business School

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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"It Is The Judgment That Counts" — Michael Price

Mr. Price began his career in 1973 when he joined Max Heine at Mutual Series. In 2001, he left the firm to begin his own fund, MFP Investors, LLC. He earned a Bachelor in Business Administration from University of Oklahoma.

G&D: You have been involved in distressed and special situation investing for a long time. How has your strategy evolved and what is the mix today?

Michael Price (MP): It has evolved indeed. As a small mutual fund at Mutual Series, we had no say. We had small amounts of stock. We could not influence proxy fights. We always had value and we always had situations involving corporate control. When the funds got bigger, we realized that we could use our significant influence for the betterment of our position, and that of all the other shareholders. We did that for a while, and then I got out of the fund business. Now I am back to a small, family office kind of fund, where we don't have that clout, but we try and influence directors and officers just because of our point of view that we think is well thought out. That is how it has evolved. We

Michael Price

don't take controlled positions. We don't try and force things to happen anymore.

G&D: Activism is the new buzzword. What do you think about it?

MP: There is nothing new under the sun. We used

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"Big Companies In Small Industries" — Paul Johnson

Paul Johnson manages Nicusa Capital, a long-term concentrated fundamental value hedge fund. He began his career as a sell-side analyst at several Wall Street firms. He has previously taught Security Analysis and Value Investing at Columbia Business School as an adjunct professor.

Mr. Johnson holds a B.A. from UC Berkeley and an M.B.A. from Wharton.

G&D: Tell us a little about your background and how you got into value investing.

Paul Johnson (PJ): In the early part of my career, I was a sell-side technology analyst. I worked for various firms on Wall Street for twenty years. I was one of the senior technology analysts on the Street during the tech bubble of the late '90s and watched that market crash, which had a big impact on my thinking. That experience reinforced how critical the intrinsic value of the underlying company is to the

Paul Johnson

ultimate performance of a stock. One can try to play the game of outguessing where a stock price is going,

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Pictured: Howard Marks at the Columbia Investment Management Conference in February 2011.

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but in the end, the market is going to gravitate to the intrinsic value of the business. If you do not have a good handle on the economic value of the company in which you are invested, you really are just playing a bit of a carnival game. I had also been an adjunct professor at Columbia Business School teaching Security Analysis and Value Investing for over ten years. The teaching experience forced me to think deeply about what investing is really about, as opposed to just being an analyst on Wall Street. Because of these experiences, I was drawn to the notion of intrinsic value-based investing, which draws one into the value investing world.

G&D: How would you describe the investment strategy at Nicusa?

PJ: By definition, nearly everyone who is a long-term investor trying to buy things at less than intrinsic value is a "value investor." The phrase that we use most often is that we are "fundamental" investors. We try to find the fundamental value of the operating business. We are much more drawn to income statements than we are to balance sheets; balance sheets are important and can harpoon an investment, but we do not start with the balance sheet. We start with the income statements, the business prospects and the quality of the business. We then look at the balance sheet to make sure there is consistency. The balance sheet can uncover issues which may preclude an investment, but a balance sheet will not make an investment for us. We focus on the operating results. We're long term investors, so we're looking at the long-term cash flow of a business, which means that we are looking at the quality of the business. To evaluate that quality, we are looking at what Professor Greenwald has pioneered: the notion of the business's competitive advantage. We look for barriers to entry, economies of scale, and consumer captivity. Our goal is to buy great businesses that are undervalued. There are two components to our approach: finding a great business and one that is undervalued. For a company to qualify as great to us, we want it to be growing faster than GDP in a defensible market where that growth is coming from within that franchise. We want the barriers to entry to be large and defensible, and the company should have some sort of scale economics because that's where the excess returns come from. On the valuation side, we take the company apart and look at the cash generation of the business as if we owned the whole company and could take the cash home every year and re-deploy it. We look at how much we have to pay for those cash flows versus the quality of the business. In general, we stick to a hurdle rate of about 10%, meaning we want a business that we can buy at a 10% cash yield or an enterprise value multiple of ten times free cash flow.

"For a company to qualify as great to us, we want it to be growing faster than GDP in a defensible market where that growth is coming from within that franchise. We want the barriers to entry to be large and defensible, and the company should have some sort of scale economics because that's where the excess returns come from."

G&D: How does that compare to the profile of an ideal short candidate?

PJ: Shorts are very much the mirror image of that,

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with one exception. When a short position goes against you, it becomes a bigger part of your portfolio, and therefore we hold smaller short positions. Shorts have what a lot of people refer to as "infinite upside." They do not really have infinite upside, but they have higher upside than downside. Also, whereas in a long we want a solid balance sheet, on a short we want a company that is losing money and has a minimal amount of cash on their balance sheet relative to the cash drain. We then look at the company and decide if we want to bet against the long-term quality of the business. On a long we look for barriers to entry, and on a short we want no barriers to entry. We want a company where even if they reach their full potential, it will still be an uninteresting business. We want a company with low gross margins, no customer captivity, no natural economies of scale, and low barriers to entry. Ideally, we want a company that is losing money, a balance sheet with some financial pressure on it, and a company with a low probability of developing into a great business. We think those conditions make for an interesting short.

G&D: How do you think about building a portfolio of longs and shorts?

PJ: One needs to ask a couple fundamental questions when constructing a portfolio. First, is the portfolio going to be concentrated or diversified? Diversified is somewhere between 50 and 200 names. Concentrated can be as few as 4 or 5 names. We have settled in the range of 10-12 names, with each position roughly the same size when we initiate it, although as time progresses that balance tends to move around. The next question is the holding period. Because we are looking at the fundamental economics of the business we tend to be longer-term investors. Because we want to make bets on specific companies, we are concentrated. However, the fewer positions in the portfolio, the more the long-term performance will ride on the success of each investment. As a consequence, the moment the portfolio is concentrated, the better you must know the true intrinsic value of a companies invested. We are research-intensive. Our portfolio is concentrated in 10-12 names, with a holding period of roughly 2-3 years.

G&D: You tend to look at smaller and even micro-cap companies. Why focus your efforts there?

PJ: Market efficiency tends to be correlated with the number of market participants in a stock. The larger the market cap, the greater the number of people looking at a name. We have found that smaller market cap stocks tend to have fewer participants, which lends itself to a more inefficiently-priced security. Because we are a relatively small fund, we have the ability to go into smaller-cap names. As we get bigger, some of that will go away, and when we got started we could look at even smaller companies than we do today. We can go down to $50-100 million market cap companies, and that part of the market tends to be less efficiently priced, so we think that there is more opportunity for excess returns.

G&D: You said that you target buying at an enterprise value of around 10 times free cash flow. How do you think about the process of valuation? Some people are very disparaging of DCF. What do you think?

PJ: It's taken me a long time to get my hands around this issue, and I do think that this is the most challenging part of investing: what is something worth? For a fundamental investor, it's either the assets that represent the intrinsic value, which orients the analysis to the balance sheet, or it's the cash flows from the ongoing business that determine the intrinsic value, which sends the analysis to the income statement. We're very much interested in the operating value of these companies, being sensitive to the

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"We can go down to $50-100 million market cap companies, and that part of the market tends to be less efficiently priced, so we think that there is more opportunity for excess returns."

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risks associated with the balance sheet.

Once you start to look at the economic value of the operations, you are really concerned with the economic earnings of the business, not the accounting earnings. It is the cash the business generates that creates its value. However, you have to be careful with this analysis. It is not the operating cash you are after, but the free cash flow that can either be invested back in the business or redeployed in some other opportunity. We are very careful about cash flows. We make adjustments to the true cash expenses of running the business to get to a real operating cash flow. We try to look at it as if we were running the business. We care about the cash coming into the business and the cash expenses going out. Taxes are important, because they have to be paid, so we do not look at EBITDA because that's really only halfway through the process. You also need to think about depreciation and capital spending. Depreciation is an accounting estimate of the economic erosion of a company's assets. If it's a bad estimate, then we need to find a better estimate of the true economic cost of operating the assets. We like businesses that are capital-light, and therefore that part of the analysis is generally not critical. Although depreciation usually is not a large number in many of our investments, we still need to understand all of the capital needs of operating the business.

"Growth is a critical component of value creation for shareholders. There are important subtleties to growth of course, but if you are not paying for growth then it is a free option, and if that company delivers growth, that will be part of your excess return. It has to be profitable and defensible growth, which means it has to be within their franchise."

Once we have done all of those calculations, we get to what we define as free cash flow. In simple terms, our definition of free cash flow is the excess cash that the Company has at the end of the day, the month, or the quarter that can be removed from the business because it is not needed to generate future cash flows. To value those free cash flows we use a simplified, no growth DCF model, which essentially is a simple multiple. When we started we used a complicated DCF model, but we quickly found that it is nearly impossible to accurately forecast cash flows far enough into the future to complete the DCF analysis. In our analysis, we use current free cash flows, scrubbed of any accounting anomalies and normalized to make sure they accurately depict the ongoing cash generation of the business. Our cash flow calculation usually contains little or no growth. Throughout the analysis we are concerned with the quality of the business and the duration of those cash flows. A company with low technology risk and high barriers tends to have a longer duration than a technology company with high technology change and low barriers.

G&D: Even though you don't pay for growth, it sounds like one of the criteria you're looking for in an investment.

PJ: Growth is a critical component of value creation for shareholders. There are important subtleties to growth of course,

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but if you are not paying for growth then it is a free option, and if that company delivers growth, that will be part of your excess return. It has to be profitable and defensible growth, which means it has to be within their franchise. You cannot pay for acquisition growth, because that generally does not generate economic value for the acquiring company. You cannot pay for growth outside of their franchise because that tends not to generate excess profits. In all of these cases, you may get revenue growth, but you are not going to get excess cash flow growth (beyond what was paid for) and you are certainly not going to get an increase in the economic value of the business.

G&D: You are typically a significant shareholder, given the small companies you target and your long-term horizon. How involved do you tend to get with the companies?

PJ: We have become increasingly active in our companies. We believe there are two kinds of activism, the more traditional activism and what we call friendly activism. We start every relationship with friendly activism. We inform the company that we are now a 2% or 7% shareholder, letting them know who we are, how we think, and why we are invested. As long as managements and boards do what we think is in the best interest of long-term shareholders, then we are going to stay in that friendly activist role. We tend to have an active dialogue with the company regarding their corporate strategy, investor relations, capital allocation and compensation, although we do not get involved in the daily operations of the business. If the company starts doing things that are not in the interest of long-term shareholders, we get a bit more active in the traditional sense. We will call or write letters letting them know that their actions are not serving shareholders and we have found that those conversations usually result in a fairly constructive dialogue. If the behavior continues to be a problem or management continues to do things that we do not think are in the interest of shareholders, we will become much more active. In terms of pure activism we have dealt with two specific situations. However, even when we get aggressive, we still try to maintain a friendly approach. We have been forced to become more aggressive with two companies over the last few years. In terms of friendly activism, we do that with all of our companies.

"We tend to have an active dialogue with the company regarding their corporate strategy, investor relations, capital allocation and compensation, although we do not get involved in the daily operations of the business. If the company starts doing things that are not in the interest of long-term shareholders, we get a bit more active in the traditional sense."

We do not go into any investment with the thought that we will get them to change their operating procedure or their business strategy because of our investment. We are not active on day one. We go in with the intention of investing in a friendly position. Over time we may encourage management to make certain strategic changes, but we always do it in a friendly manner. It's only after they have proven that they need some external pressure that we become more assertive.

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Pictured: Steve Eisman at the Columbia Investment Management Conference in February 2011.

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G&D: Could you walk through how that's turned out in a past investment?

PJ: We were a 5-6% shareholder in a company called Metropolitan Health Networks based in Florida. We first got involved with the company when the stock was at 79 cents and then bought some more at 83 cents. Over time the Company performed well. We thought the stock continued to be cheap as the Company's financial performance grew faster than the stock price. The Company then went through a period of stagnation both in business activity and the stock price. There were some internal battles between the management and the board regarding strategy. As we got to understand the dispute more clearly, we were very much on management's side. In December 2009, out of the blue, the Company announced that the CEO was resigning. We found this disturbing because we were very much in his camp and not very fond of the Board. In early January of 2010, we wrote a letter to the Board expressing those concerns and requesting that the CEO be reinstated, which is an unusual position to take. Several large shareholders approached us and it became clear that they also supported the CEO. We believed that we had enough shareholders to force a proxy battle if we wanted and we presented that information to the Board. In April 2010 the old Board resigned and a new Board was put in place. The new Board rehired the former CEO, the company was unleashed from the constraints of the old Board, and management started to execute on their business plan in a much more aggressive way.

With settlement in Washington over the future of the healthcare bill, many of the issues overhanging the industry were settled and the Company's financial performance improved impressively. The stock was in the $2 range in early 2010 and ended the year at roughly $4.50. The new Board is much better qualified and more in sync with management, and we believe it contributed to the stock doubling last year. This was a case where escalating our involvement and doing what was in the best interests of shareholders served us well.

G&D: Why did you decide it was worth it to get involved rather than sell the position and move on?

PJ: Two aspects of the company kept us in it. One, it was a cheap stock all the way through. I do not think at any point it traded at more than six or seven times free cash flow. Perhaps that is what some people think the business is worth. However, if you do the math, six or seven times free cash flow is a 15% cash yield. We were getting 3-5% growth on a 15% cash yield. Given that return, I would want to own the stock for as long as I knew that the Company's free cash flow would continue, regardless of other investors' opinions about the Company. The quality of the business was important, but the valuation was very attractive, and we never found ourselves at a point where we thought the stock was fully valued.

We were happy with something that some people thought was correctly valued but had such a high cash yield because of our assessment of the quality of the business. The Company provides all the services for Humana in certain parts of Florida. If you are a Humana customer in this area of Florida, you are being served by Metropolitan Health. Some investors do not like the fact that MDF is captive to Humana, since Humana could, in theory, terminate its relationship with MDF with only short notification. On the other hand, Humana has no other place to put these customers. Because each provider must have contracts with doctors, labs, and hospitals, there are natural local economies of scale in the business. Metropolitan dominates several of these markets and Humana has no choice but to work with them.

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Pictured: Tom Russo at the Columbia Investment Management Conference in February 2011.

There had been a lot of controversy in the healthcare industry and that had dampened overall valuations. There were concerns that the current administration wanted to eliminate health plans like that of Humana, causing many investors to avoid the area. We thought this was a business that would be difficult to replace and the controversies were fairly easy for us to get our hands around.

G&D: Can you share another example?

PJ: On the activism side, we are involved in a company called BioClinica. The Company's historical business is image management. If a pharmaceutical or biotech company is conducting a drug trial and trying to evaluate tumor shrinkage by using an image to prove efficacy, the company needs to get those images through the FDA process. The drug company needs to provide evidence that there has been a physical reaction to the drug and the images become critical to the process. BioClinica emerged as one of the largest companies in managing the image side of drug trials. They have economies of scale. We like that business. The Company has repeat customers and strong cash flow.

However, a few years ago management decided to invest in an adjacent business that we did not feel had the same attractive economics. We felt that the core business was valuable enough that we could live with management's new strategy, but in hindsight, that was a mistake. We should have sold the stock, but we stuck it out. It has taken management nearly three years to get the new business up and running. In the last eight months, we have been much more assertive in our communications with the Board, making sure that they hold management accountable for their execution. Any new acquisition should have an extra-tight filter to get through, and until the new business starts performing, management should be constrained in their ability to make additional large capital deployments. BioClinica also has a poison pill in place, which serves to protect management but not shareholders. We have actively pushed to have it removed and to hold the Board accountable for what we believe to be overly generous management compensation. The proxy vote is in May, so we'll see how other shareholders vote. We were attracted to the core business, but management began doing things that we did not think were in the best interests of shareholders, and we made our views very clear. The stock is trading where we bought the shares three or four years ago and the jury is still out how successful this investment will turn out to be.

> ***"We are interested in companies that are undermanaged and getting new management because new leadership is typically a catalyst, particularly when they begin to cut costs and accelerate growth."***

G&D: You mentioned that these active situations are rare. Can you share a more typical investment?

PJ: We are invested in a company called Accelrys, which we started buying a little bit over a year ago. The Company makes software for computational chemists and biologists, specifically aimed at pharmaceutical and biotech companies. The software assists with data management during the R&D process. The

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Company has a strong set of products, but had been undermanaged for a number of years before new management came in 2009 and 2010. We are interested in companies that are undermanaged and getting new management because new leadership is typically a catalyst, particularly when they begin to cut costs and accelerate growth.

Accelrys's valuation was attractive. We began our research in late 2009 and started buying the stock in early 2010. In mid-2010, Accelrys announced that they were merging with Symyx, a company in the same business but with complementary products. The two companies would have a broader product offering and greater economies of scale. We usually hate betting on operating synergies, but we were comfortable that management would be able to combine the two products and emerge as the dominant vendor in their market. We evaluated the combined company as if it was a new investment. Again, we found the economics attractive and believe that the companies would be stronger together than stand-alone. The valuation of the merged entity looked as attractive as our original investment and we stuck with our position. Our average cost is roughly $6 per share, and the stock is currently trading near $8. The results are starting to come through. The opportunity for the Company over the next two years will be very high. If the company is successful, it will support a high valuation. It has upside both in growth and valuation. It's one of my favorite names in the portfolio because we can get multiple expansion as well as cash flow growth.

"A PM's job is very different. It's all about portfolio construction, position sizing, buy and sell disciplines, and risk management at the individual and portfolio level. The PM's job is to produce performance by building a portfolio correctly."

G&D: So you've been doing this for around...

PJ: I have been running the fund for a little over eight years and I have been on Wall Street in various roles since the early 80's.

G&D: What do you think are the advantages of one role over the other?

PJ: I have worked in two specific roles in my career. I was a sell-side analyst for 20 years and have run my hedge fund for the past eight. The two jobs are very different. A sell-side analyst's job is to follow a specific industry and to be perceived as one of the experts in that industry. Stock-picking ability is not nearly as important as knowing your industry and companies well. Sell-side analysts need to have industry expertise, access to management, detailed financial models, a sense of the history of businesses and where the industry is in its business and growth cycle, and an understanding of the competitive pressures between companies. There is a lot of marketing and investment banking involved in that role as well. In comparison, a buy-side analyst's job is to understand the companies they follow and to be able to find opportunities where there is a mismatch in value and price. Buy-side analysts have to be able to find companies that are mispriced, do the work to gain confidence in their analysis, and then convince the PM to put the stock in the portfolio.

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A PM's job is very different. It's all about portfolio construction, position sizing, buy and sell disciplines, and risk management at the individual and portfolio level. The PM's job is to produce performance by building a portfolio correctly. In addition to being a PM, I also am charged with running the business side of the hedge fund. In that role, I have to deal with investors, and administrative issues and payroll. To be successful in running a hedge fund, one needs to do many things well.

G&D: What do you wish someone had told you when you first opened the door?

PJ: There are lots of things that someone should have told me, although it is probably a good thing they did not because I may not have opened the door. The hardest parts of the new role for me to learn have been portfolio construction and risk management. I was an analyst for a long time; analyzing companies was a fairly straightforward process. I did a lot of rigorous analysis when I was a sell-side analyst, and that helped when I moved to the buy side. However, being a portfolio manager is tricky. Portfolio construction has a lot of subtlety, and risk management has even more. The tricky part is putting it all together.

G&D: Many students find time management to be one of the most difficult aspects of working on the buy side. How do you go about allocating your time day-to-day?

PJ: Time management is the biggest challenge we all face, not just professionally,

"… high quality research is going to be crucial to surviving in the business going forward. The markets are very competitive and crowded."

but in our personal lives as well. In the job, the hard part is to learn the things you do not have to do. I suspect most business school students were like me: the first week in the program, you try to do it all, and the next week you try to do it all again. By the third week, you start to filter what you need to do and what you don't. You try a few things and the ones that work you do again, those that don't work, you eliminate. In any job, the most important activity you want to accomplish is what your boss wants you to do. Very often people think, "I'm smarter than my boss, he wants me to do all these things that I don't need to do!" I encourage people to do what their boss asks them.

Second, you want to learn to think outside the norm. You want to look at situations differently in a way that creates opportunity. You look for investment ideas that make money; the individuals who are most successful in the business are the ones who quickly gravitate to this notion of finding investment opportunities. Sometimes ugly stocks make money, sometimes beautiful stocks make money. Peter Lynch used to say that he thought one of his great advantages in the business was that he came to work with no preconceived notions and no natural biases. He might make money in airlines one day and autos the next. He did not say "I hate autos" or "I hate airlines"; it all came down to opportunity. There might be times where you want to hate the autos because they're overpriced, or hate the airlines for the

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same reason. But you do not want to have any preconceived convictions; open-mindedness helps. You always want to be looking for opportunities. Third, high quality research is going to be crucial to surviving in the business going forward. The markets are very competitive and crowded. Everyone has access to Bloomberg and the Wall Street Journal, so you have access to those sources just to stay even. You have to be creative in finding ways to make money where nobody is looking. Clarity matters because there is a finite amount of time and you will need to allocate your time efficiently to find those opportunities. Think of it as a riddle and a puzzle, and you're trying to figure out the pieces.

G&D: You've also taught at Columbia as an adjunct professor. What do you think is the most interesting gap between academics and practitioners?

PJ: I think that there's a huge gap between the two, and I think that's unfortunate because we can learn from each other. The academics think in an evidence-based, bigger-picture way and are criticized that they've lost the forest for the trees. Practitioners say their theorems do not describe the real world and that what they say has little practical value. Practitioners, on the other hand, are pragmatic, realistic, and entrepreneurial. However, while their theories may work well in practice, they do not have the robustness needed to impress the academics. When I teach, I try to balance the two. There is a lot to learn from theoretical finance. Is it perfect? Absolutely not. There are big flaws in it, but I think there's a lot to learn from the historical evidence. Combine that with a practical nature and there are opportunities to exploit the two disciplines.

"When you find inefficiency, move to exploit it and possibly try to understand why the opportunity exists. For instance, when markets get chaotic, the academics try to figure out why, while the practitioners are exploiting the anomalies."

There's an old joke about two economics professors walking on the street. One sees a ten dollar bill laying on the ground, but does not pick it up because if it were real someone would have picked it up already. The practitioners would pick it up and have a laugh as they enjoyed a few pints of beer. That's the idea: the market is efficient except when it's not. When it's not, you should exploit the opportunity. When it is, you should remain patient. Understanding the academic side of what makes a market efficient gives you a leg up in this business. When you find inefficiency, move to exploit it and possibly try to understand why the opportunity exists. For instance, when markets get chaotic, the academics try to figure out why, while the practitioners are exploiting the anomalies. I have felt for a long time that there is a gray area between the two. When I teach, we spend time on theory not because I love it but because it gives a structure to think about finance problems. At the end of the day, though, you need to go out into the market and produce results.

G&D: Thank you for speaking with us.

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