December 13, 2023

THE LONG PULL: Einhorn, Japan, & "New" Value Investing

David Einhorn did a [podcast in July 2023] where he said something like "the old way of value investing is dead. But here's how we think the new way of value investing will look going forward."

Here's how Einhorn described the "old way" of value investing (emphasis added):

> *"The way that I would tend to have looked at things a long time ago was **buy things that are sort of cheap figure out that they're going to be a bit better** or maybe quite a bit better than the world generally understands often purchasing at times of dislocation like around when a spin-off happens or when there's extraordinarily bad news relating to a particular company and people are being emotional and selling.*
>
> *Then, **figure out that things either aren't that bad or they're a little bit better** and then **patiently wait for three months to go by six months to go by** the world to see that it's not quite as bad as you thought.*
>
> *[Then you'd] have the **traditional long-only retirement funds the big mutual fund complexes and whatnot come in and buy the stocks.** And they were so big in the market, those were the dominant forces in the market, that once they started buying, it was going to take them six months nine months a year to accumulate their position. **And you could just ride that flow the whole time.***
>
> *So the very simple [idea] is if you think [a stock that trades at] ten dollars and the world thinks it's going to earn $1 and you you think it's going to earn a $1.15, then you wait a year and they've made $1.15 instead of $1. And now it looks like they'll earn $1.35 the following year.*
>
> *And you get a 13 multiple on the $1.35 and you paid a 10 multiple on the $10 you just made 60 70 percent over 12 to 18 months.*
>
> *That's really what our business was."*

We can distill Einhorn's "old" value strategy into four steps:

1) Find stocks that are “sort of” cheap due to temporary issues that caused the stock to drop farther than what’s likely rational.
2) Realize that those issues are, in fact, temporary and not as bad as everyone thinks, and buy the stock at ~10x profits.
3) Wait 3-6 months until some larger fund recognizes what you’ve known for months and buys a ton of stock over the next 9-12 months.
4) Sell the stock for 13-15x profits and party.

However, Einhorn’s entire point is that this strategy no longer works. Why? There aren’t large, active funds finding undervalued stocks. Instead, passive indexes buy the same seven stocks on every rebalance.

This results in cheap stocks staying cheap, and nobody cares. If a tree falls in the middle of a forest, and nobody’s around to hear it, why should it trade at greater than 5x profits?

Back to Einhorn (emphasis added):

> *“**The problem is that those buyers aren't there anymore**. They don't have new money. They don't have daily flows. **They've turned passive**. The fees that they have for their active business have been cut dramatically so they've cut their research staffs. **They have to sell something to buy something.** They're not looking for that new opportunity the way that they had when they were getting constant positive flows.*
>
> *And so if you play out that same story and it's supposed to earn $1 and it turns out to earn $1.15. And you think now it's going to earn $1.35.*
>
> *I mean **maybe the stock is going to be 11** at the end of that 18 months and you'll have made 6% on your money. Which beats losing and it's better than cash.*
>
> *But **it's not really the exciting result** that you're able to get a year and a half ago.”*

A lot of value investors still play the old game. They’re constantly complaining on Twitter/X about how their cheap stocks are still cheap five years after they bought them. They mumble that nobody cares about their stocks. And they’re right.

Here’s the point. The solution isn’t for other people to notice your boring value stocks. It’s to adjust *your* strategy so that you don’t need others to notice your stocks.

Einhorn pivoted. And it's what makes him one of the best value investors in the game (emphasis added):

> *"The result of this though is is that you have this enormously bifurcated Market where* ***there's this wasteland of companies where literally nobody's paying attention and nobody is following****. Maybe they're sell side analysts but sell side analysts don't matter. They don't have any money they don't have any customers and the fact that they don't have any customers with any money is the important thing.*
>
> *It doesn't matter if there's 10 analysts recommending a stock if they don't have any customers that are going to follow the recommendations the point is is there's no buyers and* ***so you can have these companies that are essentially at a wasteland valuation.***
>
> *So you have these washed out securities and if they're trading now i****nstead of buying it at 10x earnings you can buy them at 4-5x earnings.***
>
> *And then you may not know whether it's going to be if you're wrong by 10%, a 5x becomes 5.5x and there's nobody who cares anyway.*
>
> *Nobody's going to sell because they missed by 10%.*
>
> *So* ***you don't really have to get your forecast right, you need to just start at such a low value*** *and if you do it in unlevered companies that are* ***taking the vast majority of that earnings yield and giving it to you in dividends or buybacks.***
>
> *This has to work itself out over time in a favorable way.* ***If you are buying back 15% of your company the stock goes up or in six and a half years there's no stock left*** *and the last share is the golden share*
>
> *That's what we want to own."*

The "new" value investing strategy is:

1) Find companies that nobody cares about that are trading at ridiculously low valuations.
2) Ensure that those companies will keep earning profits at some sustainable level.
3) Buy the ones explicitly saying, "we will return nearly 100% of our earnings to shareholders through dividends, buybacks, or both."

Do you notice the difference between the “old” and “new” strategies? The old value investing strategy relies on *external* opinion/influence to generate returns. You needed other funds with larger pools of capital to lift your ship.

The new strategy, however, relies on *internal* actions like buybacks and dividends to generate returns.

Now, who cares who hears it if a tree falls in the middle of a forest? The tree will chop itself into firewood and pay you for standing there.

I mention Einhorn’s podcast because Japan has been a valuation wasteland for thirty years. Every value-based stock screener is littered with Japanese companies. Even some trading at negative EVs with profits!

The problem with Japanese value stocks is that they’ve *always* been cheap.

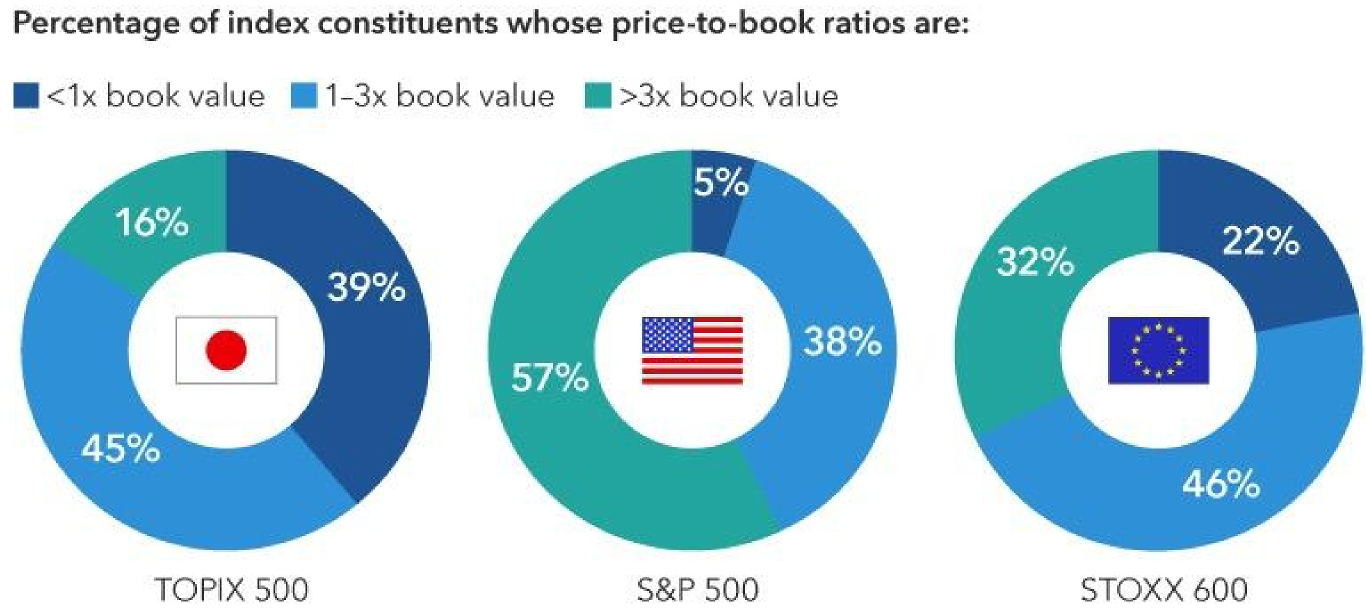
But that’s changing. And that change will create a fertile “new” value investing hunting ground.

Japan’s Value Revival

One way to close the discount-to-intrinsic-value gap is to hope and pray that investors see your discount and bid the stock to fair value. Another way is to have the leading stock exchange demand you close the gap. This September, Japan chose the latter (via Capital Group, emphasis added):

> *In terms of reforms, there is tremendous emphasis on improving corporate governance, and companies are focusing more on shareholder returns. In a recent move, the Tokyo Stock Exchange asked all listed companies to enact policies to improve profitability, long-term returns and valuations.*

For good reason, too. 39% of companies listed on the TOPIX trade below book value. This compares to 5% in the S&P 500 and 22% in the STOXX 600 (see below).



Sources: Capital Group, FactSet, Refinitiv Datastream, Standard & Poor's, STOXX, TOPIX. The price-to-book ratio is the ratio of a company's publicly traded share price to its equity value per share. As of August 18, 2023.

Capital Group sees other reasons to be bullish on Japan, including:

- ➢ Favorable valuations versus other markets
- ➢ Relatively stable political environment
- ➢ Reinvigoration in foreign manufacturing investment
- ➢ Tourism rebound post-COVID-19

There are many ways investors can win in Japan using Einhorn's "new" value investing strategy.

One way is for Japanese companies to start doing something with their excess cash. 49% of Japanese stocks have positive net cash balances. Compare that to 12% for the S&P and 11% for the STOXX 600.

The most apparent use of that cash is buybacks and dividends. Another less obvious use is take-private transactions.

One "problem" with excessively high net cash balances is that your company becomes a takeout target. If your stock trades at a $100M market cap, but you have $70M in net cash, an outsider could effectively buy the *cash-generating operations* for only $30M.

That's what happened to drug maker [Taisho Pharmaceuticals](). A family member, who owned 40% of the company, bid for the remaining 60% at a 50% premium to the most recently closed trading price. It's the largest take-private transaction ever in Japan.

Why could he pay such a premium? Because Taisho, a Y452B market cap company pre-bid, had Y260B in net cash and consistently generated ~Y50B in annual EBITDA.

Or take Outsourcing, Inc. (2427). This past week, [they announced a take-private MBO deal]() with Bain at a Y220B+ valuation, a 50% premium from the prior week's close.

Another way to reduce the valuation gap is via M&A, which the government is also incentivizing (see below).

Schoebs
@willschoebs

If acquiring 🇯🇵 SMBs could only become more attractive…👀

"Govt to allow up to 100% of the acquired stock acquisition cost from M&A to be considered as expenses (losses) for tax purposes."

7:36 PM · Dec 3, 2023 · **151.8K** Views

It's an M&A stimulus package where companies can acquire businesses and write off 100% of the acquisition cost to reduce taxable income.

Under the "old" value investing strategy, cheap Japanese companies would stay cheap. Today, they're buying back stock, going private at 50%+ premiums, and engaging in value-added M&A. They don't need outside investors to change the valuation. They can do it themselves.

The logical question is "which Japanese stocks should we focus on?" Capital Group offers some insight (emphasis added):

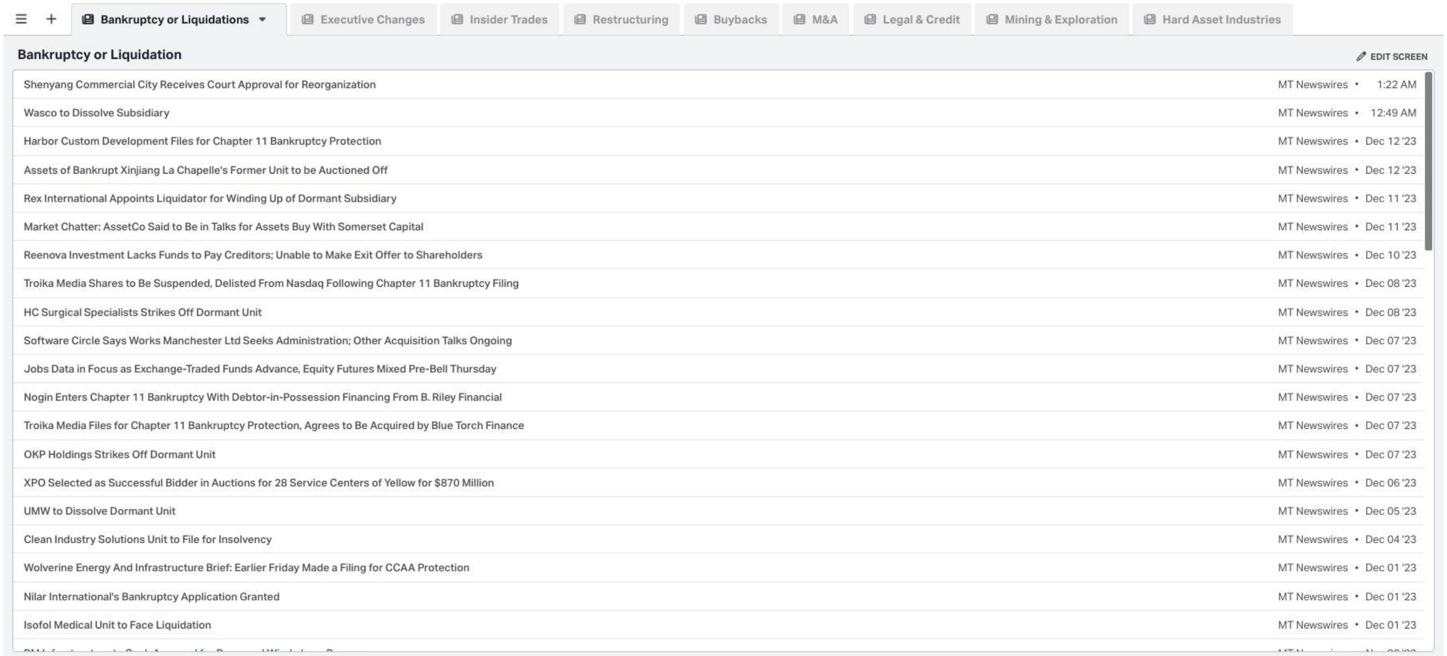
> *"Japanese firms have developed unique technologies in niche markets from which they've been able to build durable businesses with highly defensible moats. These include areas like* ***industrial automation equipment****,* ***sensors****,* ***inspection tools for semiconductor manufacturing****,* ***energy-efficient air conditioning systems*** *and* ***battery technology****.* ***Medical devices and pharmaceuticals*** *are other areas where Japanese companies have built market share.*
>
> *These types of companies should have long product cycles as we see an industrial renaissance in developed economies and ongoing industrialization in emerging markets."*

Within those industries, we should focus on companies with **high net cash balances**, a **long history of positive operating profits**, and some management directives to either buy back stock or pay special dividends.

This won't guarantee that you'll buy a stock *right* before a take-private. But at least you're in the right pond to find it.

I'm describing event-driven value investing. And you can't really screen for that. But that's why I love Koyfin (quick note – Collective members get 20% off Koyfin subscriptions!).

I created an Event-Driven Dashboard to find all buybacks, special dividends, or M&A opportunities (see below).



The Dashboard includes the following event-driven narratives:

- ➢ **Bankruptcy/Liquidation**
- ➢ **Executive Changes**
- ➢ **Insider Trades**
- ➢ **Restructuring**
- ➢ **Buybacks**
- ➢ **M&A**
- ➢ **Legal & Credit**

I'm finding a ton of Japanese companies on this list. It's one of the reasons why I wanted to write this piece.

We're in the early innings of a "new" value investing boom in Japan. One where companies take control of their valuation, buy back tons of stock, pay huge special dividends, and go private/merge at massive premiums.

Make Japan part of your weekly research process. I'd love to collaborate with other Collective members on event-driven Japanese ideas. There will be plenty to go around. Let's not miss it!