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A Private Equity Mindset in Public Equity Markets

"Everything should be made as simple as possible, but not simpler."
-Albert Einstein

I am a firm believer in the notion that if you cannot distill a topic down to its simplest and most basic elements, then you are not truly knowledgeable. In attempting to describe our investment approach in as few words as possible, a phrase stuck in my mind that roughly did the trick: private equity in public equity.

No doubt most are familiar with the corporate raiders that private equity funds are known to be. Some of these funds use deplorable tactics stripping investment targets and selling assets a la Gordon Gekko. However, I contend that many of these funds use important investing concepts and strategies that investors in public equities should be aware of and perhaps implement.

Finding What to Invest In

Private equity funds are generally purchasers of entire businesses, and they evaluate targets as such. They are not purchasers of securities to be sold for quick gains or losses in a week, a month, or a year. A fund may estimate the fair value of a business and attempt to buy it in entirety at a price lower than that estimate with the expectation of holding the business for many years. For the fund, there is value attributed to the actual ownership of the business.

Far too often, public equity investors (especially professional investors and analysts) attempt to derive the fair value of a business, buy at a discount to that value, similar to private equity funds, but subsequently sell their position once the market price increases and the discount is erased. This leads to excessive churn and requires a consistent litany of securities selling at adequate discounts, something that is frequently (and currently) unavailable. This methodology is used in the spirit of value investing but in reality it's about as much value investing as AstroTurf is grass.

These investors forget that there is significant value in the ownership and performance of a great business, especially when shares are bought at a discount to fair value. In a similar vein, Warren Buffett has frequently stated his goal is to buy wonderful business at fair prices. He isn't selling them once the price increases ten or twenty percent.

Private equity funds also give greater weight to certain factors that many investors frequently give little consideration to. For instance, in the media and in general investing culture, there is a heavy focus on the accounting measure of net income. It is the E in EPS (earnings per share) and the P/E (price to earnings) ratio, two prominent factors pushed in front of investors. Without ignoring GAAP earnings, private equity funds generally focus significantly on cash flows, specifically the measure of free cash flow. Free cash flow refers to the cash earnings net of money spent to maintain the assets of the business. The combination of an estimate of free cash flow and an understanding of a company's anticipated capital expenditures give an investor a strong insight into how much cash the business will provide that could be reinvested or returned to shareholders.

Backward-looking data is only so indicative of what's to come, and private equity funds are aware of this. Their investing is, as an ordinary investor's should be, forward-facing. Where the funds are looking for how a business can be improved i.e. cost reduction, M&A activity, strategy change, an investor should also be looking forward at a company's total addressable market, potential levers for growth, and the management team that's pulling those levers.

Once an Investment Has Been Made

To use a hypothetical, an investor has decided on an equity investment and perhaps held that investment for say, 6 months. The equity has appreciated by twenty percent in that timeframe: an excellent return for only half a year! She is quite content with her security-picking abilities thinking she has made a successful investment. In reality, the investor has most likely had significant luck due to better public perception of the business' prospects. Unfortunately, this is exceptionally prevalent in the asset management industry with institutional managers writing quarterly letters detailing the successes of that quarter's securities purchases and sales. Quite a few roosters taking credit for quite a few dawns.

Put slightly differently, Netflix (NASDAQ: NFLX) stock has gained 89% this year, at one point making up 21% of the S&P 500's returns by itself. I find it difficult to believe that the value of Netflix as a business has increased by 89% this year. However, an investor or institutional manager may believe as much, attributing their success to their astute investment decisions.

In the world of private equity, there is no ready market for purchased businesses. The funds evaluate their performance over a matter of years, not months. And they evaluate the performance of the business that they have purchased versus the price they paid for it. This mindset would be an asset to investors especially in times of crisis for in these times, stock prices detach significantly from the performance of their underlying businesses.

Lakeland Financial Corporation (NASDAQ: LKFN), for example, an Indiana bank holding company with roughly $4.7B in assets, saw its share price drop from a high of $15.95 in September of 2008 to $9.44 in March of 2009, a loss of 41%. This happened while the bank's conservative lending kept its earnings steady through the crisis. Forgetting to measure the business' results against the price paid, investors were distressed by the overall sentiment of the market and opted to sell at rock-bottom prices. It's also important to note that in these situations, not only should an investor focus, like a private equity fund, on business results not stock prices, but that negative market perception should to a certain extent be ignored (except if you're looking to buy more!).

Selling an Investment

In the private equity market, sales occur for many different reasons. It could be that the fund has improved the target business through various means and looks to sell a higher-quality business than they purchased. The business' results reflect this, and the market is willing to pay a higher price than the fund originally paid. Perhaps the market for that specific type of business has been bid up by acquisitive companies or other private equity funds to extravagant valuations, meriting a sale. On the negative side, it could be that the target company experienced a fundamental change that lowered its long-term value.

This is by no means a remotely exhaustive list. However, private equity funds tend to sell as they buy: opportunistically with the value of the business always in mind. They are not concerned with what someone may purchase the business for on any given day (unless it's unreasonably high) as they are content with the business' performance. A successful investor likewise should purchase shares with the intention of holding them for a multi-year timeframe, pay no mind to lower quotes absent an impairment of the underlying business, and sell opportunistically especially when the market is irrationally hungry for his shares.

An ordinary investor likely won't be buying entire companies as private equity funds do, but regardless he or she would do well to implement some of the same ways of thinking.

"Individual and institutional investors alike frequently demonstrate an inability to make long-term investment decisions based on business fundamentals."
-Seth Klarman

Disclosures:

I am/we are long LKFN.