Value Investing- Unearth Undervalued Stocks using the 3R Concept

by **Pauline Teo**

~ Achieving the Best Consistent Returns

~ Modeling after the Best Investors in the World, Warren E. Buffett

~ The Billionaire Next Door

- He bought his first share at age 11 and now he regrets that he started too late!
- Warren Buffett does not have a computer on his desk.
- His advice to new investor: <u>Stay away from "Trading Derivatives Instruments" and EDUCATE YOURSELF FIRST</u> before making any investment

~ There are 2 words that will kill people in term of investment: inflation and ignorance

Value Investing

- Warren Buffett is a Value/ Fundamental Investor.
  - Expected Consistent Rate of Return 15% to 25% PA

- 2 important things to learn:
  - Learn to Value a Good Business (Valuation)
  - Understand How Market Behave (Price)

3R

- Right Business Model
- Right Management
- Right Valuation vs. Price

Right Business Model

-Circle of Competence

-Buy into the business that you know

-Competitive Advantage (Moat)

1. How likely is this business to be around in ten years' time?
2. How likely is this business to be more valuable than today?

-Track Record (5-10 years)

1. Consistent revenue Growth/ Net Profit/ Earning Growth (Prefer > 15%) and minus off "One Time Gain" item
2. Strong + Cash Flow from Operation

3. Low Capital Expenditure = Capex Ratio < 0.8

4. Low Debt/ Borrowing = Gearing Ratio < 0.5

5. Current > 2/Cash Ratio > 0.5

Right Management

-Majority Shareholder?

-Integrity & Alignment with Shareholder?

1. Read Back What the Chairman Stated in the IPO Prospectus regarding the Business Model & Growth Plan and Track Their Words vs. Their Action

2. Do They Admit Mistake in Open?

-Track Record

1. Consistent Return of Equity/ Return of Asset Growth (+20% annually)

2. Consistent Dividend Payout

3. If no Dividend, What Did They Do with Your Money?

Right Valuation vs. Price

-Price Earning (PE) Ratio < 10

-Price Earning to Growth Ratio < 0.5

-Net Asset Value, Price to Book (PB) < 0.66

-Discounted Cash Flow/ Earning with 50% Margin of Safety

*Personal Preference, I assume 0% growth and apply discounted earning with 50% Margin of Safety!

Case study

Hartalega Holdings Berhad

Right Business Model

- Latex and nitrile gloves manufacturer
    - Examination Gloves
    - Surgical Gloves
- Application
    - Healthcare sectors (Hospitals, Clinics, etc)
    - Manufacturing sectors (Electronics, F&B, etc)
    - High-Tech sectors (Scientific laboratories)

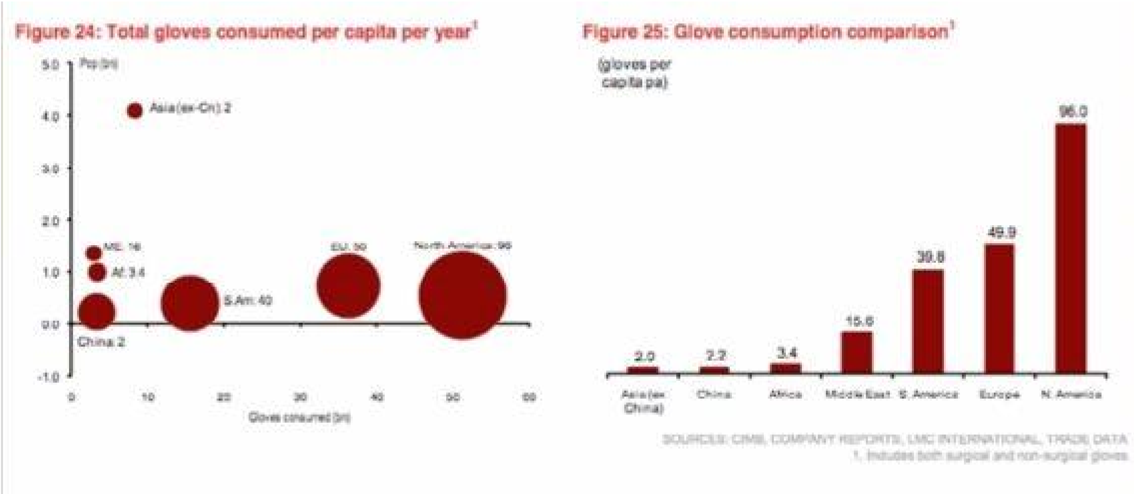
- Malaysia's largest nitrile gloves manufacturer
- Market Demand: Nitrile 45% Latex 55%
- 16% market share in nitrile gloves market
- Good product quality
  - Elastic high stress retention
    - Hartalega (55%) v.s. Industry (40%)
  - No protein allergy
- Strong track record and customer-relationship

Increasing Nitrile Gloves Demand in USA

2 Core Reasons:

1. Avoid Protein Allergies with Natural Rubber Gloves
2. 30% Cheaper due to lighter weight (3.5g as to 5g for Natural Glove) with synthetic technology, saving on transportation cost

Growth Driver



- Recession Proof in gloves sector

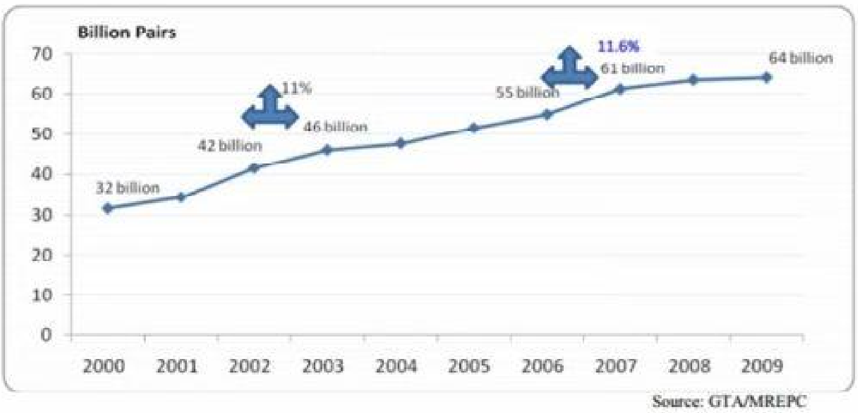


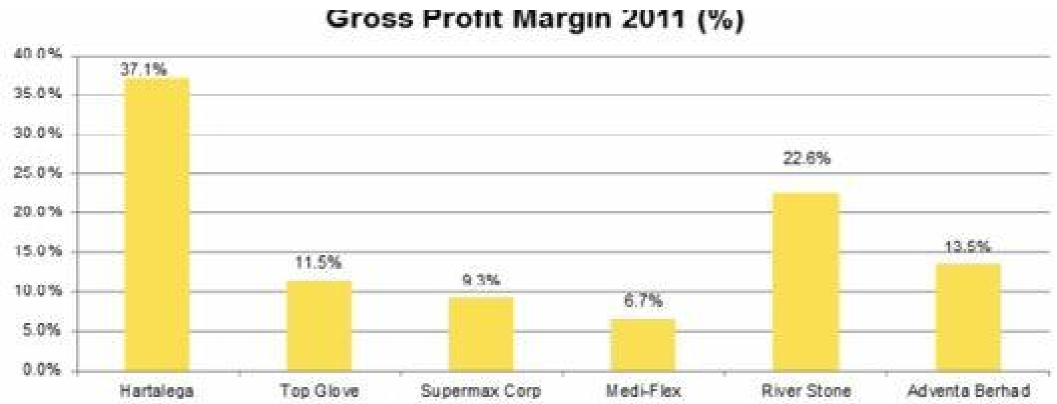
Figure 2. Global glove exports in terms of quantity, 2000 – 2009

**2010: 74 billion, 2011: 71 billion*

- Switching Momentum from NR to nitrile gloves
- Increase presence in Emerging markets like China, Brazil and middle east
- World demand will remain resilient due to emergence of diseases such SARS, H1N1
- Data of MREPC* (Malaysian Rubber Export Promotion Council) suggest that there

is an increasing demand for nitrile gloves and also increasing preference for powder-free gloves

- Lowest cost producer over its peer



- Research & Development
- Dipping Simulator
  - Fully automated
  - Precise simulation of unlimited parameters
  - Reduced product time to market
  - Accurate repeatability
  - Robotic technology
- World No. 1 Nitrile Rubber Gloves at:

10 Billion Installed Capacity in FY2012, 11 Billion in FY2013, 14 Billion in FY2014,

38 Billion in 2019

- Lowest Defect Rate of 3k pieces/million < Market Rate 10k/million
- Fastest Production Line of 45k/hr > Topglove 28k>hr > Market Rate 18k/hr
- Most Efficient at RM306k sales per worker per annum > Market rate of RM200k sales per worker per annum

  *Will increase to RM500k sales per worker per annum
- Clear and Aggressive NGC Capacity Expansion Plan with 6 new plans of additional 72 production lines from 2013 to 2019

■ Oversupply of Gloves in 2004, 2008, 2011

■ 1 year Stagnation followed by 2-3 years growth

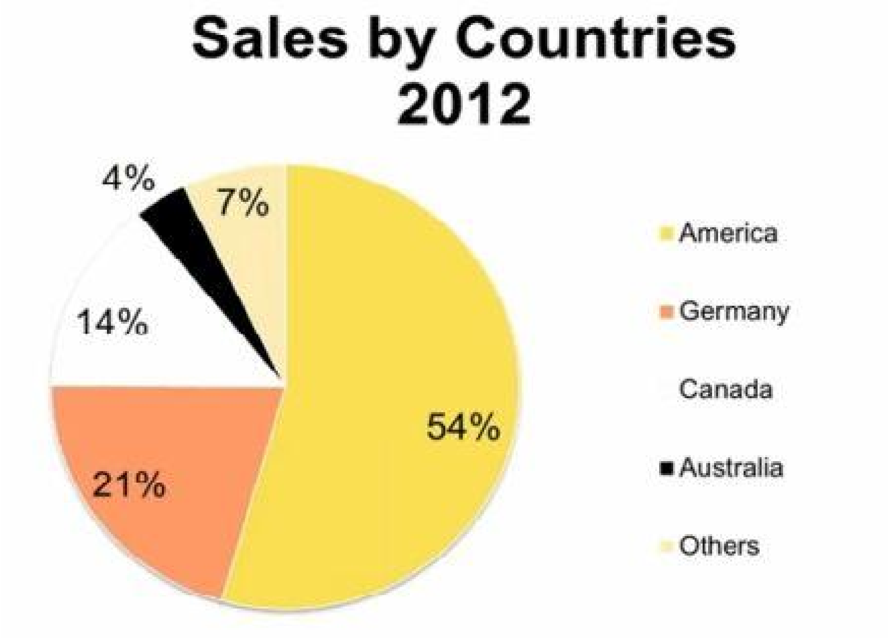
■ 5 Major Players Only, Account for 60% Export

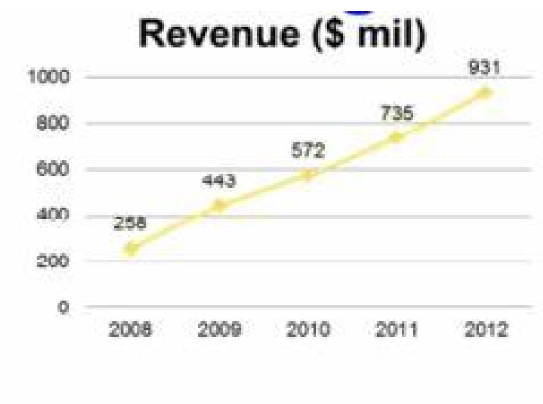
■ Heavy reliance on Developed Countries, US, Europe and Japan

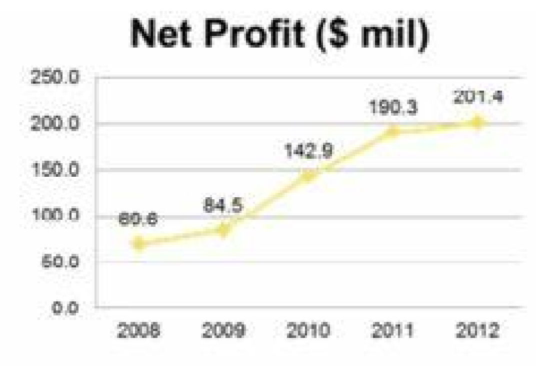
  - 2 customers accounted 50% of revenue

The following are major customers with revenue equal or more than 10% of Group revenue:

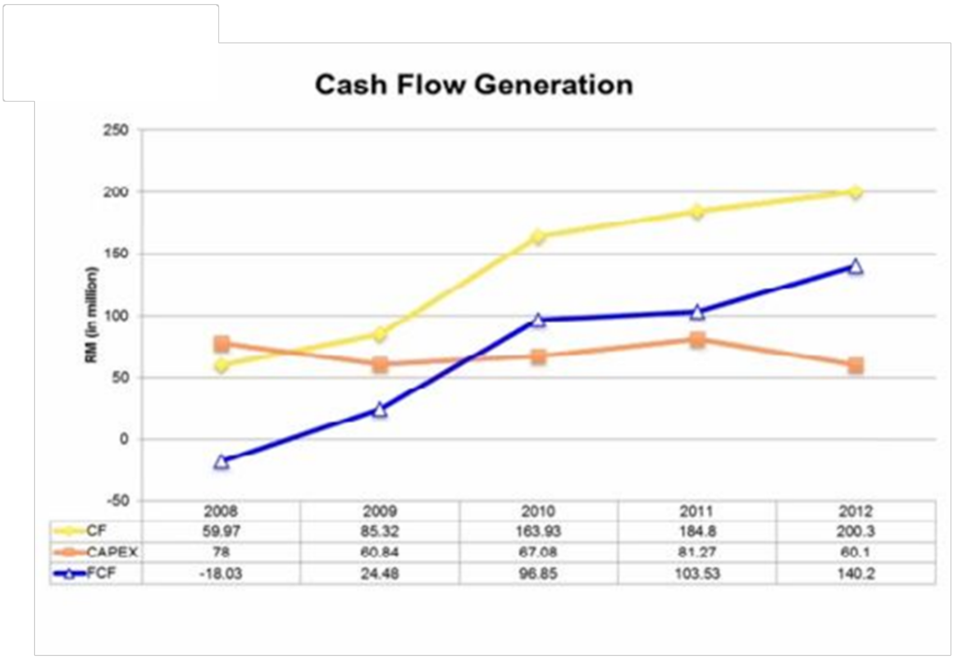
	Group 2012 RM	Group 2011 RM	Geographical location
Customer A	226,181,292	293,473,284	North America
Customer B	-	88,462,259	North America

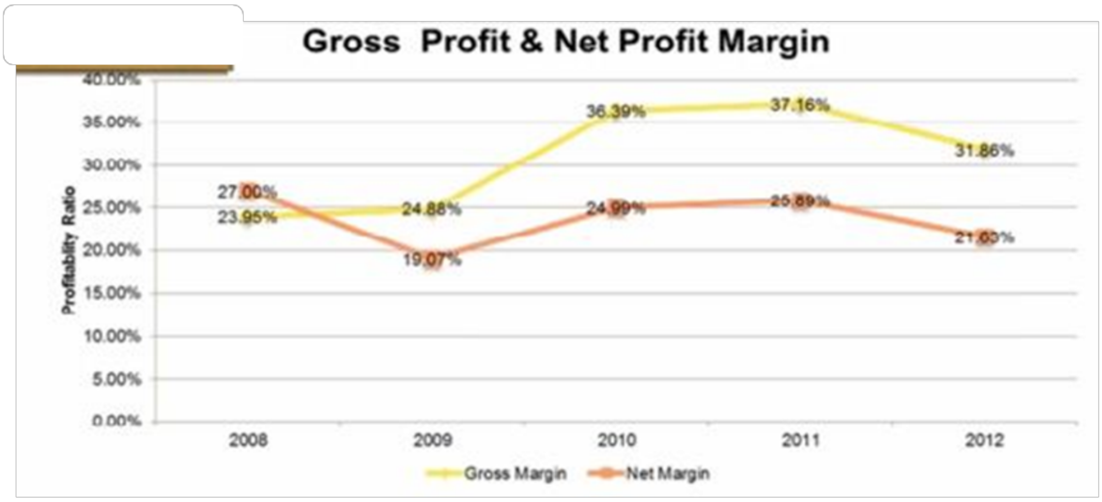


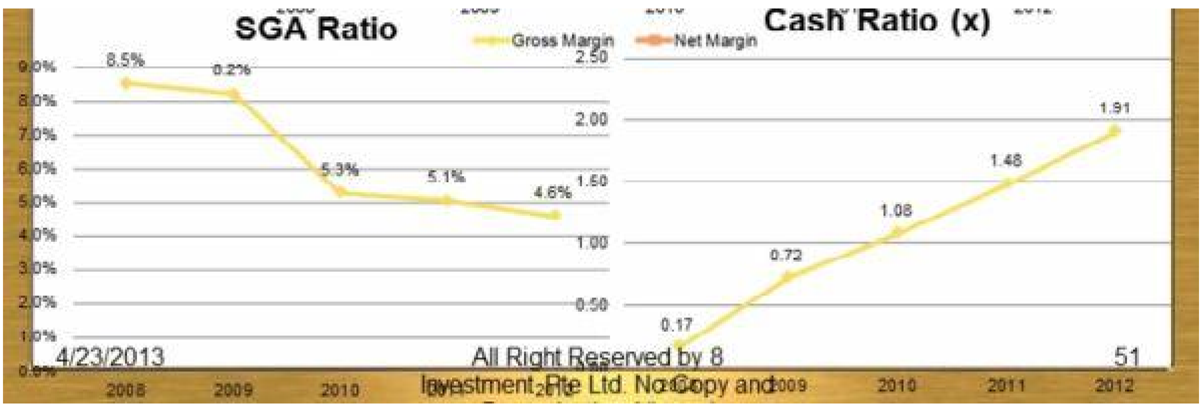




Read more: http://kclau.com/webinar/value-investing-3r/







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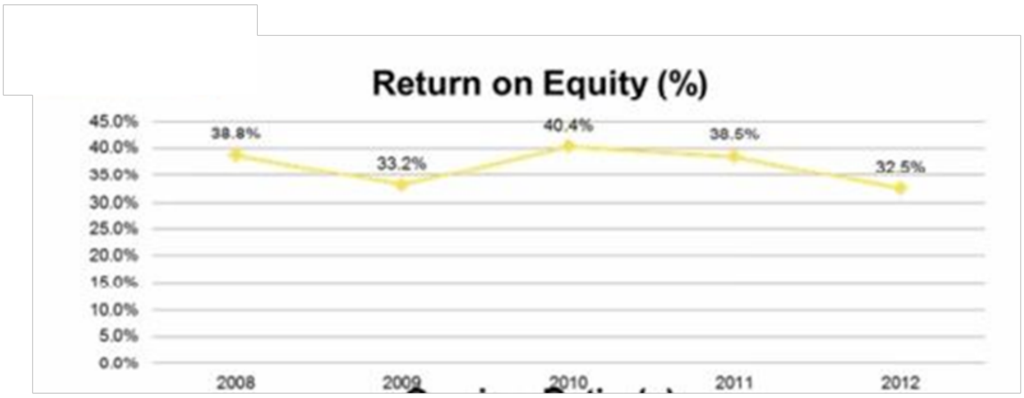
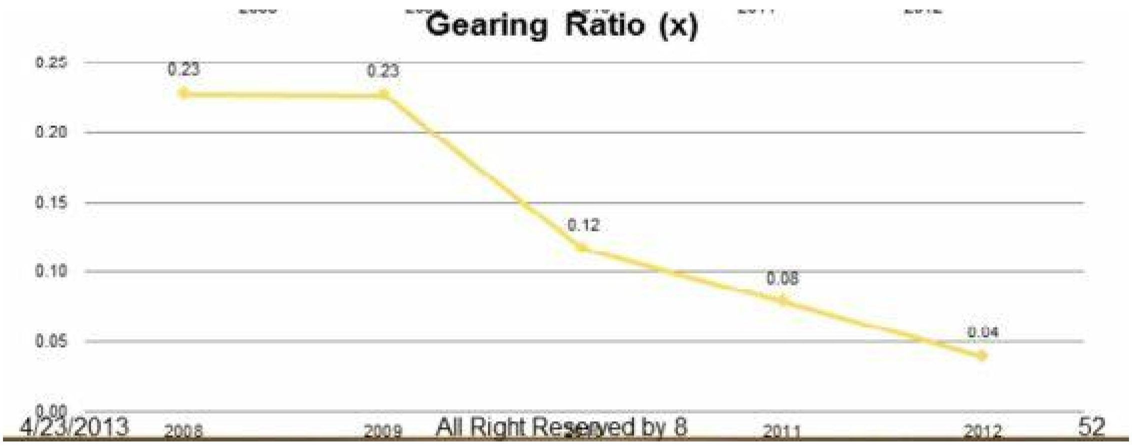

Return on Equity (%)
45.0%
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
38.8%
33.2%
40.4%
38.5%
32.5%
2008
2009
2010
2011
2012


Gearing Ratio (x)
0.25
0.20
0.15
0.10
0.05
0.00
0.23
0.23
0.12
0.08
0.04
2008
2009
2011
2012
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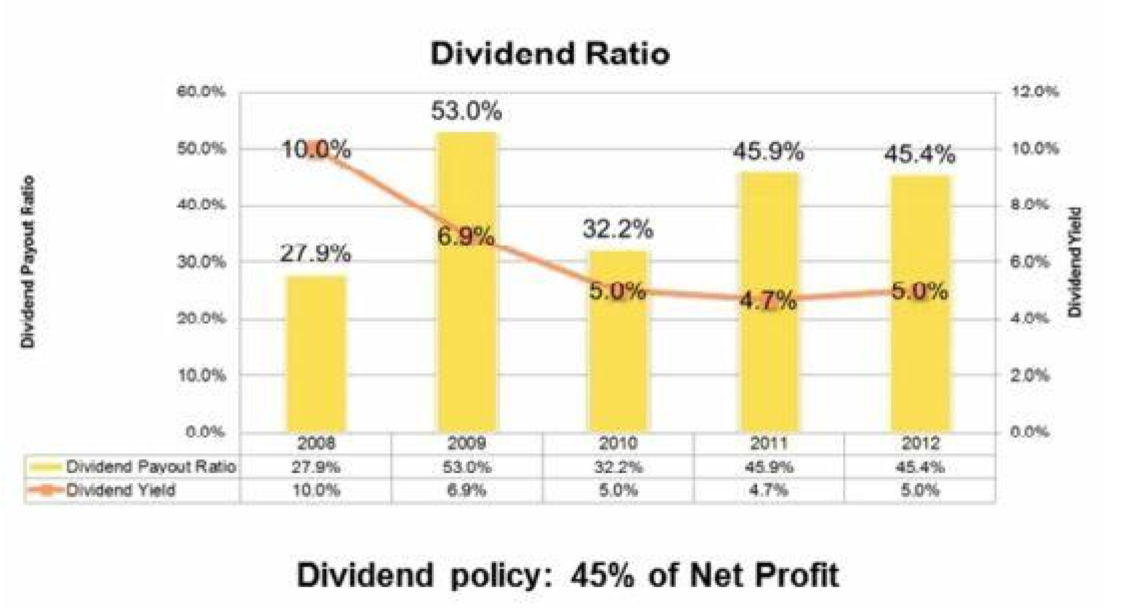
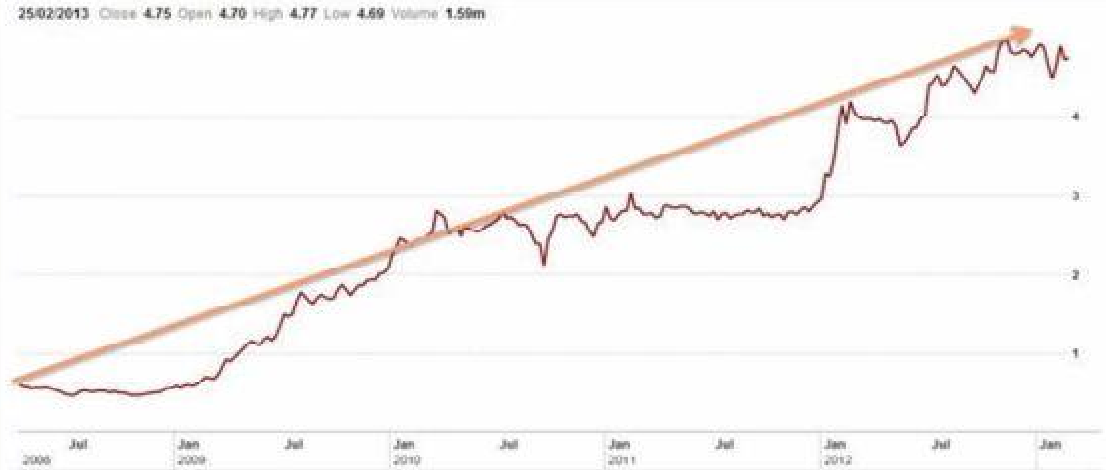

Dividend Ratio
Dividend Payout Ratio
Dividend Yield
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
27.9%
53.0%
32.2%
45.9%
45.4%
10.0%
6.9%
5.0%
4.7%
5.0%
2008 2009 2010 2011 2012
Dividend Payout Ratio 27.9% 53.0% 32.2% 45.9% 45.4%
Dividend Yield 10.0% 6.9% 5.0% 4.7% 5.0%
Dividend policy: 45% of Net Profit

Company	Price (Apr 2008)	Current	Profit/Loss per share	ROI %	Annualized Compounding ROI %	Total Dividend Yield (Passive Income)
Hartalega	$0.60*	$4.80	$4.20	**+700%**	**+68.1%**	**+82.2%**



*Speaker has vested interest in this company

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Company	Price (Jun 20011)	Current	Profit/Loss per share	ROI %	Annualized Compounding ROI %	Total Dividend Yield (Passive Income)
Hartalega	$2.83*	$4.80	$1.97	**+70%**	**+42%**	**+7.7%**

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Q & A session

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1. How do you value invest during non-crisis time?
   - Same theory
   - Always keep watch the business model, company management and in term of the pricing. If the market price falls below the valuation price, just buy it, whether it's crisis or non-crisis.
2. How do you manage your emotions?
   - Don't see the prices on the daily basis.
   - Treat it as a sale- don't let it affect you.
   - Have faith- market prices drop is not because of the company but sometimes it's because of crisis
   - Network- help to build your faith
3. Is Hartalega and Riverstone still worth buying right now?
   - Calculate the valuation by yourself- whether it's undervalue or overvalue- it's different every year
   - Learn to fish for yourself
4. Would you expect the KLSE to be in bull or bear after election?

   3 scenarios:
   - Market will go up: when it's over value- sell
   - Market will come down: when it's under value-buy
   - Market will stay sideway

   Let the market facilitates your decision
5. Value investing is associated to holding stocks for middle to long term, what would you do after investing and only to find out the company does not do well or up to

expectation? Do you continue to hold or sell the stocks even at the loss?

- No attachment for the stock, when the business does not stay anymore, even though at loss, sell it away.
- If the prices keep on dropping because of the macroeconomic situation, nothing to do with the business, continue to hold
- Free up cash and have more capital to invest in other undervalued companies

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Any questions, feel free to email Pauline at pauline@8investment.com

Notes prepared by Teo Jin Jing. Your feedback on the notes prepared is welcome. Please email to feedback@kclau.com. Thanks in advance.