

## Compound Mispricings in Moated Businesses

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“... if the market undervalues the derivative on a mispriced security or group of securities, the odds of the derivative investor can be very favorable. In effect, the investor benefits from the double leverage of two mispriced securities – the underlying and the derivative. Although such a situation doesn’t arise often, it can be particularly profitable. The ability to capture the compound mispricing can lead to extraordinary profits” – David Abrams<sup>1</sup>

Compound mispricings in moated businesses can create some interesting investment opportunities. Compound mispricings are situations where an underlying business is mispriced and a security in the firm’s capital structure or a third-party derivative is also mispriced. Non-voting common stock, holding company stock, warrants or LEAP’s are examples where derivative/security mispricing can occur.

There are various ways to analyze compound mispricings. One way involves comparing “look through” multiples of cash flows to other traded securities. The “look through” approach is the method Warren Buffet applies to cash flows from his investment portfolio holdings to assess the valuation of his portfolio. Another approach is to estimate the value of the underlying businesses and apply appropriate discounts at the security/derivative level. These discounts include: holding company costs, lack of marketability and lack of control (including voting) discounts for minority shareholders or costs associated with leverage in warrants or LEAPs.

Moated businesses are ideal compound mispricing candidates because the businesses are typically growing and are relatively immune from downward competitive shocks. In contrast, shrinking or competitively challenged businesses in combination with compound mispricings can lead to value traps. In these cases, the large discounts may be justified as the future value of the underlying firm will be lower. The challenge for declining businesses is determining the appropriate rate at which the business value will decline.

If the moated business has a shareholder oriented management team with improving governance, then the governance aspect of the discounts can also shrink as the market reflects improved governance. Management actions and communications can be a key catalyst to unlock compound mispricing discounts.

At Wide-Moat Investing Summit 2018, I will describe compound mispricings, approaches to analyze compound mispricings and then examine two compound mispricings in moated businesses. I look forward to sharing my insights at Wide-Moat Investing Summit 2018.

<sup>1</sup> Security Analysis, 6th edition by Benjamin Graham & David L. Dodd, page 621