Opportunistic Value Investing:

Franchise Businesses

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We periodically are asked to define what Opportunistic Value Investing means to Hudson Value Partners. This two-part white paper series defines the two largest components of the approach, **franchise businesses** and **special situations.**

Why Opportunistic Value?

Markets do not always offer a consistent set of opportunities across sectors, styles, or regions. Those investors who focus exclusively on one area will inevitably endure periods where they find few opportunities or are sorely out of favor. Taking an opportunistic approach avoids having to force investments in each area, and instead uses a consistent, diligent framework to invest in whatever type of market and economy are on offer. Some of the best opportunities arise when we can have a longer time horizon than the average market participant.[I]

Value Investing

Value investing has a deep intellectual history with contributions from academics and practitioners reaching back to the 1920s. Informational asymmetries gave early practitioners their edge as value investors. Benjamin Graham was reading publicly available (but hard to access) information about utilities and railroads that few if anyone else was.[II] Their simple, but elegant methodologies capitalized on bringing analytical rigor and primary sources to bear in their efforts.

Securities Analysis is the title of Prof. Benjamin Graham and Prof. David Dodd's seminal work, and the best description of what investing is. Early investors looked for those companies that were the cheapest of the cheap, selling for less than the value of the net-cash on their balance sheets. Statistical studies stretching through the 20th and 21st centuries show that these cheapest companies tended to not only outperform average stocks, but also the most expensive stocks of the day. In a rebuke to so-called modern portfolio theory (dating to the 1960s) which sees risk as volatility (not as a permanent loss, as we do), these value portfolios generated their excess returns without above average "risk." [III]

This cheapest ⅓ of the market is what makes up the bulk of the passive or factor-based ETFs with the word "value" in the name. As these insights became more well-known and as informational asymmetries have declined, the relative performance of this group of the cheapest of the cheap has declined over time. The astute reader will realize that those fabled value investors of the 20th century **did not** buy every cheap stock they saw nor blindly the entire stock market. The approach evolved from cigar-butt investments – those with one or two last puffs in them - to enduring business to own for the long-run.

The Franchise Business

What they aren't – just cheap

Just as historians name periods with the benefit of hindsight, the evolution of value investing to focus on the **franchise business**, is a term popularized by Warren Buffett to describe how his focus had shifted and appeared in his 1991 Berkshire-Hathaway Chairman's Letter. This letter is the best non-academic exposition of the difference between a franchise and a mere business. Franchises for the purposes of our work are not chain restaurants or businesses but are *a term of art* within the value investing community.

Buffett saw three key factors in creating a franchise: [IV]

- Fulfilling a need or want
- An absence of substitutes
- An absence of price regulation

Prof. Bruce Greenwald of Columbia Business School, who took up the mantle of educating a generation of value investors in the 1990s, made the concept of the franchise central to his teaching. Enduring franchise investments have grown in importance over the last thirty years, as technology and innovation have disrupted businesses across all industries. Greenwald defines the franchise firm as having: [V]

- Earnings Power in Excess of Asset Value
- Sustainable Competitive Advantages within their market
- A Return Greater than their Cost of Capital
- The ability to make growth investments in or adjacent to their Competitive Advantages

Both Buffett and Greenwald take pains to note that franchises do not last forever.

At Hudson Value Partners, we summarize these conditions as follows:

A Franchise Business, is a business where the whole, is worth more than the sum of the parts.

Below we list some of the qualitative factors we look for in a franchise business. In most cases, however, a durable franchise emerges when a constellation of factors are present:

- Enduring brand equity
- Customer captivity & loyalty
- Switching Costs
- Network effects & connectivity
- Trust
- Regional Dominance in several regions to create economies of scale
- Stable market share; little gained or ceded among the industry annually
- Oligopolies

The sad truth in the history of mergers, acquisitions, and corporate growth initiatives, is that many are long term destroyers of shareholder value. As such, identification of franchise businesses is essential to the growth of capital over time. When a franchise has been identified, as Opportunistic Value Investors, that it is the very type of growth we are delighted to pay for.

The franchise businesses within our portfolios are the ones that we have a consistent appetite for and are willing to add to those positions both above and below the price of our initial purchase. Indeed, exogenous shocks in the markets and near-term turmoil within a franchise firm or its industry create the best opportunities to build such a position.

Buying a franchise business is one thing but knowing if and when to sell a franchise business is another entirely. Since franchise businesses grow in a way that *creates* value, they do not lend themselves to explicit price targets. Like the classic cartoon of the college professor that writes on the blackboard with his right hand and erases with his left, it is a continually evolving situation.

Yesterday's franchises may not be tomorrow's, but the pace of change known to some as “fade” or “decay” in the strength of a franchise, its competitive advantage, and ability to earn excess rates of return is slower the higher the quality of a franchise.[VI] These sorts of investments must be contemplated within a minimum of a 3-5-year time horizon with the full understanding that there will be periods of relative underperformance along the way. The ability of franchise businesses to reinvest profitably means that they often eschew quarterly earnings and Wall Street expectations for the benefit of their long-term shareholders.[VII] Such long-term holdings are an important component to strong after-tax returns.

While the dynamics of the best franchise businesses have less cyclicality to them, they are not immune to recessionary pressures. Those pressures do create the opportunities for us as investors to buy them and for able managements to cement their competitive advantages.

Special Thanks

We at Hudson Value Partners are continually awed by the generosity of value investors in sharing their insights and their craft. Perhaps it is because the discipline requires a very specific temperament that most are willing to share, knowing that few will have the patience and persistence to endure. We want to highlight the academic leadership of Professors Benjamin Graham, David Dodd, Roger Murray, Jack McDonald, Bruce Greenwald, James Kelly, and Tano Santos, whose collective body of work has taught generations of value investors. We are grateful to the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School and Fordham's Gabelli School of Business for their decades of quality programing to keep the intellectual tradition alive and thriving. The writings and resources shared by Mario Gabelli's GAMCO and Thomas A. Russo of Gardner, Russo & Quinn we consider invaluable.

We humbly submit these white papers into the long tradition of generosity of thought within the value investing community.

[I] The average holding period for equities in the US has declined to less than 6 months.
Chatterjee, Saikat, and Thyagaraju Adinarayan. "Buy, Sell, Repeat! No Room for 'hold' in Whipsawing Markets." Reuters. August 03, 2020. https://www.reuters.com/article/us-health-coronavirus-short-termism-anal/buy-sell-repeat-no-room-for-hold-in-whipsawing-markets-idUSKBN24Z0XZ

[II] Kahn, Irving, and Robert D. Milne. Benjamin Graham - The Father of Financial Analysis. Charlottesville, VA: Financial Analysts Research Foundation, 1977.

[III] Greenwald, Bruce C., Judd Kahn, Erin Bellissimo, Mark Cooper, and Tano Santos. Value Investing: From Graham to Buffett and Beyond. Hoboken, NJ: Wiley, 2021. Pages 8-15.

[IV] Buffett, Warren. 1991 Chairman's Letter to Berkshire-Hathaway Shareholders. https://berkshirehathaway.com/letters/1991.html

[V] Greenwald, Bruce C., Judd Kahn, Erin Bellissimo, Mark Cooper, and Tano Santos. Value Investing: From Graham to Buffett and Beyond. Hoboken, NJ: Wiley, 2021. Page 161.

[VI] Ibid. Page 191.

[VII] Cunningham, Lawrence A. Quality Shareholders: How the Best Managers Attract and Keep Them. New York: Columbia University Press, 2020.

Disclosure Information

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