Risk vs. Uncertainty in Investing:

How to profit from Wall Street's inability to distinguish between them!

by Mohnish Pabrai

Wall Street loves consistency and certainty about the future prospects of any business and will usually over-reward for certainty. Just look at the market valuation of Automatic Data Processing (ADP) or its cousin Paychex (PAYX). ADP trades at a lofty trailing P/E of over 40 while PAYX has a P/E of 49! ADP has a record of meeting or beating street expectations and consistently rising dividends and earnings for over 40 years. There are very few businesses that can claim a record of not having any major blimps in their operations for such a long period of time.

The primary business of both companies is the boring and cumbersome task of outsourced payroll processing. Even with the enormous growth both have enjoyed over the years, both have a very small % of the entire market for payroll processing. It is a highly fragmented industry with very high switching costs and big barriers to entry.

Due to the lofty valuation of companies like ADP, returns to investors who decide to buy the stock in 2002 and hold it for 5 years will probably be lackluster. More importantly, there is no Ben Graham Margin of Safety when buying these stocks. Were there to be a single missed quarter, the stock would tank. It would only take one bad quarter to see a 50+% decline in its market cap. In the case of ADP, the disrupter may be a web-based payroll processor with its entire backoffice in Bangalore with customers just printing

emailed checks at their site. Such an entity could potentially charge 80% less than ADP and still be quite profitable.

A missed quarter seems very unlikely for ADP or PAYX, but one can look at any number of companies that at one point looked invincible and subsequently really left a lot of investors hurting. A good example is Tellabs (TLAB). *(Note: The author was an employee of Tellabs from 86-91).* Tellabs was a wonderful company with an exceptional founder/CEO, Mike Birck and a terrific management team and corporate culture. The company really started to hit its stride in the early 1990s with the release of its flagship product, the TITAN 5500. The TITAN 5500 was an optical cross-connect that helped voice and data service providers groom and manage their T1, T3 and OC-X pipes. The product was superior to all others on the market and rapidly gained customer acceptance at a number of blue chip companies including MCI, Sprint, the various RBOCs, various cellular, paging and data service provider. Through the 1990s, Tellabs enjoyed rapid sales growth and was one of the top ten stocks in overall performance from 1991-1999. Sales increased 10 fold from under $200 Million to over $2 Billion and profitability increased over 20 fold over that period.

Figure 1: Tellabs – 5 Year History of Stock Price Movement

An expert looking at the networking space as late as 1999 could only forecast continued good times ahead for Tellabs. Tellabs had a market cap of over $30 Billion in 1999 against revenues of about $2 Billion. Today the company has a market cap of $6 Billion – with over $3 Billion in cash and hard assets! Investing in Tellabs in 1999 again had no Ben Graham margin of safety and a highly risky investment. In addition, being a technology business, it's more prone to getting disrupted. The experts who saw nothing but good times ahead in 1999 would today not be able to assure us that there will even be a Tellabs in 10 years.

The dichotomy is that seemingly low uncertainty businesses are not necessarily low risk for the investor. ADP and Paychex are high-risk investments at today's prices – just as Tellabs was in 1999.

The flip side is that when the future in uncertain, Wall Street punishes the company and usually the punishment is really rigorous! Stewart Enterprises (STEI) is the second largest company in the "death care" industry worldwide. Stewart has about $700 million

in annual revenues and owns about 700 cemeteries and funeral homes in nine countries, with the bulk of them in the United States.

Figure 2: Stewart Enterprises: 5 Year History of Stock Price Movement

As shown in Figure 2, Stewart was trading at about $2/share for several months during Q3 and Q4 of 2000. Its historical high was about $28/share (achieved in 1999). At the time, Stewart had a book value of $8.50/share. It was thus trading at less than ¼ of book value.

At the time, Stewart's free cash flow was about $0.72 cents/share. The stock was trading at less than 3 times cash flow!! It was also trading at about ¼ of annual revenue. Like ADP, Stewart has a highly predictable revenue stream. We don't know *who* will die in Boise, Idaho in 2006, but any number of life insurance actuaries can tell you with a fair degree of accuracy *how many* will die in Boise in 2006 – or for that matter any year from the next 10 years. Why was Wall Street pricing Stewart at 3 times cash flow and ADP at over 40 times cash flow?

The reason was that Stewart is a leveraged company with a lot of debt. About $500 Million of that debt was coming due in 2002 and there was no clear answer in July 2000 as to how the company was going to pay it. Wall Street assumed the company may have to declare bankruptcy when it defaulted on its debt and tanked the stock to under $2/share (from $28/share).

When I looked at Stewart, I envisioned three possible scenarios for Stewart over the next 24 months.

1. Each individual funeral home is a distinct stand-alone business. Stewart was a roll-up that had bought hundreds of family-owned funeral homes. It had kept the same name etc. Most customers did not know that ownership had even changed hands. Thus, to raise cash, Stewart could elect to sell some of their “stores”. Presumably, many of the previous owners might buy them back. The company had typically paid 8 or more times cash flow for each home. They should be able to sell these for at least 5-8 times cash flow. Thus 50-100 or so homes might be sold to take care of the debt.
2. Stewart’s lenders or bankers could look at the company’s solid cash flow and predictable business model and extend the loan maturities.
3. Stewart goes into bankruptcy. In a bankruptcy reorganization like Stewart, the judge would order that some of the stores be sold and cash proceed be used to repay defaulted debt. In a distress sale, these stores should still go for at least 5-7 times cash flow due to competition among buyers. 100+ stores get sold and the company emerges clean from bankruptcy.

Even under scenario 3, the stock was mispriced at $2/share. Once one of the above scenarios unfolded, I thought that the *uncertainty* would go away and the stock would go to 10 times cash flow or $7-8/share. The Pabrai Investment Funds bought Stewart at about $2/share in Q3 and Q4 of 2000 with the intent of exiting at anything over $4/share within 2 years.

In Q42000, the company announced its intent to sell some international funeral homes and in Q12001 had definitive buyers. The stock was at $4/share by the end of Q12001 – for a 100% gain in less than 9 months. The funds exited their entire position at about $4/share. Subsequently, Stewart has been trading between $6-8/share.

Stewart had *high* uncertainty about its future course in Q32000. However, there was very *low* risk in terms of shareholder return or the company's future. Wall Street could not distinguish between risk and uncertainty and got confused between the two. Savvy investors like Buffett and Graham have been taking advantage of this handicap that Mr. Market possesses for decades with spectacular results. Occasionally, you'll see a company like Stewart which shows three interesting characteristics – *Low Risk, High Uncertainty and High Return Possibilities*. The combination of these three attributes at the same time in the same company makes for some very satisfying investing returns. Take advantage of Wall Street's handicap!

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