



# AIA

UCLA Anderson  
Investment  
Association

## ANDERSON INVESTMENT ASSOCIATION NEWSLETTER

It is our pleasure to offer UCLA Anderson School of Management's first student investment newsletter. The goal of this publication is to showcase the investing talents within the Anderson community, provide insightful interviews with leaders within the investment management industry and maintain a strong network between students, faculty, alumni and investment professionals. We would like to acknowledge the support we have received from the Fink Center for Finance & Investments, and thank Dr. Richard Roll and Dr. Jane Buchan for allowing us to interview them in our inaugural issue.

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**FINK CENTER**

FOR FINANCE & INVESTMENTS

# PROFESSOR RICHARD ROLL

## THE MERITS OF PASSIVE AND ACTIVE INVESTING



*Professor Richard Roll held the Joel Fried Chair in Applied Finance at UCLA Anderson until he retired in March 2014. He joined the UCLA faculty in 1976.*

*After majoring in aeronautical engineering, Roll's first job in the 1960s was at Boeing, where he worked on the 727 and wrote the operating manual for the first stage booster of the Saturn moon rocket. Boeing sponsored Roll for his MBA at the University of Washington, where he developed a passion for finance and later completed his Ph.D. at The University of Chicago. From 1985-87, Roll was a vice president of Goldman Sachs and Co., where he founded and directed the mortgage-backed-securities research group.*

*Roll has published two books and more than 100 articles in peer-reviewed journals. His 1968 doctoral thesis won the Irving Fisher Prize as the best American dissertation in economics. He has won the Graham and Dodd Award for financial writing four times and the Leo Melamed Award for the best financial research by an American business school professor. Roll is the past president of the American Finance Association.*

**Anderson Investment Association: The Efficient Market Hypothesis is a cornerstone of modern finance. Its believers argue that it is impossible to beat the markets, while its detractors state that certain events can serve as evidence that stock prices can seriously deviate from their fair value. What do you believe?**

**Professor Richard Roll:** I don't consider it a matter of belief; that's more of a religious term. There's evidence. This is science. Consider a simple decision rule to trade stocks, like "technical analysis" that some people believe makes money all the time. When you study the results in detail, they never work out very well. But anomalies do occur; like when two prices diverge, because it's difficult to short sell the high-priced stock. There are reasons why those anomalies happen. For example, there are papers written about the turn-of-the-year effect. Every January, stock prices go up during the first few days by a large amount. People think that's a behavioral anomaly. On December 31, if you bought stocks, their prices will increase by a significant percentage over the next few days. It is a regularity, it happens every year. But the phenomenon is concentrated in small companies where the bid-ask spread will eat you alive. It is also true that there is a reason for it. The reason is that people who have embedded tax losses sell the stock at the end of the year to take those losses. This drives the price down, and it rebounds at the beginning of the year.

I favor Fama's view of efficient markets; although, I don't believe everybody is rational on an individual and personal level. Anyone who has been divorced at least once knows that there is irrationality in this world. There are moments in finance where individuals make irrational decisions, and this shows in the market. This does not apply to the question of whether a stock's price is too high or too low, because that is the result of a lot of different people making decisions. Individuals might, and do, act irrationally, often. But there is "collective wisdom" that is much more rational. The proof is that it's really hard to "beat the market." On the other hand, if you look at mergers and acquisitions, where individual decision makers are paramount, you may find that a CEO of a big acquiring company will pay too much for a target. This is explained in my paper, "Hubris Hypothesis of Corporate Takeovers." The CEO will make an evaluation where there is already a market price, and where the market price is a valuation by other people. Sometimes the CEO is infected enough with hubris to believe that the personal valuation is correct and the market's valuation is wrong. If the CEO's valuation is higher than the market price, he/she may be tempted to buy the target. If the valuation is lower than the market price, nothing happens. The result is that you only see the valuations that are too high. So, you cut off half the distribution, which means the ones you do see are the ones that likely contain positive errors; you never see the negative ones. When you discard half the distribution you will get a biased result.

**AIA: When you wrote the paper “Adjustment of Stock Prices to New Information” in 1969, did you realize how important that piece of work would become? What other influential papers did you write?**

**RR:** Well, that was the first ever “event study,” and, no, of course I didn’t realize that. A fellow Ph.D. student, Michael Jensen (who became a very well-known Harvard professor), and I were taking Gene Fama’s course. For that course, we had to develop a term paper. Chicago, at that time, put together the Center for Research in Security Prices; the first time anybody had ever assembled a stock-price database. The database sat there on 18 big magnetic reels of tape that you had to mount one at a time. I think I was probably the first person to go through those tapes and program to get the data off. Mike and I had to write a paper for Gene’s class, and we thought, “Why don’t we study stock splits.” So, we looked to see what happens around the time of a stock split, and we got this weird pattern — prior to the split, prices go up. As soon as the split happens, the prices flatten completely. I spent two or three weeks trying to debug my code — I thought there was a mistake. However, later we realized it had to be that way.

After I graduated from Chicago, my dissertation won the Irving Fisher Award as the best dissertation in economics; Paul Samuelson wrote the forward to it. That dissertation was a study of efficient markets, but it had a little bit of a wrinkle because I used T-bills as the focus of that paper. T-bills have time varying expectations so that it may look like there is serial dependence, but once you take that into account, there is not. So, I think that was an influential paper.

I guess the one that is most cited is the critique of the asset-pricing models, “Roll’s Critique,” which I wrote a few years later. The critique centered on previous empirical tests of the Capital Asset Pricing Model. It later led to the industry of multiasset pricing models. The CAPM was a single-factor model,

and, because of that, there were some problems within it. That led to the arbitrage-pricing theory and all its descendants.

The APT was the first multifactor model, and was invented by Steve Ross who later became a very close friend and co-authored a number of papers with me. That has morphed into a bunch of multifactor models. For example, there’s the Fama-French 3-factor model. Those are all descendants of the APT. I wrote the first empirical study of the APT with Steve. Then I wrote another paper with Nai-Fu Chen and Steve about macroeconomic factors, which tries to identify what the underlying macro things are that are driving prices. Both were pretty influential papers.

There’s a recent paper, by Campbell Harvey and his students, where they did a survey of how many different risk factors have been suggested in finance. It’s 328. Obviously, there aren’t really 328 factors. We are struggling with the question of what these factors really are, and how to distinguish them and so on. Every time the *Journal of Finance* comes out, there is another paper with an additional factor suggested. The APT said there must be multiple factors, but the APT never said how many. I have a new working paper that is trying to set up a process to test whether a new suggested factor is really related to risk.

**AIA: How do you feel that time and new technology has validated your theories?**

**RR:** Computer power and a wealth of data allow one to test things empirically with much more precision than we were once able to do. The big reels of tape that I once used at the University of Chicago can now be put on a little disk. That means that the empirical work can be much deeper now compared to when I first started. There are databases now that contain every trade executed on the New York Stock Exchange and a whole bunch of exchanges all over the world. Every single second is time stamped. There’s a whole field that has been developed,



market microstructure, which studies very short-term market phenomena. It is behind all the algorithmic trading that we have been hearing about. After every single second, does the stock price go up a bit? Should you buy or should you sell? Academics have been working at the answers to these questions for years, but it has only been possible when these data became available. In the early days we only had monthly observations.

**AIA: What is your take on the merits of active and passive management?**

**RR:** The modern theory of efficient markets, not the original Fama theory, but the one that we all understand now, is that you need both active and passive investors. There's an internal equilibrium with a mix of both types. If all managers were all active, they would spend too much money on analysis and not uncover enough information for adequate returns. If all managers were passive, returns would be completely random and unrelated to pertinent information.

There are published papers explaining why we have to have this mixed equilibrium; I published one with Brad Cornell. There are models from biology that deal with evolutionary theory that gives you the same result. In biology, evolution comes up with an equilibrium that's stable. So, mathematical biologists have developed these models, which we adopted in finance to explain efficient markets and explain why in efficient markets you have to have active and passive management. The proportion is dictated by the costs and benefits of competing for these things. So, whether it's 30%-70% or 50%-50%, it depends on the relative cost and revenues.

The modern view of efficient markets does not preclude security analysis; you have to have some. But not everybody should be doing it, and at the margin it doesn't pay you to switch from doing it to not doing it because in equilibrium the marginal benefits equal the marginal costs.

**AIA: What future role do you think multifactor models will play in the investment landscape?**

**RR:** Multifactor models are the current growth industry in investments. There are a lot of firms all over the world who are developing products that are making multifactor models understandable for the average investors. The truth is that every diversified portfolio is completely driven by the underlying risk

factors; only a small fraction of risk is idiosyncratic.

The only question is how do you measure the factors and how do you measure the betas. The truth is that everybody's portfolio is completely dictated by whatever those exposures are to those factors. There is very little idiosyncratic volatility left in any diversified portfolio, but that means all you need to do to manage risk is change your beta exposure. So, I think what's going to happen in the future is that people are going to develop algorithms to advise investors. These factors really are perceptions of macroeconomic variables. I say perceptions because inflation, industrial production, the yield curve and other things are not official numbers because stock prices change too often. So, what's being changed every minute are people's perceptions about those underlying things.

There's a huge number of ETFs, each one exposed to different factors. There are about 4000 different ETFs traded on the New York Stock Exchange and there are a bunch of them traded in Europe. There are ETFs for countries, long/short ETFs and bond and inverse bond ETFs. You could pick a few of those ETFs and get whatever exposure you want to the underlying factors if you know what you're doing.

**AIA: What advice would you give Anderson students pursuing a career in investment management?**

**RR:** I think there's a place for security analysis in active management and there are firms that specialize in that. Although the investment business is a very lucrative business, it is very difficult business to get started in. It's really difficult to start your own company for instance, although once in a while that does happen. The only thing you can do as a student is study finance. You do all you can to find out what these firms do, how they think and the models they're building. They have become increasingly sophisticated over time in terms of the analytics they use, the math they use and the econometric modeling they do. You have to know a lot of statistics and econometrics. Even the top managers are fluent in econometrics at a lot of firms.

**AIA: Thank you for your time.**

# STUDENT IDEA: LANCE CANNON ('15)

## EXAMWORKS GROUP INC. (NASDAQ: EXAM) - BUY

Date of Report	12/17/14	Shares Outstanding (MM)	40.05
Current Price	\$38.20	Institutional Holdings	86.5%
52-Week Range	\$25.79-39.20	Fiscal Year End	12/31/14
Average Daily Volume (MM)	.357	Beta	1.25
FY 2013A EPS	\$-.29	FY 2013 Sales (MM)	\$616
FY 2014E EPS	\$.17	FY 2013 Net Income (MM)	\$-10.2
FY 2013A P/E	N/A	Book Value in MRQ (MM)	8.10
FY 2014E P/E	222.8	Market Capitalization (MM)	1,470
Dividend	N/A	Price/Book Value	4.57x
Dividend Yield	0%	Industry	IME Services
Index Membership	N/A	Debt/Capitalization Ratio	55%

**Business Description:** ExamWorks Group Inc. engages in the business of providing independent medical examinations, peer and bill reviews and related services. It provides these independent medical-examination services through its medical panel of independently contracted, credentialed physicians and other medical providers. The company's clients include property and casualty-insurance carriers, law firms, third-party claim administrators and government agencies that use independent services to confirm the veracity of claims by sick or injured individuals for workers-compensation, automotive, personal-injury-liability and disability-insurance coverage. The company is located in Atlanta.

**Investment Thesis:** Highly fragmented industry, with EXAM, the largest player, positioned to benefit from its two-pronged National Account Strategy, which will widen moats, expand margins and increase overall market share.

**EXAM is the clear leader in the highly fragmented independent medical examination, or IME, industry.** The IME market is nearly \$6 billion across the U.S., U.K., Australia and Canadian markets. The United States accounts for \$4.5 billion, with the other three markets splitting the remaining \$1.5 billion. IMEs are typically utilized following a work related injury or an injury where liability is at issue. Typically, a credited physician is requested to perform the IME to determine the cause and extent of the injury, as well as a review of the medical treatment performed to date. The U.S. market consists of roughly 500+ companies with more than 485 of them generating less than \$10M in revenue annually. EXAM currently commands ~10 percent market share and has increased this market share through acquisitions (46 since 2008). EXAM

generated \$375MM in revenue in the U.S. in 2013, while the next closest competitor generated only \$25-\$30MM of revenue. This vast difference in size has created a barrier of entry, as there would have to be major consolidation among the other large IME players to match EXAM's size.

**Two-pronged National Account strategy driving organic growth acceleration.** There are more than 1,500 P&C carriers in the United States; however, the largest 40 of these 1,500 drive \$1 billion in domestic IME spend (25 percent of U.S. market share). Historically, insurance carriers needed to contract with hundreds of IME companies; however, recent RFP's from the National Accounts have been attempting to reduce the number of IME vendors to lessen administrative burdens and streamline the IME process. The first prong for the National Accounts is EXAM's position to win all or part of these RFPs, which will drive deeper penetration into these large accounts (this is very much a relationship business) and will contribute to accelerating the organic growth of the company. A National Account may



**STUDENT IDEA: LANCE CANNON ('15) CONTINUED**

account for 25 percent to 50 percent of a local IME provider. If they lose this business to EXAM, it may wipe out most or all of their profitability. This could lead to IMEs delaying payment to physicians, which can lead to service levels deteriorating quickly. This is where the second prong comes into play as the door is now open for EXAM to target the larger regional players and capture even more market share. This strategy has been the driver behind a large portion of the revenue growth (industry growth is 1 percent to 2 percent for 2014; EXAM has experienced 12 percent). EXAM had three National Accounts at the beginning of 2014 and announced their ninth National Account during the 3<sup>rd</sup>-quarter call.

**Largest physician panel and most-advanced IT infrastructure enhance competitive advantage leading to ability to scale business and expand margins.** EXAM boasts the largest credentialed physician panel to perform IMEs with 29k physicians covering more than 120+ specialties. In order for a competitor to replicate this panel, it is estimated that they would need to obtain 5 percent to 6 percent market share. The current No. 2 player has less than 1 percent market share. Additionally, EXAM has spent \$30mm on technology investments to create IME\*Centric, a proprietary and scalable technology platform that streamlines the IME process through electronic reporting, scheduling and real-time case tracking while also providing superior data encryption. These two competitive advantages, together with the National Account strategy, will allow EXAM to continue to scale this business quickly without having to spend a significant amount of capital. Earlier this year, EXAM guided to a 16.5 percent to 17.5 percent EBITDA margin while also believing they could pick up one to two National Accounts. Given that they have already picked up six new National Accounts and that 25 percent to 35 percent of each incremental revenue dollar drops directly to EBITDA, margins may expand well past management’s guidance.

**Valuation-DCF vs. EV/EBITDA**

I valued the company using a traditional DCF and then the average EV/EBITDA multiple over the last three years for the company.

The DCF provided a target price of \$49.10 after utilizing the information that can be seen in the table above. EV/EBITDA

WACC	8.0%		
E/V	45% Equity	338	
D/V	55% Debt	413.4	
Beta	1.25 Interest Expense	30	
Rm	8.0% Terminal Multiple	14.3	
Rf	4.5% Out Shares	37	
Re	8.9% Terminal Growth	1.0%	
Rd	7.3% Price	\$	49.10

	2014	2015	2016	2017	2018 Terminal	Total
FCF	74	94	119	122	124	2,120.87
Discounted	74.5	87.7	103.9	100.1	95.3	1,626.4
						2,087.8

multiple was selected by looking at the multiples for various public comps (again not a true comp out there) and utilizing the average of 14. As you can see in the graph, this is well below where it has been trading recently. Price target of \$50.80 with an equal weight given to both DCF and EV/EBITDA.

**Principal Investment Risks**

**Slowdown in National Account wins:** The two-pronged national account strategy is really dependent upon EXAM’s ability to win the national accounts. Should the RFP pipeline begin to slow, organic growth could suffer; additionally, the two national sales forces (ExamWorks and MES Group, their former largest competitor in the United States) could turn against one another, as there is geographic overlap, but fewer RFPs.

**Only takes one bad doctor to damage image:** With the largest and most-experienced physician panel, the industry is still built upon trust. Many IME businesses have been done in by having just one doctor make the wrong call that turned around to cost the client millions.

**Move from roll-up strategy to focus on organic growth could raise execution risk:** Management has successfully built and driven growth through acquisitions over the past six years. Turning now to developing organic growth, management will be faced with a different type of execution risk.

**Additional selling by insiders:** EXAM recently had a secondary offering, which allowed the board and senior management to sell a significant position in the company. Additional insider sales over the near or medium term may send a negative signal to the market and weigh on shares.

**Recommendation And Price Target — Buy, price target of \$50/share**



**Lance Cannon** is a second-year Full-time MBA student at UCLA Anderson and the current Anderson Investment Association President. He graduated from Brigham Young University in 2006 with a degree in business management. Prior to Anderson, he worked eight years at GPS Capital Markets Inc., a corporate foreign exchange shop. While at GPS, Lance was a member of the credit committee and was responsible for analyzing the financials of various hedging clients. He was named the top consultant in 2006, 2008 and 2009, and led the opening of a Boston office in 2010.

## JANE BUCHAN AN ACADEMIC APPROACH TO INVESTING



*Jane Buchan is co-founder and Chief Executive Officer of PAAMCO, a global fund of hedge funds investment firm based in Irvine, Calif. Known as an early mover in both improving hedge fund transparency and supporting emerging managers, PAAMCO has grown to \$9.5 billion in AUM. Buchan began her career at J.P. Morgan Investment Management in the Capital Markets Group. She has been an assistant professor of finance at Dartmouth's Tuck School of Business and is a member of the advisory board for the Master of Financial Engineering program at the UCLA Anderson School of Management. Buchan holds both a Ph.D. and an M.A. in business economics (finance) from Harvard University and a B.A. in economics from Yale University.*

**Anderson Investment Association: Thanks for meeting with us. To start off, could you tell us a little about your background and how you became interested in the hedge fund-of-funds (“HFOF”) industry?**

**Jane Buchan:** I am much more of a data person than what I call a natural investing person. For instance, in the hedge fund industry, you meet people who have been reading annual reports since they were three years old. Slight joke, but I was more interested in learning from data and understanding the world rather than investing per se. So at Yale, I completed a senior essay on an event study for merger arbitrage transactions. This was in the '80s, and at that point in time it was clear that, unlike today, stock prices did not immediately react when a company announced it was making an acquisition.

So, through collecting and analyzing data, the result was more of a question: How can markets be efficient? Over this time, my advisor could tell I was having a lot of fun with the project and asked if I would like to enter the financial world. I didn't want to become an investment banker and didn't really know about the asset management business. My advisor introduced me to Michael Granito who had his Ph.D. from Wharton and worked in the research group at JPMorgan. I went to work for him, and in the first four months of the position I was essentially taught in a classroom. The job entailed performing problem sets covering the fundamentals of finance and developing research projects. So mechanically, it was a lot closer to being a graduate student. I had a strong mathematical background and spent a lot of time translating very fundamental fixed income ideas into what you would now call structured products.

So, that's how I was introduced to finance. After I had worked in that position for 10 months, I had an opportunity to train for the Olympic trials in track and field so I came out to California on a leave of absence. Given my background in structured fixed income, my boss wanted to make sure that what we considered our secrets were not shared with certain other bond firms so he got me a position with a small consulting firm out here that invested corporate pension plan assets in hedge funds.

**AIA: And given your previous experience working in the HFOF space, what were the factors that motivated you and your partners to start PAAMCO?**

**JB:** The asset-management industry is full of times when people decide to leave a firm and start up their own business and do things differently. And in our case, we were frustrated with some of the things that were being done at the corporate level where we were before. You know, you try to change things, and when that doesn't work you vote with your feet. And several clients called me at the time and said, 'Set up a firm and we will move the assets,' and that's how we founded PAAMCO.

**AIA: With a number of complementary leadership positions in industry organizations such as the CAIA as well as your involvement in academia, how have those positions informed your vision not only for PAAMCO but also the HFOF industry?**

**JB:** There are a couple of things really. Having worked as a tenured-track professor early on in my career, you're taught that research is only going to be published if it can be substantiated with data regardless of your existing emotional biases or particular views as to what you would like to think the world is. And so, I think

starting in academia was very helpful for me because, in the asset-management business, a lot of people are unwilling to accept what new data shows.

To use a statistical term, I'm a Bayesian and I have prior views. And, what's interesting is that when you make the switch from academics to industry, it can be difficult, because by the time you've proved something to a publishable state, the real world has moved on. And so, what you have to be really good at on the investment front is having a framework to identify canaries in the coal mine to confirm a decision. Or, if you see canaries in the coal mine that contradict what you believe, you have to quickly disregard your theory. So, I think that has been very helpful. And, having these positions requires me to look at this industry from very different perspectives. So, if I just sat here solely as PAAMCO's CEO, I don't think I would see half of the trends forming in the industry that the firm has benefited from.

**AIA: PAAMCO is known as a thought leader in improving HF transparency on behalf of clients. Can you talk about some of the ways your firm has been able to improve HF fiduciary responsibility and what challenges remain in this area?**

**JB:** All four founding PAAMCO partners have Ph.D.s, and I think what that taught and put in the DNA of the firm is that you have to very objectively look at the facts. And, there are certain historical reasons behind the ways hedge funds are structured. Hedge funds grew up in the high-net-worth space, and clients historically did not care about things like corporate governance. The concern was centered on whether the fund could produce returns. And for us, investing on behalf of pension plans and sovereign wealth funds — pools of money that are custodial for beneficiaries of large populations — we have both a legal and a moral obligation to be very prudent.

And so, traditional asset management was structured one way and hedge funds were structured another way. Is there a real reason why the hedge fund industry needs to be structured that way? The answer in most cases is "no." Now what's interesting is that obviously the more market power you have as a hedge fund manager, the more you can dictate terms. And so, we have walked away from some very high-profile managers because of that, and we have produced better returns than our competitors that choose to invest with those managers. On average, we are going to do a lot better understanding what it is we are investing in.

**AIA: And what trade-offs have you experienced with the emerging manager focus?**

**JB:** As we've become larger, we no longer invest in commingled funds, which gives us greater opportunity to customize what the manager is doing and in many cases gives the manager more latitude than he or she would get in a commingled fund. But, on the other hand, it also creates more liability for us, so we have changed our resource allocation dramatically in terms of the amount we spend on operations, risk management and infrastructure.

**AIA: Moving to the more tactical questions, which hedge fund strategies do you find compelling in 2015?**

**JB:** Some of the most compelling places we've made money are where the directional markets have become discouraging to most people. So for example, last year we made a lot of money in China even though the Chinese market collapsed. When people walk away from markets they sometimes throw away the baby with the bathwater. And while most sales are justified, you can also find very good opportunities. In this sense, we think hedge funds are well positioned to perform needed fundamental analysis and



develop innovative strategies. You've also seen some hedge fund strategies become very mainstream. For instance, nobody knew what a convertible bond was 25 years ago, but now they are part of a very mainstream hedge fund strategy.

We try to stay very diversified. Looking forward, we see opportunities in Europe, the energy space and markets that have been affected to the point where there is limited downside.

**AIA: Speaking of energy markets, do you think it is too early or too late to invest?**

**JB:** Based on the numbers we are factoring in internally, we believe that oil could get into the mid 30s. We don't think it's likely, but that is the downside we are factoring in. We are going to continue to run on oil and we feel that, while the market panics when oil is down 50 percent to 60 percent, it is actually less risky to invest in energy right now given depressed values.

**AIA: Going back to your other outside interests, can you talk about your involvement with 100 Women in Hedge Funds, as well as other philanthropic endeavors?**

**JB:** When I was a professor at Dartmouth's Tuck Business School, I taught some of the more quantitative classes. I replaced a male professor and a colleague pointed out to me that since I began teaching, female enrollment had gone up substantially. Until that point, I never really appreciated the importance of role models

and I still think this is underappreciated in a lot of places. And so, I've been a big supporter of the 100 Women in Hedge Funds for this reason. I also donate a lot of money to the Garden Grove public school system to support math and science education.

**AIA: Any other advice for our readers pursuing or developing careers in investment management?**

**JB:** In the investment management business, like a lot of careers in finance, it is not possible to work 40 to 50 hours a week and be highly competitive. This business attracts some of the most competitive people in the world. I'd like to think that those of us who can't make it in sports could still bring the same passion into this field. And when you don't have the heart and stomach for the game, either at the start or at the end, you need to leave because it is so consuming. I have friends involved in professional sports, and when you play at a high level, it is interesting how microscopic differences can make such a large impact. So for instance, those at the professional level are only one or two percent better than those that didn't make the cut, but that's still a huge amount. And, it is important to remember that the same thing is true in investment management because it is very competitive.

**AIA: Thank you again for taking the time to chat with us.**



# STUDENT IDEA: BRIAN SHEN, AMITESH BAJAD, IRENE KIM

## FINALISTS AT CORNELL UNIVERSITY JOHNSON SCHOOL OF MANAGEMENT

### MBA STOCK PITCH CHALLENGE

#### SIGNET JEWELERS LTD. (NYSE: SIG) - SELL

Current Price	\$124.68	Market Cap	\$9.97M
Target Price	\$112.73	52-week Range	\$134.62/\$74.34

\*As of January 16, 2015. Thesis was originally presented in November 2014.

**Business Description:** Signet is the largest jewelry and watch retailer in United States. The company targets the mass market, and its main brands are Kay, Jared, H.Samuel, Ernest Jones and Zales, which was acquired in May 2014. As of FY13, the total number of stores operated was 3,653.

**Investment Thesis:** Signet earns 75 percent of revenue from the bridal business. Since marriage rates are in decline, we are structurally negative on the company's long-term business outlook. The Zales acquisition will increase revenue by 47 percent and generate \$100MM in synergies over the next three years, but this is fully reflected in consensus forecasts and the share price. Earnings growth CAGR is expected to be 16 percent/year over the next three years, but without further acquisitions, long-term growth will be limited.

**Unattractive market:** Seventy-five percent of sales are from diamond products, and the contribution is higher in the U.S. market. The marriage rate in the United States has steadily declined from 85 percent in 1965 to less than 40 percent in 2013. Also, the recent trend of socially responsible or ethical jewelry is increasing the popularity of alternative gemstones, even though the market share of this segment is currently minimal. We don't think Signet has a competitive advantage in nonbridal merchandise. Overall, we are negative on mass-diamond jewelry consumption in United States, which is Signet's main focus. We are not convinced by the company's market consolidation story as Signet has not gained market share over the past five years. There are no meaningful acquisition targets left in the industry.

**M&A fully priced in:** The acquisition of Zales has been the primary source of positive sentiment around the stock, driving the share price up by > 60 percent in one year. Zales revenue was

\$1,888MM and Signet's was \$3,983MM, increasing topline by 47 percent post-acquisition. Initially, profitability can decline as Zales was making losses and the EBITDA margin for Zales was 3.6 percent compared to Signet's 16.6 percent. We expect some cannibalization as well due to similar target consumers and location overlap. Expected synergies of \$100MM from supply chain/purchasing sharing, expense reduction, overhead optimization and cross-selling are fully reflected in the consensus numbers as EBIT margin growth expectations are >100bps/year for the next four years, which will be challenging to exceed based on the current \$100MM estimated synergy impact.

**Valuation:** SIG trades at 19x forward PE and 15.5x forward EV/EBITDA, representing peak valuations compared to its 10-year historical averages of 13x PE and 7.2x EV/EBITDA. This is the high end of the range for peers and similar to Tiffany's valuation, but TIF has 2x higher margins and global exposure. With M&A synergy expectations fully priced in, we don't see much upside from here, and the consensus target price has only 7 percent upside.

**Target price and recommendation:** Our target price of \$112.73 is based on 17x 2016PE, which is a 30 percent premium to its historical average and 20 percent discount to industry leader Tiffany & Co. We expect 17 percent EPS growth over the next three years, which is not overly conservative. Our DCF-based target price is \$108.60, assuming 8 percent WACC and 3 percent long-term growth rate. We recommend investors SELL Signet on recent share-price strength.

**Risks to our view:** More acquisitions, strong consumer sentiment and spending, global market expansion and weak gold and diamond prices.

STUDENT IDEA: BRIAN SHEN, AMITESH BAJAD, IRENE KIM **CONTINUED**



**Brian Shen** is a first-year Full-time MBA student at UCLA Anderson. He graduated from UC Berkeley in 2010 with degrees in business administration and economics. For the past four years, he worked at Brandes Investment Partners, a global value mutual fund firm headquartered in San Diego with \$30 billion under management. As a member of the financial institutions team, he covered banks, insurers and real estate companies across all geographies and market capitalizations. He holds the CFA designation.



**Amitesh Bajad** is a first-year Full-time MBA student at UCLA Anderson. Prior to Anderson, Amitesh worked as an associate at JPMorgan's Mumbai branch. As part of the Client Credit Management team he conducted credit research and due diligence for new large corporate loan transactions. His responsibilities also included co-

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**Irene Kim** is a first-year Full-time MBA student at UCLA Anderson. Irene previously worked at CLSA (Credit Lyonnais Securities Asia) Korea for five years as an equity research analyst where she covered the consumer sector, including retail, F&B, hotels and casinos. Prior to that, she spent a year at Macquarie. She earned her undergraduate degree from Ewha Woman's University where she majored in business administration.

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## MEET THE EDITORS



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**Kyle Schultz** is pursuing his MBA at the UCLA Anderson School of Management with a focus in private equity. He completed his summer internship with Vintage Fund Management and will be returning to the company full-time after UCLA Anderson. Before business school, Kyle

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