

Distressed M&A and corporate strategy: lessons from Marvel Entertainment Group's bankruptcy*

Joseph Calandro, Jr.
The Gabelli Center for Global Security Analysis at Fordham University

Structured Abstract

Purpose: This paper illustrates the viability of distressed M&A by way of case study utilizing the modern Graham and Dodd valuation approach.

Design/methodology/approach: The paper presents a distressed acquisition case study of the 1996 Marvel Entertainment Group (Marvel) bankruptcy. It draws on previously published Graham and Dodd methodological materials as well as a financial case study of Marvel that was prepared at the time. The valuation presented in this paper is the sole work of its author.

Findings: The case study supports the view that distressed M&A can be a viable corporate strategy alternative. It also demonstrates how a multi-layered valuation approach such as Graham and Dodd can be ideal for identifying value that may be hidden in the confusion and distress of bankruptcy.

Practical and research implications: The case study illustrates, first, the viability of distressed M&A as a corporate strategy alternative, and second, the valuation insights that the modern Graham and Dodd approach can produce in a distressed setting.

Originality and value: This is the first paper that we are aware that applies Graham and Dodd-based distressed M&A valuation to corporate strategy. This paper is an updated and revised version of a paper that was previously published in *Strategy & Leadership*, Vol. 37, No. 7 (2009), pp. 23-32; meaning, it contains a fair amount of new material including an Appendix on Estimating Goodwill and Franchise Lifecycles.

"Liquidating Value. The amount which would be available for a security if the business were wound up and the assets turned into cash. Is less than 'book value,' because allowance must be made for shrinkage in the value of the various kinds of assets if sold during a short period."
-- Benjamin Graham and Spencer Meredith¹

"Conventional wisdom is generally very bad wisdom when it comes to value investing in general and distress investing in particular."
-- Martin J. Whitman and Fernando Diz²

"Sometimes Mr. Market just doesn't seem to pay attention
(isn't that right, efficient markets' theorists?)."
-- James Grant³

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Introduction

Investing in distressed securities has been a core value investing competency from the time Benjamin Graham founded the discipline, and many of today's top value investors continue in this tradition. From time-to-time, corporate development opportunities arise in the distressed investment area. Consider, for example, Federated Department Stores' 1994 take-over of R.H. Macy as Macy emerged from Chapter 11 bankruptcy.^{4,5} Such examples could be a reason why distressed-based corporate development opportunities have received some attention in the financial press.⁶ However, distressed M&A does have unique characteristics that corporate managers must be aware of including: (1) valuing distressed opportunities from both liquidation and going-concern perspectives, (2) negotiating and bargaining in a bankruptcy setting, and (3) understanding distress-related risks.⁷

To illustrate the kinds of opportunities sometimes found in distressed M&A, this paper revisits the colorful bankruptcy of the Marvel Entertainment Group, Inc. (Marvel). It begins by briefly discussing how Marvel became a distressed investment, and then proceeds to a valuation of Marvel from both liquidation and going-concern perspectives to assess a proposed bankruptcy reorganization plan. The paper concludes with a discussion of distressed-related corporate M&A risks and opportunities.

Marvel Entertainment Group

At its core, Marvel is a publisher of comic books featuring proprietary characters such as *Captain America*, *Iron Man*, *Thor*, etc. Comic books have a very long and interesting history, and were especially popular in the late 1930s to the late 1940s (known as the Golden Age of Comics), and from the late 1960s to the early 1970s (the Silver Age of Comics). Comic books experienced another era of popularity in the mid-1980s to approximately 1993-1994, which some refer to as a

“boom and bust” due to the speculative interest in comic books during this time, particularly with respect to the comics of earlier eras (i.e., those published in the Golden and Silver Ages). Comic book publishers took note of the demand during the boom, assumed it would continue indefinitely and flooded the market with new comics, which ultimately ended in a bust.⁸

In this environment financier Ron Perelman acquired Marvel in 1989, for \$82.5 million in a leveraged buyout (debt, of course, being the fuel of every boom-bust cycle).⁹ Mr. Perelman quickly set about improving the firm’s performance and building a diversified youth entertainment company. For example, he acquired a trading card company, a manufacturer of sports and entertainment stickers, and other comic book companies. He also acquired a significant interest in a children’s toy company (Toy Biz) to manufacture Marvel-based action figures.¹⁰ Initially, this strategy seemed to work, but it began to falter in 1994 as boom turned to bust.

The demand that ignited the boom was based, in part, on the scarcity of older comic books: Many people who read comic books in their childhood years (including this author) did not save their books, which were frequently either discarded, lost or simply ruined, and as a result those books became scarce. When those children grew into adulthood and started buying those same books again as collectables (not including this author) the increased demand and relatively low level of supply caused prices to increase, sometimes dramatically. This same dynamic occurred in baseball (and other trading) cards. However, once the speculative boom ran its course, and prices started to fall, Marvel’s diversified businesses experienced performance issues, which were magnified by the amount of debt Mr. Perelman used to fund his "diversified youth entertainment company." Marvel's debt-load ultimately led it to file for bankruptcy (specifically, Chapter 11 of the bankruptcy code) in December of 1996.^{11, 12}

Liquidation Value

In bankruptcy proceedings a firm's management has the exclusive right, for a limited period of time, to file a *reorganization plan*, which "is essentially a proposal to exchange the firm's existing financial claims for a new basket of claims (possibly including cash). The firm's immediate objective is to reduce the total amount of debt in the capital structure."¹³ Therefore, in the Marvel bankruptcy, Ron Perelman filed a reorganization plan that contained three parts. Due to space considerations this paper will only consider one of the parts: the offer to invest \$350 million in Marvel so long as Mr. Perelman maintains at least an 80% ownership in the firm, which implied a going concern value (equity) of \$431 million. The structure of this offer is strategically significant because that level of ownership allows Mr. Perelman to retain the benefit of Marvel's valuable net operating loss carry-forwards (NOLs).¹⁴ However, the value of the offer implies a pre-offer value of Marvel of \$0.85 per share, as will be explained below, which did not reconcile with the stock market price at the time. In evaluating this plan, it is important to first distinguish between liquidation value and going concern value.

If a firm is deemed not viable it will be liquidated under Chapter 7 of the bankruptcy code. A test of whether this should occur involves an analysis of a firm's liquidation and going concern values. *Going concern value* in this context refers to the value of a bankrupt firm that is reorganized and emerges successfully from Chapter 11 (for more information, see the definitions profiled in endnote 5 below). In assessing liquidation value, priority is given to cash and cash equivalents, obviously, with drastic reductions taken as one moves down the balance sheet. As a result, intangibles assets are frequently written down to zero. Applying this process to evaluate Mr. Perelman's plan resulted in the liquidation value of Marvel that is illustrated in **Exhibit 1**.*

* Because value is subjective (**Value Investing General Principle 2**), *all* valuations are based on *assumptions*, which are opinions of key financial parameters that are derived either explicitly or implicitly. Value investing is a bottom-up analytical discipline (**Principle 3**) so all of its assumptions are explicitly derived this way (i.e., from the bottom up). Whether an assumption is correct or not depends on an analyst's

< Insert **Exhibit 1** from p. 23 here >

Cash (the first balance sheet entry) is \$35.9 million, which when adjusted at 100% obviously equals the same amount. The second balance sheet entry (accounts receivable) is \$257.2 million, which when subjectively adjusted down to 85% gives a value of \$218.6 million. Because this entry was adjusted it is identified in the exhibit by parenthetical note (1L). Given this background, the valuation is relatively easy to follow:

- Notes (3L), (4L), (7L), (9L), (10L), and (11L) identify line items written down to zero for liquidation purposes.¹⁵
- Accounts Receivable (note (1L)), Inventory (2L), Property, Plant and Equipment (5L), Accounts Payable, and Accrued Expenses and Other Current Liabilities (both designated by note (8L)) were subjectively adjusted downward to their expected liquidation values. In practice, expert appraisers could be consulted to more accurately quantify these types of adjustments (for information on the adjustment process in general see the Conclusion to Joseph Calandro, Jr., *Applied Value Investing* (NY: McGraw-Hill), pp. 201-221).
- Goodwill and other intangibles (note (6L)) were written down by 50%, rather than to zero which is typical of liquidation adjustments, due to the perceived on-going value of Marvel's highly distinguished character portfolio. This is another area that would require expert input to accurately quantify.

knowledge of the item being valued (**circle of competence**), the process and inputs used to form the assumption (financial statement analysis, private market analysis, strategic analysis, etc.) and the valuation approach being used (Graham and Dodd, Net Present Value, comparables, etc.). Because assumptions are opinions, value investing takes a measured, conservative approach (**Principle 4**) to both deriving and using them. While this may seem simple in theory, consistently executing it over time is extremely difficult. For more information see: Joseph Calandro, Jr., *Value Investing General Principles* (09/21/2016 [03/08/2015]), Available at SSRN: <http://ssrn.com/abstract=2575429>

Subtracting liabilities from assets in the exhibit gives a liquidation value of \$424.7 million (note (12L)), the majority of which would be used to pay off Marvel debt-holders (the nominal value of their claims being \$654.5 million (or the total of note (9L) line items). In sum, this liquidation value relatively reconciles with Mr. Perelman's \$431 million implied value. As noted above, this value implicitly prices Marvel's equity (pre-offer) at only \$0.85/share = \$350 million equity injection / 410 million of new shares,¹⁶ which equates to a pre-offer value of \$86.5 million (given share levels at the time).^{17,18} But was this valuation adequate given the fundamental dynamics of the Marvel enterprise at the time? To answer this question, we will next value Marvel on a going concern basis.

Going Concern Value

Ron Perelman's offer was greeted with significant consternation by Marvel's stockholders who, in short, "felt ripped off."¹⁹ To understand why, consider that the day before Mr. Perelman's plan was announced Marvel equity was selling for \$4.625 per share on the market.²⁰ This "value gap" is strategically significant because if Mr. Perelman was able through bankruptcy proceedings to maintain control of Marvel at its liquidation value, and the firm turned out to be a viable going concern, he would be able to profit by the difference in those two values. However, if the firm was not a viable going concern then it technically should be liquidated via Chapter 7 of the bankruptcy code. To assess whether Marvel was a going concern at the time we will evaluate it with a modern Graham and Dodd valuation.

The first step in modern Graham and Dodd valuation is to reconstruct the balance sheet on a reproduction basis to derive a more economically consistent Net Asset Value (NAV). My NAV of Marvel is presented in **Exhibit 2**, and is based on the same balance sheet that was

employed in **Exhibit 1** but uses different adjustments, all of which are identified by a parenthetical note.

< Insert **Exhibit 2** from p. 24 here >

Note (1A) discounts the deferred tax asset by Marvel's estimated discount rate, which is discussed below.

Note (2A) subjectively increases net Property, Plant and Equipment so that it more accurately reflects a reproduction value. If this was an actual valuation this adjustment could be informed based on the findings of professional real estate appraisals.*

Note (3A) pertains to "Goodwill," which in a modern Graham and Dodd context refers to the intangible assets a firm uses to create value such as its product portfolio, customer relationships, licenses, etc. When estimating the value of intangible assets the modern Graham and Dodd approach, "add[s] some multiple of the selling, general, and administrative line, in most cases between one and three years' worth, to the reproduction cost of the assets."²¹ In this valuation, we evaluate Marvel's goodwill at three times its 1995 SG&A of \$231.3 million, which is the maximum of the preceding range, based on the historical strength of its rich character portfolio. A marketing or consulting firm could help to qualify adjustments like this one in live valuations. For more information on goodwill analysis see the **Appendix**.

Note (4A) eliminates the current portion of short-term debt and transfers it to long-term debt (note (5A)) at 90% of face value to reflect the expected results of a restructuring. Other long-term liabilities (note (6A)) were reduced by the same percentage. These adjustments were subjectively derived based on the restructuring negotiations typical of many bankruptcy

* As noted above, for information on the adjustment process in general see the Conclusion to Calandro (2009), pp. 201-221. Needless to say, a key difference between professional value investors and non-professionals is how assumptions and adjustments are approached.

proceedings. Were this an actual valuation, bankruptcy advisors (legal, accounting and tax) would assist in formulating and/or validating such estimates (again, for information on the adjustment process in general see the Conclusion to Calandro (2009), pp. 201-221).

Note (7A) eliminates Marvel's minority interest in Toy Biz based on a bankruptcy analysis prepared at the time.²² We will revisit this adjustment later in this paper.

Subtracting the reproduction value of assets from the reproduction value of liabilities gives a NAV of \$469 million (note (8A)) or \$4.61/share,²³ which suggests that Marvel was a viable going concern thereby validating the stock price the day before Mr. Perelman's plan was announced, which was \$4.625 per share as noted above: There is nothing odd about these values reconciling as most of the time the market does, indeed, "get it right." It is when the market is wrong that opportunity arises. To confirm this value, we will proceed to the next level of modern Graham and Dodd value, Earnings Powers Value (EPV).

EPV differs from traditional discounted cash flow (DCF) in that it estimates a level of past earnings that are expected to be sustainable into perpetuity. This is much more conservative than DCF, which forecasts yearly estimates for five-to-ten years before estimating a final, "sustainable" level of earnings, which is applied to estimate a terminal value.

The earnings estimate that EPV is based on reflects the historical record under the assumption that if a firm earned a level of income in the past its operations should be able to earn it again, all else equal. However, in a bankruptcy all else is not equal because a firm has defaulted on its financial obligations and filed a legal proceeding to either restructure those obligations or liquidate if a restructuring cannot be accomplished. Estimating expected sustainable earnings for such firms therefore requires a somewhat different—albeit related—approach. Consider, for

example, the EPV of Marvel that is presented in **Exhibit 3**, which is divided into three sections to make it easier to follow.

< Insert **Exhibit 3** from p. 25 here >

Before proceeding with the analysis, it is important to note once again that the objective of EPV is to estimate earnings that are sustainable on a non-growth basis into perpetuity based, predominantly, on the historical record. Making such estimates is not easy and prone to error, and therefore should be formulated conservatively especially when the firm being valued is distressed (and by “distress” I mean either financial distress, which is the subject of this paper, or operational distress, which is not addressed here).²⁴

Prior to estimating earnings first consider the graph of Marvel’s revenue and margin from 1991-to-1995 that is illustrated in **Exhibit 4**.

< Insert **Exhibit 4** from p. 26 here >

If Marvel emerges from bankruptcy we can assume that its operations will focus on its core comic book business in a cost effective manner, and that it will leverage Marvel characters to generate revenue through media (television and films) and derivative toy sales. To quantify this assumption, we can conservatively estimate Marvel’s ultimate level of sustainable operating earnings at \$128.3 million (= \$415.2 million * 30.9%) or the product of Marvel’s mid-level margin and revenue performance over the past five years, as illustrated in **Exhibit 4** (note (1E)).*

* Debt has contractually defined fixed terms for a specified duration and thus effectively “self-liquidates”—in the case of a viable going concern—whereupon the entire earnings’ stream flows to the firm. Therefore, in certain M&A (and longer-term equity) valuations, like this one, it can make sense to base earnings power estimates on operating earnings instead of earnings after interest estimated on a year-by-year basis. To perform the later calculation, one must project earnings over some time horizon, model in both the interest payments on debt and the amortization of debt, and then adjust weighted average costs of capital to reflect the yearly capital structure changes. In practice, the difference in the two calculations (earnings power as estimated here and the more detailed approach just described) can be minor when the interest deduction and amortization are off-set by a lower cost of debt, tax shield and the risk of error inherent in yearly forecasts thereby warranting simplifying the estimate. Note that simplifying this process

Subtracting interest earned on Marvel's cash of \$1.8 million (based on an assumed 5% interest rate, note (2E)) gives a conservative estimate of Marvel's "Sustainable Pre-Tax Earnings Before NOLs" (note (3E)).

Turning to the middle EPV section (i.e., notes (4E) to (8E)), we will first estimate the expected development or realization of Marvel's Pre-Tax Earnings until they become sustainable in 1999: working backwards from Sustainable Pre-Tax Earnings like this is more conservative than more traditional DCF-based valuation because it bounds the estimate by a level of past earnings that are expected to be sustainable once the firm is able to overcome its current level of distress. For simplicity, we will assume that it will take two years for Marvel's earnings to become sustainable and therefore we will assign a development rate of one-third per year (note (4E)). Multiplying these rates by \$126.5 (note (3E)) gives the "Pre-Tax Earnings" per year estimates (note (5E)).

Note (6E) applies Marvel's \$100 million in "NOL Carry-forwards" to the valuation. Under Mr. Perelman's plan, which was profiled above, he would maintain at least 80% control of Marvel thereby securing the right to use Marvel's approximate \$100 million of NOLs.²⁵ Therefore, in valuing his plan it is important to consider the value of NOLs, which we will accomplish under the simplifying assumption that the NOLs will be fully used in two years. In

by deducting the book value of debt from an earnings power value is generally not advisable unless it is assumed that the acquirer is going to pay-off the debt when the acquisition closes, which rarely occurs. Additionally, and to state the obvious, the balance sheet is a point-in-time estimate while earnings power is a perpetual estimate and thus they value different things that require different valuation approaches. Analysts obviously need to know when and how to apply the proper valuation approach, which is **circle of competence**-dependent. While the **circle of competence** maybe an easy principle to understand, very few people actually have one and/or know how to effectively work one over time. For more information see: Joseph Calandro, Jr., *Value Investing General Principles* (09/21/2016 [03/08/2015]), Available at SSRN: <http://ssrn.com/abstract=2575429>

practice, NOLs should be applied in consultation with experienced bankruptcy, accounting and/or tax counsel.

Note (7E) refers to taxes, which will be calculated by multiplying the difference of Pre-Tax Earnings (note (5E)) and NOLs (note (6E)) by 30%.

Note (8E) refers to Marvel's "Preliminary Earnings," which were derived by subtracting taxes (note (7E)) from Pre-Tax Earnings (note (5E)).

We now proceed to the bottom and final section of the exhibit (notes (9E) to (14E)). First, we will estimate Marvel's discount rate at 1.5 times the risk-free rate at the time (note (9E)),^{26,*} and then capitalize Marvel's Preliminary Earnings at this rate as a simple, non-growth perpetuity for the year 1999 (note (10E)). Earnings for 1997 and 1998 were simply brought down from note (8E).

Note (11E) pertains to the present value discount factor, which is based on our 9.9% discount rate (note (9E)).²⁷ When multiplied by Earnings (note (10E)) this factor gives the "Present Value of Earnings" (note (12E)). Earnings Power, note (13E), is simply the sum of the three yearly Present Value Earnings' figures while the Earnings Power Value (EPV; note (14E)) is the sum of Earnings Power and cash of \$35.9 million on the balance sheet for a total of \$808.9 million.

* The discount rate used in this valuation is a *hurdle rate* or *required rate of return*, which is defined as the minimum return an investor will accept to undertake an investment or project. In practice, hurdle rates are often based on the weighted average cost of capital, but not always. Which rate to choose in a valuation is a subjective consideration (**Value Investing General Principle 2**) and thus is **circle of competence**-dependent. When I was trading in the 1990s, money managers I knew would estimate hurdle rates as a multiple of a risk-free rate (two-to-three times were typical), which is a practice that investors and investment bankers I also know apply at times, and which I apply in cases like this. As used here, the hurdle rate is the *absolute return* required to make an investment, or execute a project, and therefore it is not capital structure-dependent. As such, it does not need be revised to reflect changes in that structure for valuation purposes. Analysts obviously need to know how to estimate an applicable discount rate, and how to correctly apply it in the context of their valuation which, again, is **circle of competence**-dependent. For more information see: Joseph Calandro, Jr., *Value Investing General Principles* (09/21/2016 [03/08/2015]), Available at SSRN: <http://ssrn.com/abstract=2575429>

Our EPV is significantly larger than our NAV thereby identifying the existence of a possible *franchise*, or a firm operating with a sustainable competitive advantage. As noted above, the foundation of Marvel's value proposition is its rich portfolio of proprietary characters that, for decades, has generated substantial levels of entertainment to a wide range of customers of all ages. Significantly, these characters cannot be copied so anyone who desires to make an *Iron Man* movie, for example, must obtain Marvel's permission and then pay them for the privilege. While other firms have substitute characters, most prominently *Superman* and *Batman* of rival DC Comics, the Earnings Power generated by Marvel's characters in the past, and the high probability of future Earnings Power, qualified the firm as a franchise assuming it is managed properly as a going concern. Were this a live valuation, this assumption could be validated through consultation with brand, strategy and management experts.

Having established the firm's franchise status, we now proceed to the final level of modern Graham and Dodd value, growth. While it may seem strange that we are considering growth for a firm that filed for bankruptcy, recall that most firms' "immediate objective [in a bankruptcy filing] is to reduce the total amount of debt in the capital structure." In short, viable firms can suffer distress due to financial issues rather than operational ones, which was the case with Marvel, and which is a reason why bankruptcy can, at times, generate corporate development opportunities.

Consider the growth valuation presented in **Exhibit 5**, which is based on variables from Marvel's NAV and EPV. For example, note (a) in the exhibit pertains to an EPV variable, "Sustainable Pre-Tax Earnings Before NOLs" (note (3E in **Exhibit 3**)), which when divided by NAV (note (d)) on an after tax basis gives Marvel's estimated Return on Net Asset Value (or RNAV, note (e)). Dividing RNAV by our estimate of Marvel's discount rate (note (f)) gives a

growth multiple (note (g)), which when multiplied by our EPV derives a growth value of \$1,538.8 million.

< Insert **Exhibit 5** from p. 27 here >

Based on our valuation, Mr. Perelman's offer with an implied \$86.5 million value significantly understates the value of Marvel as a going concern. Such value gaps at times occur in distressed investing, but the value realization potential of such gaps are contingent upon the happening of some event or sequence of events (i.e., catalysts) that will close the gaps.

In the next section, we will discuss how the Marvel bankruptcy concluded and provide some suggestions for corporate strategists to consider in evaluating future distressed M&A opportunities.

Conclusion

One of the loudest voices opposing Ron Perelman's plan was Carl Icahn's.²⁸ The story of these two financial titans slugging it out in bankruptcy was superbly captured by Dan Raviv in his incredibly well titled book, *Comic Wars* (NY: Broadway, 2002). However, at the end of this bankruptcy neither Mr. Perleman nor Mr. Icahn gained control of Marvel; Isaac Perlmutter, the largest stockholder of Toy Biz at time—the minority interest of which we wrote off in our NAV (note (7A))—emerged as the owner. Recall that the Toy Biz line item was written down based on a popular case study at the time, and thus I am confident that it appeared to be a reasonable write-down at the time. However, transparency risk can be somewhat high in bankruptcy proceedings, which can obscure financial and stakeholder analyses.²⁹

However, it is important to note that Mr. Perlmutter did not gain control of Marvel because he was “hiding in plain sight.” Rather, he likely gained control of Marvel because he understood its business better, much better actually, than either Mr. Perelman or Mr. Icahn. Significantly, Mr.

Perlmutter's key advisor on this deal was Avi Arad who thoroughly understood Marvel's character portfolio as well as its potential Earnings Power, especially with respect to media (movie, television) and related toy sales income. Business understanding in distressed M&A can be crucial, especially in cases of distressed franchises like Marvel. Therefore, corporate strategists can have an "information advantage" assessing distressed franchises *if* they focus on deals within their areas of expertise (or circles of competence). Doing so will enable them to efficiently leverage their specialized knowledge in a field widely considered a specialty due to its unique legal and valuation dynamics.³⁰

The legal aspects of distressed M&A include a number of risks, such as the risk that a bankruptcy judge will "cram down" a reorganization plan on stakeholders, and tax risks especially with respect to NOLs. Such risks should be assessed and managed with the assistance of experienced counsel and advisors. In this regard, corporate strategists could work with their General Counsel's office to retain the necessary level of expertise to effectively identify, assess and manage such risks.

In addition to specialized knowledge and General Counsel's assistance, corporate strategists can have another advantage in distressed investments: a longer time frame over which to operate. Some distressed investors seek relatively quick rates of return so they can move on to the next deal. Corporate strategists, on the other hand, generally operate over longer time frames thereby enabling them to realize more of deal's value, which can be significant. For example, consider the Marvel case: Toy Biz acquired Marvel for \$238 million in October of 1998.³¹ On December 31, 2008, Marvel stock sold for \$30.75/share with a value of \$2,397.9 million,³² which exceeds our growth value as illustrated in **Exhibit 6**. Over those 10 years Marvel's value appreciation equates to an impressive compounded return of 26%.

< Insert **Exhibit 6** from p. 28 here >

Such levels of value realization were driven directly from Marvel's character portfolio. Most of the people reading this paper will likely be familiar with Marvel's various blockbuster movies such as *Spider Man*, *X-Men*, *Iron Man*, *Thor*, *Captain America*, *The Avengers*, etc., as well as its various cartoons that feature the same characters. However, the sales from these media are derivative of the firm's core comic book business, and the quality of the stories produced in that business over time. Perhaps no greater example of this can be found in Marvel's incredibly popular "Death of Captain America" comic book story arc that made national news in 2007. As luck would have it, I was researching the article version of paper shortly after news coverage of Cap's death broke so I decided to buy a collection of the comic books and see for myself what the quality of the story was like. What I found both entertained and surprised me.

Author Ed Brubaker and artist Steve Epting created a storyline as good as any action novel that I am aware of; in fact, it is a great deal better than just about any that I am aware of. For example, consider the popular illustration from their work shown in **Exhibit 7**. Truth be told, I enjoyed their story so much that I followed Mr. Brubaker's work for his entire run on the *Captain America* comic book and the related stories of the character he created, "The Winter Soldier." In sum, if Marvel's stories can "hook" someone like me (i.e., a middle-aged business economist) imagine the value realization potential of their core customer base.

< Insert **Exhibit 7** from p. 29 here >

Marvel Coda

After the article version of paper was published, on August 31, 2009, Disney acquired Marvel for \$4 billion. If you have followed the case thus far you know this was a great price for Isaac Perlmutter, but was it also a great price for Disney? The editor of *Strategy & Leadership*

asked me to write a paper addressing this question for his corporate M&A readers. I wrote that paper, which included a pricing analysis that is summarized in **Exhibit 8**. Based on this analysis, the \$4 billion purchase price did not seem to contain a margin of safety, which Disney's CEO, Robert Iger, confirmed at the time via his statement that, "We paid a price that reflects the value [Marvel] created and the value we can create as one company. It's a full price, but a fair price."³³ But if Disney paid a full price for Marvel, which the exhibit suggests that it did, then how could it profit from this acquisition?

< Insert **Exhibit 8** from p. 30 here >

As is now widely known, Disney's value creation strategy was based on aggressively growing the media profile of its rich character portfolio and decades-old source material. One way they accomplished was through integrated story arcs and character team-ups, which resulted in the blockbuster movie *The Avengers* and a number of subsequent blockbusters that, cumulatively, generated profitability well in excess of the acquisition price. Significantly, this profitability was generally *not* foreseen at the time of the acquisition—hence, the "full price, fair price" comment—resulting in a meaningful margin of safety. But why did my—and many other—analyses not see it?

Strategies such as the one profiled above are, obviously, highly intangible and require a fairly specific circle of competence. I have neither a media nor a comic book-based circle of competence,³⁴ which is why my pricing assessment validated Disney's "full price" hypothesis and missed the deal's actual value potential. In contrast, Kevin Feige and his team members at Marvel Entertainment both understood the value potential of this deal and, perhaps more importantly, they knew how to realize value from it over time, which they have accomplished exceedingly well for Disney since this acquisition closed. Understanding the strategic

implications of this moving forward is very important. Readers interested in exploring it are referred to: Joseph Calandro, Jr., “The ‘Next Phase’ of Strategic Acquisition,” *Journal of Private Equity*, Winter (2015), pp. 27-35.

Appendix: Note on Estimating Goodwill and Franchise Lifecycles

“A bargain is something which can be bought well below its ascertained value. The conception of bargain involves essentially a comparison of the current price with a *definite* value—i.e., one not chiefly speculative or anticipatory.”
-- Benjamin Graham (*italics original*)³⁵

"The wheel of time brings many changes and reversals."
-- Benjamin Graham, David Dodd and Sidney Cottle³⁶

"Most profitable business niches last only as long as the competition takes to discover them. They vanish when a swarm of imitators attack the innovator with a better idea, lower prices or both at the same time."
-- James Grant³⁷

A central theme of this paper is that value investing is *not* easy when it is performed properly. This is obvious to anyone who approaches the discipline seriously, but it is particularly applicable to the area of *goodwill* valuation. By way of background, Benjamin Graham defined goodwill as an “Intangible Asset purporting to reflect the capitalization of excess future profits expected to accrue as a result of some special intangible advantage held, such as good [i.e., brand] name, reputation, strategic location, or special connections. In practice, the amount at which goodwill is carried on the balance sheet is rarely an accurate measure of its value.”³⁸

While the initial adjustment mechanism for goodwill is straightforward in modern Graham and Dodd valuation—applying a multiple, typically between 1-to-3,³⁹ to either selling, general and administrative (SG&A) expenses or research and development expenses—deciding which multiple to apply is much more complex and dependent on, for example, the strength of a firm’s brand,⁴⁰ customer relationships, patent portfolio, and/or product portfolio. The basic relationship of these components is illustrated in **Exhibit 9**.

< Insert **Exhibit 9** from p. 31 here >

For the majority of firms, brand and customer relationships frequently emerge as the primary driver of goodwill value, and as a result I tend to focus on SG&A multiples as the basis of goodwill estimates. This does not mean that other factors do not influence goodwill value; only that it can be very difficult to tell if that is the case—especially absent on-site inspections and/or expert input. As a result, the risk of overvaluing goodwill can be high, which is something I have witnessed many times. Fortunately, the risk of over-valuation is a basic one to mitigate. Consider that as most firms are neither franchises nor turnaround opportunities most should reflect the “base case valuation pattern,” i.e., their NAV relatively equals their EPV.⁴¹ Such a pattern helps to conservatively bound valuations. For example:

- Aside for a limited number of firms, NAV should relatively equal EPV. Therefore, if NAV is significantly greater than EPV in a firm that does not have obvious turnaround characteristics (such as eroding profitability, excess leverage, etc.) there is a possibility that goodwill may have been valued too high.⁴²
- Similarly, if EPV is significantly greater than NAV in a firm that does not have obvious franchise characteristics (i.e., *obvious* brand appeal, a pattern of abnormally strong earnings, which is say returns materially greater than those required, etc.) there is a possibility that earnings may have been valued too high. In my experience, over-estimating earnings is a very common valuation error.

It is important to specify that, regardless of its usefulness, the above is only a guideline, *not* a rule. The specifics of every valuation depend on the fundamentals of the firm being valued at a particular time given the business and financial environments the firm is operating in at that time.

Mechanics aside, the sales basis of the SG&A multiple has precedent. For example, consider the below quote from a historical biography of banker Eugene Stetson:

Throughout his career Stetson viewed advertising as a valuable source of corporate worth for any company, especially in the new age of national brands and interstate retailers. As lenders, Stetson argued that banks should evaluate the 'intangible good-will created through intelligent sales efforts applied to a product of unquestioned merit.' In the 1920s, Stetson thought, there were plenty of good examples: Coca-Cola, Proctor and Gamble, Beech-Nut, Aunt Jemima, Old Dutch Cleanser, Victrola, and the cigarette industry generally.⁴³

By way of overview, I tend to approach goodwill adjustments as follows: first, determine qualitatively if there is some level of intangible value to the firm's assets. For example, it was obvious to just about everyone that Marvel's character portfolio was extremely valuable. Similarly, the brand value of a firm like Heinz was pretty much obvious to just about everyone at the time it was acquired.⁴⁴ Second, evaluate the competitive dynamics of the products the firm is selling. If those products are truly innovative they will stand out in the marketplace much like Apple products did after Steve Jobs introduced them. Third, I look for patterns of "free advertising" by which I mean media—including social media—that "talk-up" a firm's products without being overtly influenced by the firm to do so: the reason for including the word "overtly" is obvious inasmuch as it is impossible these days to know how much of "free advertising" is really "free" given the influence PR firms have on modern markets.⁴⁵

To the extent a firm "scores" low on the above tests I tend to apply a goodwill multiple in the range of 0-to-1. To the extent it "scores" high, I tend to apply a multiple in the range of 2-to-3, all subject to expert validation. Note that the reference to "scores" is purely qualitative; I do not try to overly quantify the scores but rather heed Warren Buffett's admonition that the objective of valuation is to be "approximately right [rather] than precisely wrong."⁴⁶

As noted above, the relationship of NAV and EPV is used to check the reasonableness of each valuation. NAV is, of course, a point-in-time estimate while EPV is a perpetual estimate and thus the interaction of net assets and earnings over time is an extremely important valuation consideration, especially in the areas of franchises and distressed investments. For example, to the extent the goodwill of a firm has significant value *and* it still is able to generate and sustain a significant level of earnings, the firm will likely be deemed a franchise for valuation purposes. However, *not* all franchises are equally sustainable.

The products that firms produce have well known life cycles, and therefore so do the abnormal returns of many franchises. The transitory nature of franchises is well known and well documented. For example, consider the famous quote of Horace that Benjamin Graham uses to open his seminal *Security Analysis*, “Many shall be restored that now are fallen and many shall fall that now are in honor.”⁴⁷ Consider also James Grant’s quote that introduces this **Appendix**: “Most profitable business niches last only as long as the competition takes to discover them. They vanish when a swarm of imitators attacks the innovator with a better idea, lower prices or both at the same time.”⁴⁸ An insightful study conducted by Professor Pankaj Ghemawat validated this phenomenon by finding that, “the return on investment of business units in the PIMS [Profit Impact of Market Strategy] database indicated that performance differences were largely wiped out over a 10-year period.”⁴⁹ This finding is illustrated in **Exhibit 10**.

< Insert **Exhibit 10** from p. 32 here >

If, in general, the abnormal returns of a franchise can be expected to last for approximately a decade then—generally—then the odds of value realization are maximized when investments are made in *nascent franchises*, or firms at the beginning of their advantage horizons. This does not mean that *developed franchises*, or firms generally midway or more through a typical decade-

long advantage horizon, are not viable investments, only that the value realization risk associated with such investments could be elevated. Similarly, this does not mean that *mature franchises*, or firms toward the end of an advantage horizon, are not viable investments. In fact, such firms can at times offer reasonable margins of safety; for example, consider the case of Garmin (GRMN), the GPS manufacturer, in the year 2010. At that time, Garmin hit one of my screens largely due to the competitive risk it faced. After I valued Garmin and stress tested its earnings power I purchased it on July 29, 2010 for \$28.78 per share. At that price, Garmin was yielding 5.21% and was operating off of a clean balance sheet (i.e., no long-term debt). I sold it on January 19, 2012 at \$41.80 per share.

In closing, it is important to underscore the fact that the 10-year advantage horizon identified above is a guideline *not* a rule; in fact, some of the best franchise-based investments are firms that have been able to extend their franchises for decades including Marvel, which was the subject of this paper, as well as Heinz and GEICO.^{50,51} However, margin of safety-rich opportunities in such firms tend to be rare, especially during times not subject to some form of distress.

Exhibit 1 – Marvel’s Liquidation Value

	<u>Sep-96</u>	<u>Adjustment</u>	<u>Value</u>	<u>Notes</u>
		<i>\$000,000s</i>		
Cash	\$35.9	100%	\$35.9	
Accounts receivable	\$257.2	85%	\$218.6	(1L)
Inventory	\$99.1	50%	\$49.6	(2L)
Deferred income tax	\$32.5	0%	\$0.0	(3L)
Income tax receivable	\$18.2	100%	\$18.2	
Prepaid expenses and other current assets	<u>\$58.2</u>	0%	<u>\$0.0</u>	(4L)
Current assets	\$501.1		\$322.3	
Property, Plant & Equipment (net)	\$87.7	50%	\$43.9	(5L)
Goodwill and other intangibles (net)	\$595.7	50%	\$297.9	(6L)
Investment in subsidiaries	\$3.2	0%	\$0.0	(7L)
Deferred charges and other assets	<u>\$72.7</u>	0%	<u>\$0.0</u>	(7L)
Total assets	\$1,260.4		\$664.0	
Accounts Payable	\$95.8	90%	\$86.2	(8L)
Accrued expenses and other current liabilities	\$170.1	90%	\$153.1	(8L)
Short-term borrowings	\$28.7	0%	\$0.0	(9L)
Current portion of long-term debt	<u>\$625.8</u>	0%	<u>\$0.0</u>	(9L)
Current liabilities	\$920.4		\$239.3	
Long-term debt	\$0.0	0%	\$0.0	(9L)
Other long-term liabilities	\$56.6	0%	\$0.0	(10L)
Total liabilities	\$977.0		\$239.3	
Minority interest in Toy Biz	\$102.9	0%	\$0.0	(11L)
Liquidation Value	\$180.5		\$424.7	(12L)

Data Source: Jason Auerbach and Benjamin Esty, *Bankruptcy and Restructuring at Marvel Entertainment Group*, HBS Case Services #9-298-059, July 2 (1998), p. 11. All adjustments are the author’s and have been rounded. Note: The valuation is prepared from the standpoint of 1996 throughout this paper.

Exhibit 2 – Marvel’s NAV

	<u>Sep-96</u>	<u>\$000,000s</u> <u>Adjustment</u>	<u>Value</u>	<u>Notes</u>
Cash	\$35.9	100%	\$35.9	
Accounts receivable	\$257.2	100%	\$257.2	
Inventory	\$99.1	100%	\$99.1	
Deferred income tax	\$32.5	0.910	\$29.6	(1A)
Income tax receivable	\$18.2	100%	\$18.2	
Prepaid expenses and other current assets	<u>\$58.2</u>	100%	<u>\$58.2</u>	
Current assets	\$501.1		\$498.2	
Property, Plant & Equipment (net)	\$87.7	125%	\$109.6	(2A)
Goodwill and other intangibles (net)	\$595.7	\$98.2	\$693.9	(3A)
Investment in subsidiaries	\$3.2	100%	\$3.2	
Deferred charges and other assets	<u>\$72.7</u>	100%	<u>\$72.7</u>	
Total assets	\$1,260.4		\$1,377.6	
Accounts Payable	\$95.8	100%	\$95.8	
Accrued expenses and other current liabilities	\$170.1	100%	\$170.1	
Short-term borrowings	\$28.7	100%	\$28.7	
Current portion of long-term debt	<u>\$625.8</u>	-\$625.8	<u>\$0.0</u>	(4A)
Current liabilities	\$920.4		\$294.6	
Long-term debt	\$0.0	\$563.2	\$563.2	(5A)
Other long-term liabilities	\$56.6	90%	\$50.9	(6A)
Total liabilities	\$977.0		\$908.8	
Minority Interest in Toy Biz	\$102.9	0%	\$0.0	(7A)
NAV	\$180.5		\$468.8	(8A)

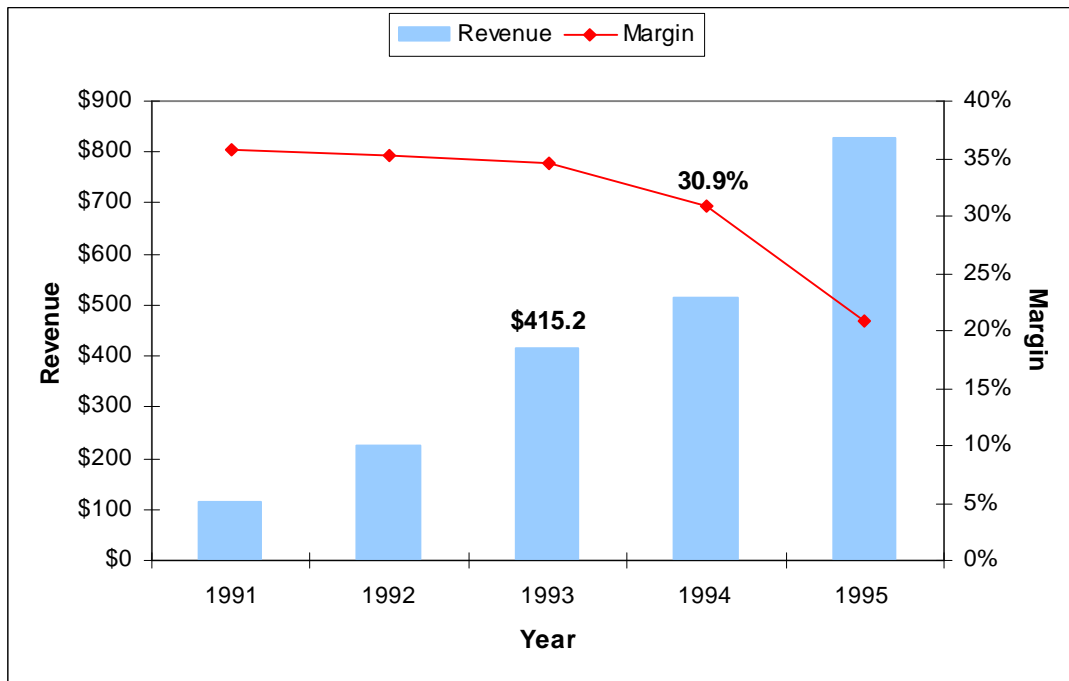
Data Source: Auerbach and Esty (1998), p. 11. All adjustments are the author’s, and have been rounded.

Exhibit 3 – Marvel’s EPV

	<i>\$000,000</i>			
	1997	1998	1999	Notes
Expected Sustainable Operating Earnings			\$128.3	(1E)
Interest income			<u>\$1.8</u>	(2E)
Sustainable Pre-Tax Earnings Before NOLs			\$126.5	(3E)
Percent of Sustainable Realized	33%	67%	100%	(4E)
Pre-Tax Earnings	\$42.2	\$84.3	\$126.5	(5E)
NOL Carry-forwards	\$42.2	\$57.8	\$0.0	(6E)
Taxes	<u>\$0.0</u>	<u>\$8.0</u>	<u>\$38.0</u>	(7E)
Preliminary Earnings	\$42.2	\$76.4	\$88.6	(8E)
Discount Rate	9.9%	9.9%	9.9%	(9E)
Earnings	\$42.2	\$76.4	\$891.9	(10E)
Present Value Factor	0.910	0.827	0.753	(11E)
Present Value of Earnings	<u>\$38.4</u>	<u>\$63.2</u>	<u>\$671.4</u>	(12E)
Earnings Power			\$773.0	(13E)
EPV			\$808.9	(14E)

Data Source: Auerbach and Esty (1998), cited above, p. 12. All calculations are the author’s, have been rounded and, once again, the valuation is prepared from the standpoint of 1996.

Exhibit 4 – Marvel’s Historical Earnings



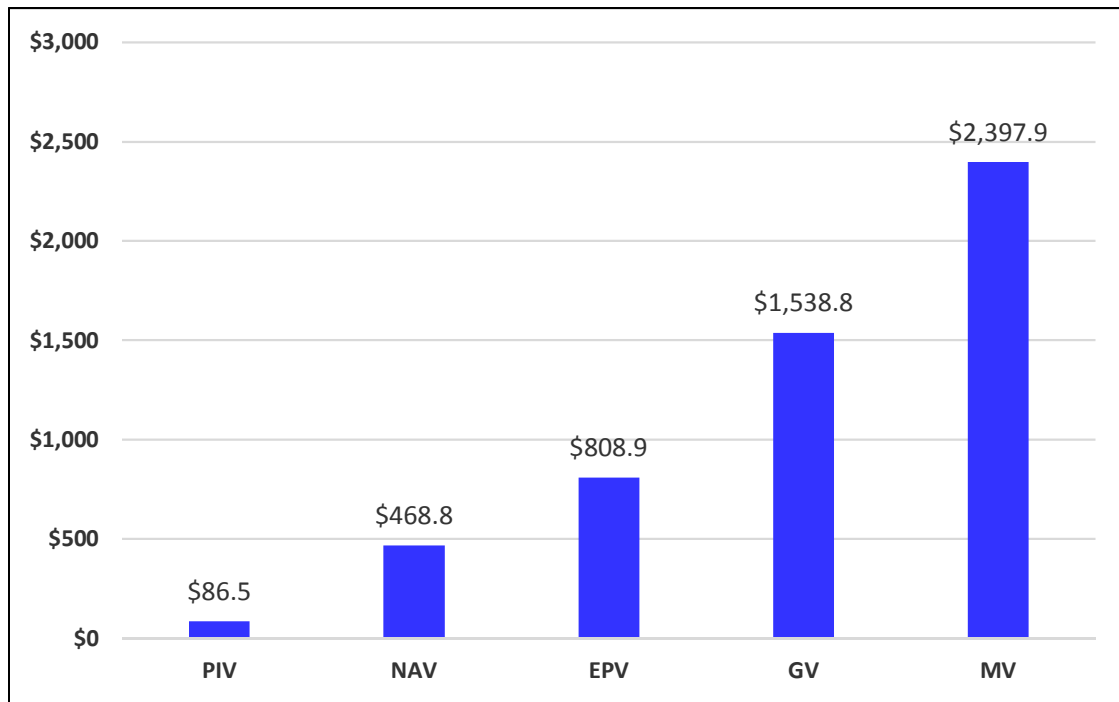
Data Source: Auerbach and Esty (1998), p. 12. Dollars in millions; margin is based on the author’s calculations, which have been rounded. Readers are generally encouraged to follow Benjamin Graham’s “two pieces of advice... The first is: Don’t take a single year’s earnings seriously. The second is: If you do pay attention to short-term earnings, look out for booby traps” (*The Intelligent Investor 4th Ed.* (NY: Harper & Row, 1973 [1949]), p. 165).

Exhibit 5 – Marvel’s Growth Value

	\$000,000s	<u>Notes</u>
Sustainable Pre-Tax Earnings Before NOLs	\$126.5	(a) = (3E)
Tax Rate	30.0%	(b)
Sustainable Earnings Before NOLs	\$88.6	(c) = (a) * [1 - (b)]
Net Asset Value (NAV)	\$468.8	(d) = (8A)
Return on NAV (RNAV)	18.9%	(e) = (c) / (d)
Discount Rate	9.9%	(f) = (6E)
Growth Multiple	1.9	(g) = (e) / (f)
EPV	\$808.9	(h) = (14E)
Growth Value	\$1,538.8	(i) = (g) * (h)

All calculations are the author's and have been rounded.

Exhibit 6 – Marvel’s Value Profile



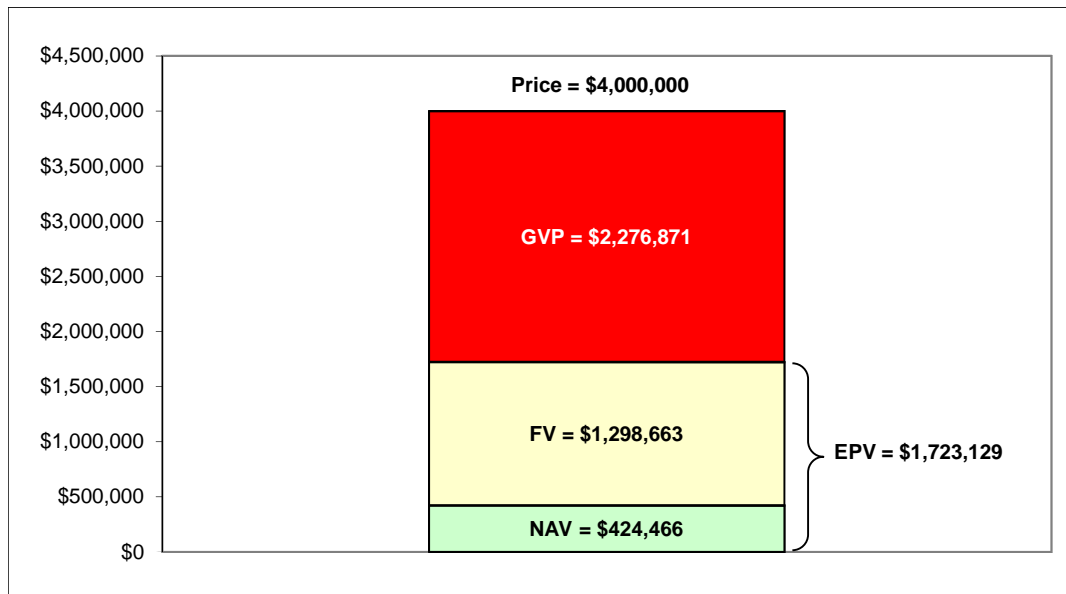
Dollars were rounded and are in millions *where* “PIV” is Perelman's Implied Value, “NAV” is Net Asset Value, “EPV” is Earnings Power Value, “GV” is Growth Value, and “MV” is the market value of Marvel’s equity on December 31, 2008.

Exhibit 7 – Marvel and Value Realization: "The Death of Captain America"



Source: <https://www.inter-comics.com/blog/news-views/devil-in-the-detail-002-is-captain-america-still-relevant> Captain America is a character that is owned by Marvel, which was acquired by Disney. The artist who drew this picture is Steve Epting. Interested readers are referred to the story arc written by Ed Brubaker, Steve Epting and Mike Perkins, *Captain America Omnibus* (NY: Marvel, 2007). This is the book that introduced the "Winter Soldier" character, which was the subject of the 2014 blockbuster movie, *Capital America: Winter Soldier*.

Exhibit 8 – Disney’s Marvel Acquisition: Pricing Analysis



Source: Joseph Calandro, Jr., “Disney’s Marvel acquisition and strategic financial analysis,” *Strategy & Leadership*, Vol. 37, No. 5 (2009), p. 44. All calculations are mine and have been rounded where “NAV” is net asset value, “FV” is franchise value, EPV is earnings power value, and “GVP” is the growth value premium.

Exhibit 9 – Goodwill

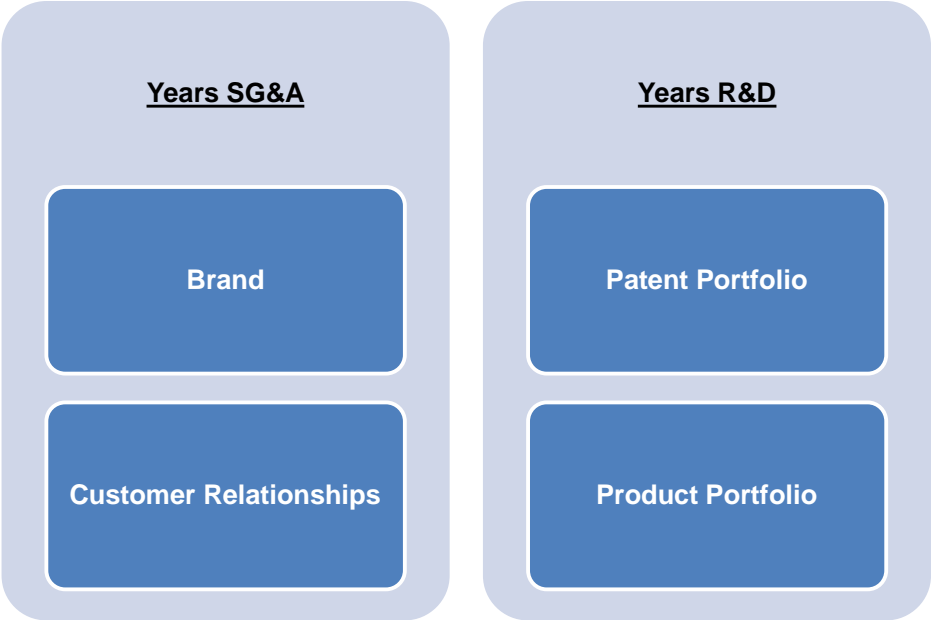
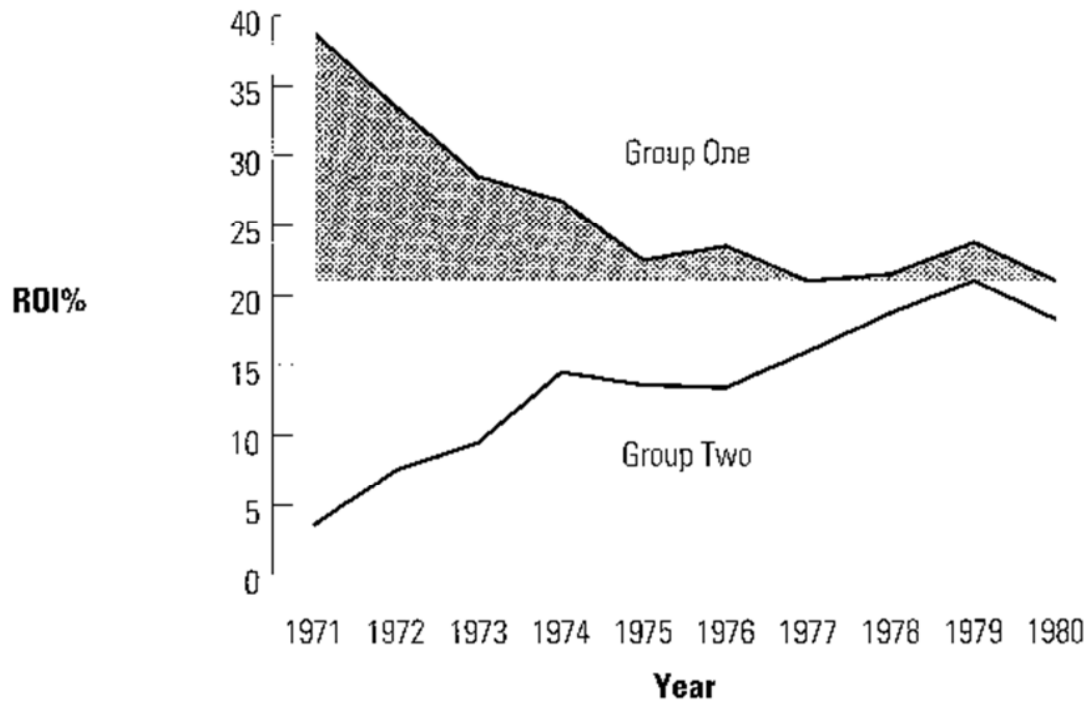


Exhibit 10 – The Transitory Nature of Abnormal Returns and Franchises



Source: Pankaj Ghemawat, "The Risk of *Not* Investing in a Recession," *MIT Sloan Management Review*, Spring (2009 [1993]), p. 37.

Endnotes

¹ Benjamin Graham and Spencer Meredith, *The Interpretation of Financial Statements* (NY: McGraw-Hill, 1998 [1937]), p. 110.

² Martin J. Whitman and Fernando Diz, *Distress Investing* (Hoboken, NJ: Wiley, 2009), p. 27.

³ James Grant, "One last gasp for Treasuries?" *Grant's Interest Rate Observer*, Vol. 32, No. 1, January 10 (2014), p. 3.

⁴ Stuart Gilson, "Investing in Distressed Situations: A Market Survey," *Financial Analysts Journal*, November-December (1995), p. 22. Retail-based distressed opportunities also existed with Kmart, but the opportunities were seized by hedge fund managers, not other retailers. For more information on Kmart see Whitman and Diz (2009).

⁵ Regarding the terms "bankruptcy" and "Chapter 11," Seth A. Klarman, *Margin of Safety* (NY: HarperBusiness, 1991) defines each as follows:

Bankruptcy--a legal state wherein a debtor (borrower) is temporarily protected from creditors (lenders); under Chapter 11 of the federal bankruptcy code, companies may continue to operate (see **Chapter 11**). (p. 229)

Chapter 11--a section of the federal bankruptcy code where by a debtor is reorganized as a going concern rather than liquidated (see **bankruptcy**). (p. 230)

For "A Brief Overview of Chapter 11" see Whitman and Diz (2009), Ch. 8.

⁶ See, for example, Chelsea Emery, "Besieged companies selling off parts to stay whole," *Financial Week*, February 2 (2009), <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090202/REG/901299969/-1/FWDailyAlert01>

⁷ Gilson (1995), p. 23.

⁸ This is covered extremely well in the documentary *Comic Book Superheroes Unmasked*, The History Channel (2003).

⁹ For more information see Joseph Calandro, Jr., "Systemic Risk and Risk Management: Overview and Approach," forthcoming in the *Journal of Insurance and Financial Management* (2016).

¹⁰ For more information see Jason Auerbach and Benjamin Esty, *Bankruptcy and Restructuring at Marvel Entertainment Group*, HBS Case Services #9-298-059, July 2 (1998).

¹¹ There is obviously a great deal more to this bankruptcy than can be covered in this overview. Interested readers are referred to Dan Raviv, *Comic Wars* (NY: Broadway, 2002). This book is just about as fun to read as almost any of Marvel's popular comic books, more of which later.

¹² For an excellent schematic that outlines distress resolution see Stuart Gilson, *Creating Value Through Corporate Restructuring* (NY: Wiley, 2001), p. 181.

¹³ Gilson (1995), p. 10.

¹⁴ Generally, a net operating loss occurs when tax-deductible expenses exceed taxable revenues in a given taxable year. Those losses can be carried forward to some extent to reduce future tax liabilities. As noted later in this paper, NOLs should be assessed in consultation with experienced accounting, legal and/or tax advisors as the rules governing them can be extremely complex.

¹⁵ Marvel's long-term debt became current (reflected in note (9L) entries) upon violation of its debt provisions, which led to its bankruptcy filing.

¹⁶ Auerbach and Esty (1998), p. 5.

¹⁷ The value was derived by multiplying \$0.85 by the 101.8 million shares outstanding at the time (*ibid.*, p. 9).

¹⁸ Benjamin Graham memorialized liquidation value-based analysis with a measure he called "net-net value," which is calculated by subtracting total liabilities from current assets. For more information see, for example, Graham and Meredith (1998 [1937]), pp. 55-56.

¹⁹ Raviv (2002), p. 59.

²⁰ Auerbach and Esty (1998), p. 5.

²¹ Bruce Greenwald, Judd Kahn, Paul Sonkin, and Michael van Biema, *Value Investing – From Graham to Buffett and Beyond* (NY: Wiley, 2001), pp. 61-62.

²² Auerbach and Esty (1998), p. 15-16.

²³ Calculated at 101.8 million shares.

²⁴ For more information see Joseph Calandro, Jr., "Turnaround Value and Valuation: Reassessing Scott Paper," *Journal of Private Equity*, Winter (2011), pp. 67-78.

²⁵ The exact ownership percentage was 81.2% per Auerbach and Esty (1998), p. 9.

²⁶ The 10-Year T-Note was yielding 6.62% at the time per Auerbach and Esty (1998), p. 18.

²⁷ The equation for calculating the factors is: $1 / (1 + .099)^{\text{Year}}$

²⁸ For information on Carl Icahn see Mark Stevens, *King Icahn: The Biography of a Renegade Capitalist* (NY: Penguin, 2014 [1993]).

²⁹ It is important to carefully analyze *all* stakeholders that are identified in a bankruptcy proceeding to the fullest extent possible, which is a topic beyond the scope of this paper.

³⁰ For information on distressed investing and M&A see, for example, Peter Nesvold, Jeffrey Anapolsky and Alexandra Lajoux, *The Art of Distressed M&A* (NY: McGraw-Hill, 2011), Whitman and Diz (2009), Stephen Moyer, *Distressed Debt Analysis* (Boca Raton, FL: J. Ross, 2005), and Gilson (2001).

³¹ "Comic Book Publisher Marvel Emerges From Bankruptcy," *Los Angeles Times*, October 2 (1998), p. D-5, <http://articles.latimes.com/1998/oct/02/business/fi-28533>. The settlement included a mix of warrants and cash.

³² Data source: www.wsj.com, all calculations are the author's and have been rounded.

³³ As quoted by Joseph Calandro, Jr., "Disney's Marvel acquisition: a strategic financial analysis," *Strategy & Leadership*, Vol. 30, No. 2 (2010), p. 43.

³⁴ Many years ago I worked for an insurance company whose President thought it would be a good idea to insure film-making. This particular executive was technically very weak, ignorant of the movie business in general and incredibly arrogant. Predictably, his film-making insurance venture lost a great deal of money. The takeaway being that the *circle of competence* concept applies to **all** forms of investment, including risk transfer (for more information see Joseph Calandro, Jr., *Applied Value Investing* (NY: McGraw-Hill, 2009), Ch. 6). Nicholas Dunbar comments on film insurance in his book, *The Devil's Derivative* (Boston, MA: HBS, 2011), pp. 14-15.

Appendix: Note on Estimating Goodwill and Franchise Lifecycles

³⁵ Rodney Klein, Ed., *Benjamin Graham on Investing* (NY: McGraw-Hill, 2009), p. 339.

³⁶ Benjamin Graham, David Dodd and Sidney Cottle, *Security Analysis 4th Ed.* (NY: McGraw-Hill, 1962 [1934]), p. 689.

³⁷ James Grant, "Up and at 'em, Mr. Bear," *Grant's Interest Rate Observer*, February 21 (2014), p. 1.

³⁸ Graham and Meredith (1998 [1937]), p. 106.

³⁹ Greenwald, et al. (2001), pp. 61-62.

⁴⁰ For more information on brands see David D'Alessandro, *Brand Warfare* (NY: McGraw-Hill, 2001).

⁴¹ For a description of base case value see: Joseph Calandro, Jr., *Value Investing General Principles* (September 21, 2015), Appendix 2, Available at SSRN: <http://ssrn.com/abstract=2575429>

⁴² It bears repeating that valuation is an involved multi-layer process, *not* a quick spreadsheet exercise. For more information see the Conclusion to Calandro (2009), pp. 201-221.

⁴³ James L. Hunt, *Relationship Banker: Eugene W. Stetson, Wall Street, and American Business, 1916-1959* (Macon, GA: Mercer, 2009), p. 238.

⁴⁴ For more information see Joseph Calandro, Jr., "Taking Heinz Private: Managing Value Realization Risk," *Journal of Private Equity*, Fall (2013), pp. 46-56.

⁴⁵ And thus healthy skepticism is a core driver of conservative valuation. One humorous anecdote to drive home this point: I once had a philosophy student in one of my MBA classes. This student was finding the value investing course material difficult to comprehend, and as result he tended to want to debate pretty much everything as philosophy students are sometimes prone to do. When he began debating the merits of skepticism I pretty much lost my patience. "Look at it this way," I said, "If value investors have a patron saint, philosophically speaking of course, it is David Hume; radical skepticism." This student went on to excel in the class, which to date is one of my proudest moments as a professor.

⁴⁶ *Berkshire Hathaway Annual Report, 1993*; <http://www.berkshirehathaway.com/letters/1993.html>

⁴⁷ Note also Tad Crawford, “Forward: Taking Stock” in John Brooks, *Once in Golconda* (NY: Alworth, 1997 [1969]), “Today, Golconda is in ruins, a symbol that our yearnings for wealth and our actual riches are transitory in the ceaseless flow of time” (p. vi).

⁴⁸ Continuing along this line Mr. Grant observed that, “The invisible hand probably poses a greater threat to elevated profit margins than even the federal government [e.g., regulation, taxes, etc.]” (“Couldn’t be better,” *Grant’s Interest Rate Observer*, May 16 (2014), p. 8). I agree with the qualifier “probably” in these most unfortunate days of ever increasing governmental intervention.

⁴⁹ Pankaj Ghemawat, “The Risk of *Not* Investing in a Recession,” *MIT Sloan Management Review*, Spring (2009 [1993]), p. 37. For more information on PIMS see Robert Buzzell and Bradley Gale, *The PIMS* Principle* (NY: Free Press, 1987).

⁵⁰ For more information on GEICO see Calandro (2009), Ch. 3 and Joseph Calandro, Jr., “Growth-based Franchise Opportunities: Lessons from the GEICO Acquisition,” *Journal of Private Equity*, Spring (2011), pp. 6-17.

⁵¹ For more information on competitive advantage sustainability see Eric van den Steen, *Sustainability of Competitive Advantage*, HBS case services #9-714-480, March 31 (2014), and Pankaj Ghemawat, *Commitment* (NY: Free Press, 1991).