LI LU LECTURE NOTES
Spring 2012

These are my notes from Li Lu's 2012 lecture at Columbia University. They're incomplete and edited for clarity, so this shouldn't be considered a transcript. If you have questions or comments, please reach out to me at turtlebay.io.

It's good to be back in Professor Greenwald's classroom. I took his class when I was a student. His class, in fact, helped launch my investment career. So it's an honor to come back and do this lecture. I've done it for twelve years, and I look forward to it every year.

I want to start by going over the three basic concepts of value investing:

(1) Stocks represent partial ownership in a business—they aren't just pieces of paper;
(2) Investing demands a margin of safety; and
(3) The concept of Mr. Market.

The first concept, stocks aren't just pieces of paper, is easy to understand but hard to apply. When you have a piece of paper that gets quoted all the time, you tend to trade it. That's human nature. Some people, however, view these pieces of paper as fractional interests in businesses. And those are the people we're referring to when we talk about value investors.

The second concept, margin of safety, is also easy to understand. Investing involves making predictions, but the future is unpredictable. No matter how smart you are, how much you know or how much work you've done, you're still dealing with probabilities. The odds should be high enough so that over a lifetime you end up ahead—way ahead. But because you're dealing with probabilities, nothing is 100% certain. You need a margin of safety to allow for mistakes and misfortune.

What about the third concept: Mr. Market? You've all heard about Ben Graham's Mr. Market. Tell me about him.

[Student: Mr. Market is the irrational and erratic fellow that's always willing to trade with you.]

Right. Of course, Mr. Market is a fictional character. You can't point to someone and say, "That's Mr. Market." We use him as a mental model to help ignore market noise and have confidence in our convictions.

It's another concept that's easy to understand but hard to apply. Over your career, you won't just encounter irrational and erratic people. This business has lots of thoughtful people, too. What happens when one of them presents a well-reasoned case against you? You'll think to yourself, "This fellow is smart, he knows more than I do and he holds the opposite view." You end up asking, "What am I doing [betting against this person]?" That's the more common experience, and it's why many of you will be influenced by what others have to say.

Every investor must develop the frame of mind to deal with thoughtful people disagreeing with them. But how do you do this? How do you get to the point where you're comfortable being told you're wrong? How do you get to the point where you think it's all noise?

Charlie Munger has a saying: "I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do." What does he mean? He means you're entitled to your opinion after reading everything you can find, talking to everyone who will talk to you and listening to all the arguments. Only then can you say, "I can hold this view because I can't find anyone who knows more than I do."

Let's move on to the case studies.

<u>First Case Study: Megastudy</u>
Picture the following: It's December 2004 and a South Korean company called Megastudy is about to go public. You've decided to research the company as a potential investment.

You have the handouts with Megastudy's information. Tell me about the company.

[Student: They provide educational services.]

What type of educational services?

[Student: They offer online tutoring services that help students prepare for the Suneung, which is the Korean college entrance exam.]

Do we have any South Koreans in the room? Tell us about your college entrance exam.

[Korean student: You take the Suneung in high school. It determines where you go to college.]

What about your school grades, class rank or other test scores? Do colleges look at those as well?

[Korean student: Colleges look at your Suneung score above everything else.]

Does the college you attend matter more in Korea than in other countries?

[Korean student: Yes. A lot more.]

Why?

[Student: Your college degree determines your career prospects. You can't get a job at a top Korean company unless you have a degree from a good school.]

Is it fair to say that the college entrance exam is one of the most important things a Korean will do in their life?

[Korean student: Yes.]

How do parents help their kids prepare for the test? Can they, for instance, send them to private schools?

[Korean student: You can send your kids to a private school in elementary and middle school. But all students must attend the same public high schools.]

So how do parents prepare their kids for the exam?

[Korean student: They send them to after-school tutors.]

Right. In Korea, everyone goes to tutors. And because this exam is so important, you want to go to the best tutor you can afford. But there are only so many good tutors, and their time is limited. With so much demand for their time, good tutors end up with a lot of pricing power.

It's no different than someone facing a life-threatening medical condition. That person wants the best surgeon they can find. There's a problem though: Everyone else dealing with the same life-threatening condition wants that surgeon, too. The surgeon can charge a premium, and only a few people can afford the procedure.

How does Megastudy help students prepare for the entrance exam?

[Student: Megastudy provides a platform for the best tutors to teach online classes.]

They hire the top teachers, tape them and put the material online. Students pay a fee that's less than the cost of an offline tutor. Now everyone, not just the rich, can afford the best test preparation.

The model has caught on with customers. And it's turned into a great business: triple-digit revenue growth, 40% operating margins, no capital requirements, etc.

MEGASTUDY CO.

KRW billions; USD millions at 1,000:1 fx rate	Year ended December 31,		
	2003	2002	2001
Online lectures	35	16	4
Offline lectures	4	1	-
Supplies & other	7	3	1
Total revenues	46	20	4
year-over-year	*126%*	*376%*	*638%*
Gross profit	30	14	3
gross margin	*66%*	*67%*	*66%*
Operating profit	20	9	1
operating margin	*45%*	*46%*	*30%*
Net profit	15	7	1
Shares outstanding	4.7	4.7	4.7
Net profit per share	3,234	1,459	189
Return on beginning shareholders' equity	145%	187%	197%
Cash	21.7	11.9	3.4
Receivables	0.9	0.6	0.3
Prepaid & other	0.2	0.3	0.0
Current assets	22.8	12.8	3.7
Property, plant & equipment, net	8.2	0.6	0.1
Investments	3.4	1.4	0.7
Other	0.5	0.0	0.0
Total assets	34.9	14.8	4.6
Payables	0.5	0.6	0.2
Accrued & other	7.5	3.5	0.6
Current liabilities	8.0	4.1	0.9
Long-term liabilities	0.8	0.3	0.0
Equity	26.0	10.4	3.6
Total liabilities & equity	34.9	14.8	4.6

What about the valuation? Megastudy planned on selling shares at 19,000 to 30,000 won, but the IPO priced at 18,500. They have 6.3 million shares outstanding and 50 billion won in cash (post-IPO). You can translate won to dollars at a 1,000 to 1 ratio by replacing the 'billion' with 'million'. So the market capitalization is $120 million—or $70 million after netting out the cash.

How much money did they make the previous year?

[Student: 3,234 won per share…]

I don't want per-share figures. Remember the first rule of value investing: A stock represents partial ownership in a business—it's not just a piece of paper. Don't think in 'per-share' terms. Give me the overall results.

[Student: 15 billion won.]

Megastudy has a $120 million market value, $50 million in net cash and earnings of $15 million. That's 8 times earnings or 4 times earnings net of cash. Remember, the $15 million in earnings was from 2003—almost a year ago. They're growing 100% a year, but I'm not even looking at forward earnings.

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KRW billions; USD millions at 1,000:1 fx rate

Share price at IPO -- 12/21/2004	KRW	18,500
Shares outstanding -- post-IPO		6.3
Market capitalization ……		117
Cash at IPO date -- estimate		30
Cash from IPO -- estimate		20
Debt		-
Net cash ……		50
Market capitalization, net of cash		67
P / E ……		7.7
P / E -- net of cash ……		4.4

What's wrong? Why is the company so cheap?

[Student: The government released a free online tutoring service.]

When was it released?

[Student: April 2004]

In April 2004, the government released a service like Megastudy's that students can use for free. Megastudy had been growing by over 100% per year. How did this new free service affect Megastudy's business?

[Student: In the second quarter 2004, online revenues fell 7%. Then they fell 28% in the third quarter.]

MEGASTUDY CO.

KRW billions; USD millions at 1,000:1 fx rate	2004		
	Q3	Q2	Q1
Online lectures	11.1	6.8	11.5
Offline lectures	2.4	1.9	2.4
Supplies & other	2.1	1.2	2.3
Total revenues ……………………………..	15.6	9.9	16.2
year-over-year - total	*-24%*	*6%*	*89%*
year-over-year - online lectures	*-28%*	*-7%*	*76%*
Gross profit …………………………………..	10.1	6.2	10.7
gross margin	*65%*	*63%*	*66%*
Operating profit ……………………………..	7.0	3.2	7.6
operating margin	*45%*	*33%*	*47%*

We've discovered Mr. Market's opposing view: Megastudy's fee-based business model may not be viable in a market where the government offers a competing free service. Is that a realistic point of view? Yes. A thoughtful person could make a good argument, supported by the company's recent results, that students won't pay for online tutors when they can get them for free. And if that's the case, Megastudy isn't a bargain.

Let's talk more about Megastudy's business model. How do they pay their teachers?

[Student: They charge students a fee and give the teachers a 23% commission on all the fees they generate.]

The government, on the other hand, pays teachers a fixed salary. It may make sense for an average teacher to switch to the government's service. But what about the top teachers? Top teachers attract nearly all the students, and they get 23% of everything these students spend on Megastudy. Are they going to give that up for a fixed government salary?

[Student: No.]

What about the students? Why would students pay for Megastudy when they can use the government's service for free?

[Student: Exams are zero-sum, so what matters is how well you do relative to other test-takers. Koreans paid high-priced tutors for an edge in the past. They shouldn't have a problem paying a small fee to Megastudy for that same edge in the future.]

What about new competition? What if someone started a competing service using the same commission-based model? What if someone offered teachers a higher commission? This business has 40% operating margins and doesn't need capital—there's lots of room to pay teachers more. Competitors could, for instance, offer teachers 33% commissions. Would that be enough to persuade the best teachers to leave Megastudy?

[Student: Teachers go where they make the most money. If Megastudy offers a lower commission but has more students, teachers will still make more money on their platform.]

Correct. 33% of a small number isn't the same as 23% of a large number. And if that's the case, Megastudy will still attract the best teachers because they have more students.

Does that mean Megastudy has a network effect? Consider the dynamics:

> …as more students use Megastudy, the tutors earn higher fees; as the tutors earn higher fees, they will continue to produce material for Megastudy; as they continue to produce material for Megastudy, more students will use Megastudy…

If Megastudy has a network effect, how should they compete? Network-effect businesses compete in winner-take-all markets. We need to answer the question: Who will be the winner?

[Student: eBay won in the online marketplace by having the most buyers and sellers? Perhaps Megastudy can win in their market by having the most students and teachers.]

They need to provide a platform where (a) teachers earn the most money and (b) students earn the highest exam scores. That's the feedback loop. If they do this, pricing becomes less of an issue.

What about first-mover advantage? In a network-effect business, the first to market has an advantage over everyone else. Is Megastudy the first mover in online education?

[Student: Yes. The founder of Megastudy was one of the best exam teachers in the country. He knew all the other top teachers, and he offered them equity. He signed up the best teachers in every subject.]

Let's go back to our investment decision. It's the day of Megastudy's IPO, and you've reached the following conclusion about the company: they deliver an essential service; they're the leader in a winner-take-all network-effect business; they're growing more than 100% a year, have 40% operating margins and don't need capital to grow; and they're trading at 8 times earnings or 4 times earnings net of cash. But we're still faced with one big unanswered question: Is Megastudy's fee-based model viable when the government offers a competing free service?

Do you invest in December at the offering price of 18,500 or not?

Say you decided to invest. What happens after the IPO? What happens in the fourth quarter 2004?

[Student: Online revenues increased by 15% and total revenues increased by 14%.]

This is an improvement. Maybe we're right that Megastudy won't be affected by the government's free service. Or maybe Megastudy dressed up the results to help sell the December IPO. Both are possible.

Let's move on to 2005. What happened in the first quarter?

[Student: Online revenues were down 12% and total revenues were up 3%.]

So what do you do? Are you wrong about Megastudy? Online revenues fell 7% and 28% in the second and third quarters, respectively. Things improved in the fourth quarter, but that could have been due to the IPO. Now revenues are down another 12%. If you believe Megastudy's business will be unaffected by the government's free service, how can you explain these results?

You need to ask yourself: Do I know enough to be entitled to an opinion? Those who haven't done the work will look at these results and think, "Maybe Mr. Market is right." But if you've done the work, if you know more about the company than anyone else, if you've earned the right to hold an opinion, then times like these present an opportunity to act. It's one of the defining qualities of a good investor: When the time is right, you must act. [Note: Li Lu bought more]

What happened next? What happened in the second quarter 2005?

[Student: Online revenues were up 22% and total revenues were up 45%.]

This was an important quarter. Students are getting serious about preparing for the exam, which takes place in November. Perhaps students tried the government's new service in the first quarter when there was still lots of time, but now it appears they're returning to Megastudy. If that's the case, we could be right about the viability of their business model.

Let's move on. What happened in the third quarter 2005?

[Student: Online revenues increased by 37% and total revenues increased by 57%.]

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KRW billions; USD millions at 1,000:1 fx rate	2005			2004			
	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Online lectures	15.2	8.3	10.1	6.2	11.1	6.8	11.5
Offline lectures	6.0	4.5	4.6	1.1	2.4	1.9	2.4
Supplies & other	3.1	1.6	1.9	1.2	2.1	1.2	2.3
Total revenues …………………………..	24.4	14.4	16.7	8.6	15.6	9.9	16.2
year-over-year - total	*57%*	*45%*	*3%*	*14%*	*-24%*	*6%*	*89%*
year-over-year - online lectures	*37%*	*22%*	*-12%*	*15%*	*-28%*	*-7%*	*76%*
Gross profit …………………………………..	15.4	8.8	10.3	5.1	10.1	6.2	10.7
gross margin	*63%*	*61%*	*62%*	*60%*	*65%*	*63%*	*66%*
Operating profit ……………………………..	10.6	4.8	5.0	1.9	7.0	3.2	7.6
operating margin	*43%*	*34%*	*30%*	*22%*	*45%*	*33%*	*47%*

It's becoming clear that the government's free service won't have a lasting impact on Megastudy's business. Now the question becomes: Will Megastudy dominate the online-tutoring market?

[Student: It's a winner-take-all business. Megastudy was the first mover and has a big lead. They have a good chance of dominating their market.]

Over the next few years, Megastudy did indeed dominate Korea's online-tutoring market: they overcame the threat of both new entrants and the government's free service; they reached 80% subscriber market share and had revenues 6 times larger than their nearest competitor; and they grew 50% a year and maintained 35% operating margins. No one else came close.

MEGASTUDY CO.

KRW billions; USD millions at 1,000:1 fx rate	CAGR (2007-2004)	2007	2006	2005	2004	2003	2002	2001
		Year ended December 31,						
Online lectures	41%	99	59	44	36	35	16	4
Offline lectures	78%	44	31	19	8	4	1	-
Supplies & other	43%	20	12	9	7	7	3	1
Total revenues ……………………………..	48%	163	101	71	50	46	20	4
year-over-year		*61%*	*43%*	*41%*	*9%*	*126%*	*376%*	*638%*
Gross profit ……………………… ………..	47%	102	63	44	32	30	14	3
gross margin		*63%*	*62%*	*62%*	*64%*	*66%*	*67%*	*66%*
Operating profit ………………………………..	43%	58	32	25	20	20	9	1
operating margin		*36%*	*32%*	*35%*	*39%*	*45%*	*46%*	*30%*
Net profit	46%	46	26	21	15	15	7	1
Shares outstanding	10%	6.3	6.3	6.1	4.8	4.7	4.7	4.7
Net profit per share …………………………..	33%	7,290	4,345	3,464	3,115	3,234	1,459	189
Dividends per share …………………………..	-	1,800	900	750	-	-	-	-
payout ratio		*25%*	*21%*	*22%*	-	-	-	-
Return on beginning shareholders' equity		40%	29%	32%	57%	145%	187%	197%
Cash		63.0	60.7	50.6	52.7	21.7	11.9	3.4
Receivables		7.7	4.3	2.1	1.5	0.9	0.6	0.3
Prepaid & other		11.1	8.2	4.4	1.8	0.2	0.3	0.0
Current assets …………………… ……………………		81.8	73.1	57.1	56.1	22.8	12.8	3.7
Property, plant & equipment, net		47.4	30.7	23.7	8.7	8.2	0.6	0.1
Investments		68.7	39.0	23.9	8.2	3.4	1.4	0.7
Other		8.1	0.7	0.5	0.6	0.5	0.0	0.0
Total assets ……………………… ……………………		206.0	143.4	105.2	73.6	34.9	14.8	4.6
Payables		3.4	1.7	1.1	0.6	0.5	0.6	0.2
Accrued & other		38.7	20.7	11.2	7.3	7.5	3.5	0.6
Current liabilities …………………………………………		42.2	22.4	12.3	7.9	8.0	4.1	0.9
Long-term liabilities		2.8	5.7	2.4	0.6	0.8	0.3	0.0
Equity		161.0	115.4	90.5	65.1	26.0	10.4	3.6
Total liabilities & equity …………………………………		206.0	143.4	105.2	73.6	34.9	14.8	4.6

[Student: What about the stock price?]

The stock went up more than 10 times. But a stock that rises like that presents a new set of issues. When Megastudy went public, investors were paying $70 million for $15 million in earnings. Now investors are paying $1.5 billion for $50 million in earnings. You need to ask yourself: Do I still have a margin of safety? Is this stock still a bargain? Are there better uses for my capital?

[Student: What about saturation? Korea isn't a big market, so how much longer can they grow 50% a year?]

That's another question you need to ask. Megastudy started when online was 1% of the overall tutoring market. You can grow a lot if you start from a low base—even in a small country. But what about when everyone uses online tutors and you control 80% of the market? Will Korea's tutoring market continue to grow? Will students continue to move from offline to online? Will Megastudy continue to take market share? And do I know enough about these things to pay 30 times earnings?

We don't have time to answer these questions today. I'm focused on Megastudy's IPO because I want you to see that you can find bargains in all kinds of places, including IPOs. But I suggest you study what happened to Megastudy and answer some of these questions for yourself. It's another good case study.

Let's move on to the second case study.

Second Case Study: Amorepacific Corp

The Megastudy case began in December 2004. The second case, Amorepacific Corp., takes place today. It's a live situation, which makes it more interesting because we don't know the outcome.

You all have the Amorepacific handouts. Tell me about the company.

AMOREPACIFIC CORP.

KRW billions; USD millions at 1,000 to 1 fx rate	CAGR (2011-2006)	Year ended December 31, 2011	2010	2009	2008	2007	2006
Domestic	*14%*	2,248	2,004	1,720	1,493	1,331	1,169
International	*24%*	306	248	220	185	127	104
Sales ……	*15%*	2,555	2,252	1,940	1,678	1,457	1,273
year-over-year		*13%*	*16%*	*16%*	*15%*	*14%*	*9%*
Gross profit ……	*15%*	1,780	1,674	1,401	1,180	1,027	878
gross margin		*70%*	*74%*	*72%*	*70%*	*70%*	*69%*
Operating profit ……	*10%*	373	356	309	246	234	231
operating margin		*15%*	*16%*	*16%*	*15%*	*16%*	*18%*
Net profit	*15%*	327	284	226	184	179	162
Shares outstanding	*0%*	6.9	6.9	6.9	6.9	6.9	6.9
Net profit per share ……	*15%*	47,411	41,242	32,746	26,695	25,984	23,457
Dividends per share ……	*8%*	6,500	6,000	5,500	5,000	5,000	4,500
payout ratio		*14%*	*15%*	*17%*	*19%*	*19%*	*19%*
Return on beginning shareholders' equity		21%	22%	20%	19%	22%	22%
Cash		343	326	302	197	203	203
Receivables		152	141	150	134	110	114
Inventories		226	204	160	173	136	106
Prepaid & other		32	39	24	23	38	29
Current assets ……		754	711	636	527	488	453
Property, plant & equipment, net		1,771	1,186	967	858	726	642
Investments & other		291	128	151	153	123	85
Total assets ……		2,815	2,024	1,754	1,538	1,337	1,180
Payables		78	81	71	54	43	46
Accrued & other		332	209	193	177	162	158
Current liabilities ……		410	290	265	231	205	204
Postretirement & other		205	163	169	166	160	156
Debt, including short-term		61	13	20	25	19	22
Equity		2,138	1,558	1,300	1,115	953	798
Total liabilities & equity ……		2,815	2,024	1,754	1,538	1,337	1,180

[Student: It's a Korean cosmetics and skincare company. They're the market leader in both retail and direct sales.]

What else?

[Student: They own all the top domestic skincare brands and have three times the market share of their next-largest competitor.]

What about the financial results? When you look at the results, what makes this business stand out?

[Student: They have a big international business.]

What else?

[Student: They're growing and earning good returns on capital.]

We're looking at a business with the following qualities: ownership of the leading brands; dominant market share; strong multi-channel distribution capabilities; mid-teens growth with high returns on equity and no net debt; and an international business that has succeeded in large markets—including China. Does that sound like an appealing company? Of course it does. If you can't recognize that, you're in the wrong business.

What about the valuation? What makes Amorepacific a unique situation?

[Student: The common and the preferred trade at different prices.]

What prices do they trade at?

[Student: The common trades at 1,180,000 won per share and the preferred trades at 275,000 won per share.]

What about the market capitalization? What's Amorepacific's market capitalization based on the common stock price?

[Student: $8.1 billion.]

They have 6.9 million shares outstanding—5.84 million common shares and 1.06 million preferred shares. At 1,180,000 won ($1,180), Amorepacific has a market capitalization of around $8 billion.

What about at the preferred price of 275,000 won ($275).

[Student: $1.9 billion.]

Right. 6.9 million shares times the 275,000 won preferred price gets you a market capitalization of around $2 billion.

How much did Amorepacific earn last year?

[Student: Their net income was $327 million.]

What about their shareholders' equity?

[Student: $2.2 billion.]

And do they pay a dividend?

[Student: Last year, they paid 6,500 won to the common and 6,550 won to the preferred.]

We have the same company with two different valuations:

- Common shares: 25 times earnings, 4 times book value and a 0.6% yield.
- Preferred shares: 6 times earnings, 1 times book value and a 2.4% yield.

AMOREPACIFIC CORP.

	Common	Preferred
Share price	KRW 1,180,000	KRW 275,000
Shares outstanding	6.9	6.9
Market capitalization	8,139	1,897
Cash	(343)	(343)
Investments	(262)	(262)
Debt	61	61
Net debt (cash)	(544)	(544)
Market capitalization -- net of cash	7,595	1,353
P / E	24.9	5.8
P / E -- net of cash	23.2	4.1
P / B	3.8	0.9
Dividend yield	0.6%	2.4%

Why are the preferred shares cheaper? How are the preferred different from the common?

[Student: The preferred shares don't have voting rights.]

What else?

[Student: The preferred pays a higher dividend.]

Yes. The preferred are entitled to 50 won per share more than the common.

Any other differences?

[No comments]

Can we agree that the preferred are equivalent to non-voting common that pays a higher dividend? If that's the case, why do the preferred trade at a discount? Are voting rights worth a 400% premium?

[Student: Voting rights aren't worth a lot because the founding family controls the company.]

Right. The family controls a holding company, Amorepacific Group, and the holding company owns a majority interest in Amorepacific Inc. Common shareholders have voting rights. Those rights, however, aren't worth a lot if insiders control the company.

Any other reasons for the discount?

[Student: Maybe it's due to a lack of convertibility. Can you convert the preferred shares into common shares?]

You can't convert the preferred into common. But that doesn't, by itself, make them less valuable.

[Student: It could be due to a liquidity discount.]

The preferred are more illiquid. But should the liquidity discount be 75%? I don't think so.

[Student: Maybe it's due to the dividend rights. Can Amorepacific stop paying dividends to the preferred but still pay them to the common?]

Korean companies must pay preferred dividends before they pay common dividends. Of course, the preferred are noncumulative and don't have a coupon, so Amorepacific could stop paying them. But then they would have to stop paying common dividends as well.

[Student: It seems like investors don't think the preferred have a claim on the company's earnings.]

Do we all agree that Mr. Market doesn't think the preferred have the same rights to Amorepacific's earnings as the common?

[Students: Yes.]

How can we research what rights the preferred have?

[Student: We can look at the company's financial statements.]

Let's look at the financials. How does the company allocate their earnings in last year's annual report?

[Student: They don't allocate any profits to the preferred.]

Right. The company allocates all the profits to the common. But that's not all. If you look at the footnotes, you'll notice that they also (a) exclude the preferred from the number of shares outstanding and (b) deduct the preferred dividend from net profit like it's an interest payment to a junior security.

Amorepacific 2010 Annual Report

18. Earnings Per Share

Basic earnings per share is computed by dividing net income allocated to common stock by the weighted average number of common shares outstanding during the year.

Basic earnings per share for the years ended December 31, 2010 and 2009, is calculated as follows:

	2010	2009
Net income attributable to common stock[1]	₩ 278,097 million	₩ 220,022 million
Weighted average number of common stock outstanding[2]	5,842,589	5,842,598
Basic earnings per share	47,598	37,658

[1]Net income attributable to common stock follows:

(in millions of Korean won)	2010	2009
Net income	₩ 284,481	₩ 225,878
Adjustment	(6,384)	(5,856)
Net income attributable to common stock	₩ 278,097	₩ 220,022

The details of dividends declared by the Company, dividend payout ratio and dividend yield ratio for the years ended December 31, 2010 and 2009, are as follows:

		2010	2009
Number of shares eligible for dividends	Common stock	5,842,563	5,842,598
	Preferred stock	1,055,178	1,055,199
Dividend rate	Common stock	120%	110%
	Preferred stock	121%	111%
Dividend amount	Common stock	₩ 35,055 million	₩ 32,134 million
	Preferred stock	6,384 million	5,856 million
Dividend payout ratio (Dividends/Net income)		14.57%	16.82%
Dividend yield ratio (Dividend per share/Market price)	Common stock	0.53%	0.59%
	Preferred stock	1.94%	1.86%

Are there any other ways we can confirm the status of the preferred?

[Student: We can research the legal rights that preferred shares have in Korea.]

Anything else?

[Student: We can look at Amorepacific's preferred offering documents in the securities filings.]

Anything else?

[Student: We can look at some other Korean companies that have issued preferred shares.]

What company should we look at? Think of a large Korean company—a company that sets the standard for accounting best practices in the country.

[Student: Samsung Electronics.]

How does Samsung calculate earnings per share?

[Student: They allocate a pro-rata interest in their earnings to the preferred.]

Right. They allocate a pro-rata interest in their earnings to the preferred and divide by the number of preferred shares. The result? Earnings per preferred share of 105,592 won, which is close to the earnings per common share of 105,992.

Samsung Electronics 2010 Annual Report

28. Earnings Per Share

Basic earnings per share is calculated by dividing the profit attributable to equity holders of the company by the weighted average number of ordinary shares in issue during the year excluding ordinary shares purchased by the company and held as treasury shares.

Basic earnings per share for the years ended December 31, 2010 and 2009, are calculated as follows:

(In millions of Korean Won)

	2010	2009
Net income as reported on the statements of income	₩ 15,799,035	₩ 9,571,598
Adjustments:		
Dividends for preferred stock[1]	(199,530)	(159,823)
Undeclared participating preferred stock dividend[1]	(1,896,887)	(1,124,027)
Net income available for common stock	13,702,618	8,287,748
Weighted-average number of common shares Outstanding (In thousands)	129,280	127,724
Basic earnings per share (In Korean Won)	₩ 105,992	₩ 64,888

[1] Basic earnings per preferred share (In Korean Won)

(In millions of Korean Won)

	2010	2009
Net income available for preferred stock	₩ 2,096,417	₩ 1,283,850
Weighted-average number of preferred shares Outstanding (In thousands)	19,854	19,854
Basic earnings per preferred share (In Korean Won)	₩ 105,592	₩ 64,665

Where does that leave us? Perhaps Amorepacific was wrong to exclude the preferred shares from earnings per share? Perhaps the preferred shares do represent a claim on the company's earnings? And if the preferred represent a claim on the company's earnings, then perhaps the market is wrong to discount them by 75%.

It reminds me of the debate over stock options. Until 2006, businesses didn't have to account for stock options as an expense. Executives argued that if options weren't expensed for accounting purposes, then they must be free. But that logic was flawed. Warren Buffett, in fact, wrote an article about it in 2002. Buffett asked three questions:

- If options aren't a form of compensation, then what are they?
- If compensation isn't an expense, then what is it? And
- If expenses shouldn't go into the earnings calculations, then where should they go?

You should apply this same reasoning to the Korean preferred:

- If preferred shares aren't a form of equity, then what are they?
- If equity isn't a claim on earnings, then what is it? And
- If a claim on earnings shouldn't go into the earnings per share calculations, then where should they go?

NOTE

Soon after Li Lu gave his lecture, Amorepacific published their 2011 annual report. The report included an updated earnings per share footnote that allocated a pro-rata interest in the company's earnings to the preferred shares.

Amorepacific 2011 Annual Report

31. Earnings per Share

Basic earnings per share is calculated by dividing the profit attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year excluding treasury shares.

Basic earnings per ordinary share as of December 31, 2011 and 2010, is as follows:

	2011	2010
Profit attributable to equity holders of the Company	W 327,029 million	W 287,752 million
Net income attributable to common stock	276,957 million	243,688 million
Weighted average number of ordinary shares in issue (unit: shares)	5,842,562	5,842,589
Basic earnings per ordinary share (in won)	W 47,403	W 41,709

Basic earnings per preferred share as of December 31, 2011 and 2010, is as follows:

	2011	2010
Profit attributable to equity holders of the Company	W 327,029 million	W 287,752 million
Net income attributable to preferred stock	50,072 million	44,064 million
Weighted average number of preferred shares in issue (unit: shares)	1,055,176	1,055,194
Basic earnings per preferred share (in won)	W 47,454	W 41,759

Any questions?

[Student: Can you describe how to think about the control issue. Amorepacific is an emerging-market company, and the family controls both management and the board of directors. The outside shareholders have no say in how the company is run. How do you get comfortable with this?]

In most situations, either a majority shareholder or the management controls the company. So your question applies to all publicly-traded businesses. You need to ask yourself: Do I want to be a passive minority shareholder in this company? It's a question that must be answered before you make any investment.

[Student: Do you invest in China? What are your thoughts on A shares, H shares and Chinese ADRs?]

I don't focus on where the company is listed. Remember the three basic concepts of value investing:

(1) Stocks represent partial ownership in a business—they aren't just pieces of paper;
(2) Investing demands a margin of safety; and
(3) The concept of Mr. Market.

When looking at a business, I focus on three things:

(1) Do I understand it?
(2) Is it a good business? And
(3) Is it available at a good price?

Those are the things you need to think about—not where the company is listed.

Concluding Remarks

Today we covered two of my investments—Megastudy and Amorepacific. Why choose these two investments? Because I want you to know what it's like to take the opposite view of Mr. Market. You must always remember Charlie Munger's advice: "I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do." Those who don't listen to his advice will be influenced by the market's ups and downs. Those who do listen, however, will have made a big step towards becoming a good investor.

Thank you all.