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Urbana offers tempting discount to underlying value

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Benjamin Graham, the father of value investing, was famous for his method of investing in a basket of ordinary companies at deeply discounted valuations.

While our preference is to invest in great businesses at fair valuations, on occasion we come across situations that are just too tempting to pass over. Our investment in Urbana Corp. (URB and URB.A) is a case in point.

For more than a decade, Urbana has operated primarily as an investment vehicle to acquire seats or interests in private stock exchanges, such as the New York Stock Exchange prior to its demutualization.

Urbana's management correctly predicted the coming wave in initial public offerings of stock exchanges and the higher valuations that public listings would unleash.

The strategy was brilliant, well executed and created excellent returns for Urbana's early investors up until the end of 2007.

Urbana's management is to be commended for these early home runs. However, we believe that this investment thesis has largely played out.

Urbana's private-company investments represented more than 62 per cent of total assets at the beginning of 2008 but have declined since then and currently represent less than 19 per cent of Urbana's net assets.

Since the beginning of 2008 and the onset of the financial crisis, Urbana's results have lagged the major market indexes. The total return on Urbana's non-voting common shares (URB.A) over this period was a loss of 66.4 per cent, a result far worse than the S&P 500 (which returned 31.6 per cent) and the S&P/TSX (which returned 9.7 per cent).

As a result, Urbana has traded at a discount to its net asset value (NAV) since mid-2008. In our view, and apparently in Mr. Market's, the company has evolved into a typical closed-end mutual fund. Urbana's current NAV is approximately $2.54 compared with its URB.A shares, which trade at around $1.73.

Despite Urbana's recent track record of underperformance, we believe that the size of the current discount to NAV (32 per cent) is unwarranted and Urbana's stock is undervalued.

The company's publicly traded holdings alone are worth $2.06 a share, net of all liabilities. The remaining 48 cents a share in value comes from Urbana's investments in private companies and other assets.

Urbana's management also deserves credit for repurchasing a meaningful percentage of the company's shares each year since 2010 under successive normal course issuer bids.

By doing so, while the stock has traded at a material discount to its NAV, each purchase has created value for the remaining shareholders.

Our wish is that management would be more aggressive at current prices and launch a substantial issuer bid or even liquidate the portfolio entirely and return the proceeds to shareholders.

However, in its most recent annual report, management made it clear that, at present, it is more focused on increasing the assets of the company than in narrowing the discount to NAV.

Notwithstanding our attempts to convince Urbana's management and its board of the wisdom of a more aggressive approach, it is clear to us that things are unlikely to change.

We knew going into the investment that the principals of the company have majority control by virtue of Urbana's dual share voting structure.

Urbana's management is optimistic that more impressive investment returns are just around the corner.

Despite our concerns, we are comfortable with our investment in Urbana. We started purchasing the shares at much lower levels and with our average cost base of $1.26, our investment is a safe one and should deliver a satisfactory result. We wish that we could turn it into a home run.

New investors to the stock should also do just fine at current levels as the shares remain undervalued.

And if Urbana's management can once again find the investment magic that its possessed prior to the financial crisis, investors may be treated to a truly spectacular result.

Not a bad place to be in a market where bargains are hard to come by.