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CHARACTERISTICS OF A GOOD COMPANY

And Yes, You Can Have a Good Company, but a Bad Stock!

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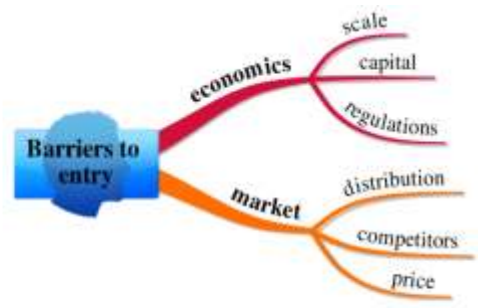
INTRODUCTION

As with most things and people in life, not all are created equal. Same holds true with companies. With over 30,000 investable companies listed worldwide (nearly 60,000 public ones) compared to a need of only 45-70 in a diversified portfolio, how does a global portfolio manager navigate these waters? Knowing which characteristics to seek in a company is the epicenter of investment success.

WHAT MAKES A GOOD COMPANY?

STRONG MANAGEMENT TEAMS WITH A COHERENT BUSINESS MODEL AND STRATEGY

Finding this is more rare than one would initially imagine! I have met dozens of CEOs and CFOs who could not articulate or pinpoint their underlying business model and how it is unique. Management's ability to develop a strategy and implement it can often be more important than the underlying industry fundamentals. A capable and devoted management team can make all the difference in separating stars from eventual duds. If top management cannot easily explain their company story and how they generate income or cash, then it is a red flag to avoid them. Management's competence and operational know-how is vital. A premium is warranted for management which does not become distracted chasing irrational strategic fit ambitions.



BARRIERS TO ENTRY

Warren Buffett often refers to a "moat" as a prerequisite competitive advantage for investing in any company. This can include:

- Being in a **niche market** that is not threatened by large incumbents.
- Having **dominant or leading market share** is appealing, such as being a Top 3 player or largest player in a fragmented niche with 50% more market share than the next largest competitor.
- **Mass market** potential in their product or service also scores highly on a "moat or franchise-like" checklist.
- Having **First-Mover Advantage**—the initial significant occupant of a market segment—and establishing strong brand equity or differentiated positioning in the minds of consumers.
- **Differentiation** with an innovation or reliability of their product or service or even a highly regarded customer service reputation to create barriers against competitors or new entrants.
- **Underserved markets** that are operating near full capacity (demand outstripping supply) also act as barriers.

- **Economies of scale, regulation, customer loyalty, capital resources, research and development, branding, vertical integration** (participation in most of the value chain to control quality and eliminate middlemen/wholesalers).
- **Cost advantage** in production or servicing.
- **High switching costs** (costly or delays for a customer to leave one company for another).

These all act as formidable barriers. No company will score perfectly on all of these. Nonetheless, the most appealing ones will demonstrate several of them over many years.

Some Predictability to Earnings Potential

The more attractive companies have some predictable attributes like:

- *Recurring revenues or profits from consumables or Aftermarket services*
- *More controllable margin drivers from a better position in the value chain*
- *Better customer service or wider sales network reach*
- *Dominant market share (the "go-to leader")*
- *An annuity or royalty revenue stream model*
- *Less reliance on passing through input cost movements (not commodities)*
- *A more flexible operating cost structure (quickly scaled back during tough times or enhanced easily to meet a demand resurgence)*

Higher Margin Companies

Firms that retain a higher percentage of their revenues over time are compelling. While operating and profit margins can vary sporadically due to some one-time expense or economic downturn, **companies which uphold higher margins, while still growing revenues, are more attractive**. This requires a unique value proposition, proper handling of expenses and being strongly positioned to maintain or grow market share. Think game-changing products or services which enlarge the overall addressable market like Apple iPods and iPads or Netflix instant delivery of streaming movies over the internet. Taking the extra step to "decompose" the margin drivers to learn what truly fuels expansion potential (i.e., volume, pricing power, acquisition boost, scalability on a larger fixed-cost basis, purchasing power) is crucial for determining sustainability versus only one-term benefits (i.e., foreign currency or derivatives boost, artificially low tax rate, unsustainable financial income). Requiring low recurring capital investment to grow is also vital in maintaining high margins (unlike airlines or autos).

Healthy Balance Sheets

Companies with little to no debt are better positioned to prosper than those heavily indebted. Debt-laden firms are restricted from large internal investments like:

- **Research and development** for new products or services

- **Marketing** to grow awareness and brand value or **Funding** for sensible small tack-on acquisitions

Less debt means more flexibility when opportunities arise. Furthermore, companies with heavy debt burdens unfortunately allocate too much of their operating profit to servicing interest expense. At some firms, 20-40% of operating profit is consumed by interest expense, preventing pass-through to retained earnings or shareholders. Leverage (too much debt) can clearly magnify gains in perfect economic conditions, but can also become addictive for management teams – and dangerously become asymmetric during downturns. Not only will it then consume most of any operating profit in a recession, but it could also lead to unprofitable periods while concurrently limiting their opportunity set. It blocks the opportunity to steal market share when their competitors struggle. More often than not, investors are not compensated enough for a burdened balance sheet.

PRICING POWER AND ORGANIC GROWTH

Long-term value creators can be truly uncovered by their ability to raise prices on their products and services even when commodity input costs are falling or during some minor economic slowdown. Sustainability of these unique companies is predicated on a value proposition that can range from dominant market share, unique niche positioning, large purchasing power scale (for more discounts on their inputs or labor), better customer service, quicker and more appealing innovation rate (typically a function of effective *research and development* or *marketing spending*) and precision in their tactical execution of operational strategies.

- *How fast does the market think the company can grow earnings?*
- *What is that gap in growth pace versus your own expectations and why?*

Companies that **grow organically** through pricing, volumes, market share steal or creation, internal investments or geographic expansion **tend to outperform ones dependent on acquisitions for growth**.

FREE CASH FLOW GENERATION

In theory, most stocks should be valued on their stream of future cash flows discounted back at a rate for their cost of capital. Cash generation is vital to a company's health and the prospect of being in an ongoing entity. **Free Cash Flow** (operating cash flow less capital expenditures) is important to monitor since it cannot be as easily manipulated or massaged as *net income, revenues or earnings per share* (EPS). Tracking a company's progress on free cash flow helps decipher the sustainability and quality of potential future worth.

Management teams need to keep their cost structure in check and not let it spiral upward ahead of sales growth potential or downturns. Properly managing their **working capital** (things like inventories, receivables or their payables owed to suppliers) is essential. Free cash flow coupled with low current "Net Debt" status (total debt minus cash on hand) represent flexibility to pursue investment opportunities beyond budgeted investment plans. Management teams conscious of not outspending their cash inflows tend to be better stewards of capital allocation. They avoid the temptation traps of investing in non-value-adding projects or ambitious acquisitions.

CAPITAL ALLOCATION

How a company allocates its capital is probably the most important component of all. One can better grasp how devoted the management is to their business by how they evaluate their opportunity set and if there are hurdles or benchmarks in place. ***Possibly half the small and mid-sized companies encountered do not even have strict criteria in place for how to invest!*** It is important to avoid firms which operate by the seat of their pants or by "hunches." To be a long-term success, there needs to be financial criteria in place for their investments. Publishing a discipline is not enough. Sticking to guidelines without making frequent exceptions prevents inefficient use of shareholder capital.

A common pitfall is a management team focused on "Empire Building" through large acquisitions or random geographic expansion simply to grow their footprint. One of the quickest ways for a company to derail itself (and us as shareholders) is to make a large acquisition of a less familiar entity, lose the prior management team in place at that target, assume massive revenue and cost synergies into their "offer price," issue heavy debt at high interest rates and then only realize six months later what they truly bought! This becomes even more disastrous after economic downturns, as in 2008, when demand slows and you cannot get reasonable loan terms. More often than not, it is wiser for management to do share buybacks or increase dividends than to make large acquisitions.

One can avoid capital destroyers by studying the track record of management teams, namely **their returns** (return on equity, return on capital or investment, return on assets, total shareholder return with dividends and buybacks). Impressive management teams constantly evaluate and benchmark their business units. They also divest underperforming margin-drag businesses with anemic sales growth so they can better reinvest behind:

- *Logical operational shift*
- *New product or service launch*
- *An improving strategic situation*

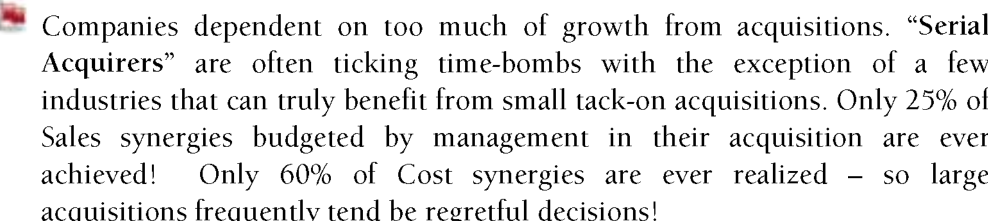
Consistency or upward trend in returns is an important lead indicator. A firm must be capable of returning cash profit on shareholder's equity.

TRANSPARENCY INTO ACTIVITIES AND INCENTIVES

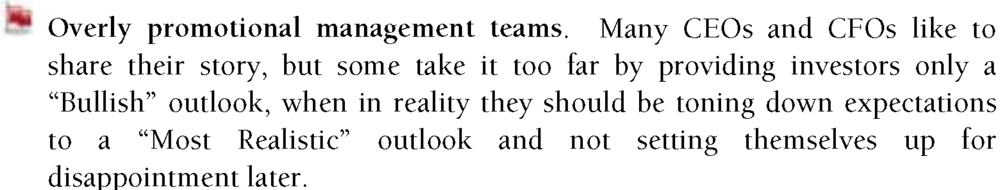
The more attractive companies disclose details about their subsidiaries and do not consolidate them into opaque reporting. It is better to find companies sharing their geographic and business division revenues and profits. This improves predictability and comprehension of their drivers. Properly incentivized management teams are also more compelling, such as ones with salaries below the industry average, but potential compensation (bonus and stock vesting awards) tied to proper capital allocation hurdles, improving margins or total shareholder return above their peers over a multi-year period. Incentives should be aligned with shareholders and not based on things easy to financially engineer through debt or stock issuance and short-term cost cutting at the expense of longer-term growth.

Lastly, it is encouraging to see management teams or board members with their "own skin in the game" by owning a sizeable percentage of shares.

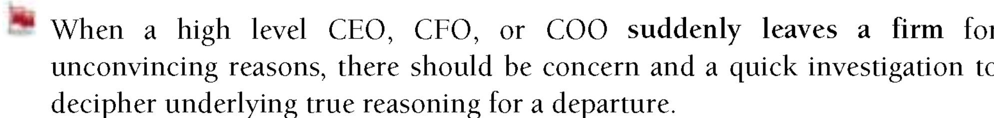
RED FLAGS AND WARNING SIGNS



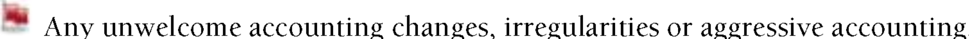
- Companies dependent on too much of growth from acquisitions. "**Serial Acquirers**" are often ticking time-bombs with the exception of a few industries that can truly benefit from small tack-on acquisitions. Only 25% of Sales synergies budgeted by management in their acquisition are ever achieved! Only 60% of Cost synergies are ever realized – so large acquisitions frequently tend be regretful decisions!



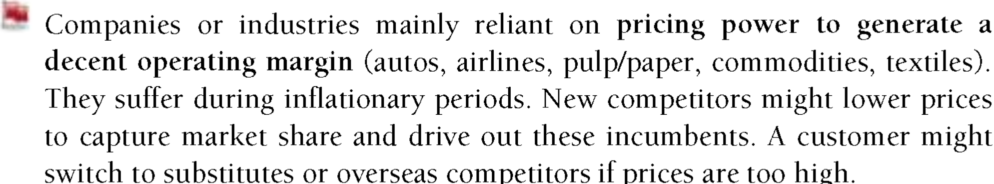
- **Overly promotional management teams**. Many CEOs and CFOs like to share their story, but some take it too far by providing investors only a "Bullish" outlook, when in reality they should be toning down expectations to a "Most Realistic" outlook and not setting themselves up for disappointment later.



- When a high level CEO, CFO, or COO **suddenly leaves a firm** for unconvincing reasons, there should be concern and a quick investigation to decipher underlying true reasoning for a departure.



- Any unwelcome accounting changes, irregularities or aggressive accounting.



- Companies or industries mainly reliant on **pricing power to generate a decent operating margin** (autos, airlines, pulp/paper, commodities, textiles). They suffer during inflationary periods. New competitors might lower prices to capture market share and drive out these incumbents. A customer might switch to substitutes or overseas competitors if prices are too high.

- **Start-ups or concept stocks** not producing cash earnings and instead in early phase consumption capital. Many biotech companies fall in this camp.

- Companies that cannot grow without needing substantial capital raising (debt or equity issuance). Firms that constantly issue Equity Shares to fund their acquisition or growth appetite. This dilutes current investors and is only worthwhile for very accretive projects or investments. The more compelling companies can "self-fund" expansion or growth through their internal cash flow.

- Companies **too big to grow**. Mega-Cap firms like Wal-mart, Dell, Cisco, Microsoft, General Electric, IBM, etc., simply become too large for their sales or earnings growth to outpace the overall stock market. After post- recession recovery is done, they then become reliant on acquisitions or lag.

- Management teams **selling an abnormally high percent of their holdings**. They could be jumping ship before published results show a rapid deterioration in the industry or within their own company.

- Sporadic and unprofitable geographic entrances and exits into new countries with limited or no experience there. These are costly management distractions.

Navigating the Choppy Waters Boils Down to Pattern Recognition and Framework

High quality firms are not always apparent and need extra digging. Their **common denominator** is management with strong consistent track records, good capital allocation, leading niches or market shares, some enduring competitive advantage and not overly burdened with debt. *It is essential to pursue companies with some control over their fate, that are not at the mercy of commodities or macroeconomics.*

By employing "Pattern Recognition" and a consistent "Framework," one can better focus time and resources on funneling down their stock universe into a manageable subset of attractive candidates. Over time, an experienced stockpicker will **recognize similar traits, themes or commonalities surfacing in less known companies**. By honing in on these patterns that occurred in other companies (which might be too large now) or in other geographies (a similar story emerged in the US a few years ago and is now only beginning in Europe), one can more effectively analyze a new candidate and catch it earlier on before too much upside is already given away. As with most stocks, a company without earnings or improving book value will be more difficult to justify as an investment. One needs an "antenna" to identify a pattern of ideal qualities like earnings growth or acceleration in sustainable earnings before other investors realize it and buy the stock.

Good Company, but a Bad Stock?

Could you have a good company but a bad stock? Of course. **Valuation** would be the main cause of this disconnect. The company could be trading at too high an absolute or relative valuation (its valuation multiple versus the peer group average). Plus, investors or sell-side analysts could eventually have too lofty expectations for earnings or sales growth. These too glamorous or emotionally-attached ("fallen in love") stocks have little to no room for error. Any disappointment that appears fundamentally driven usually triggers a large stock price drop. This type of high momentum stock could have its valuation multiple quickly compress by a third in a single week.

So, ***good companies do <u>not</u> always translate to good stocks.*** There will always be overvalued and stretched stocks, which are more prone to correct or collapse in their stock price. Catalysts could include large customer concentration or single product dependency that could be problematic to earnings if one customer does not renew or if there is a defect recall on a product comprising much of its profit.

- *Do the company's future opportunities outweigh its threats?*
- *What are investors' current expectations of future results (revenues and profit)?*
- *Are there events or catalysts to narrow the gap between the current market price of the stock and intrinsic value within a reasonable time period?*
- *What is the probability of those catalysts occurring?*
- *How sustainable and likely is free cash flow generation?*

Obscure and ignored companies do not translate to bad stocks. In fact, these can become some of the best stocks. Conversely, very loved stocks with 75%+ "Buy" ratings by sell-side analysts and held by nearly all the largest institutional managers can quickly turn into the worst stocks!

Boring companies do not mean boring, bad stocks. Berkshire Hathaway's purchase of Burlington Northern Railroad might have seemed dull at the time, but is likely to prove to be one of the best acquisitions by Berkshire in a decade. Most companies have some shortcomings, but the more compelling ones continually exceed expectations.

Simply because a stock goes up or down by 5-10% in one day does not mean that it is a good stock or a bad stock. What matters is its *future prospects* and what has fundamentally changed for the company, its outlook, the industry or the economy.

KEY TAKEAWAYS

1. ***In order to outperform the stock market, one needs to find great management teams, unique business models and improving or underappreciated prospects and without stretched stock valuations for their potential.*** Honing in on superior long-term growth potential, emerging secular growth trends for stronger positioning (niche, market share or pricing power) and profitable capital redeployment are essential to separating good companies from distracting or lackluster ones.
2. ***While there is no single "magic formula" for a good or great company, there is a common set of characteristics and traits.*** Furthermore, one cannot easily define an "average" or "normal" year in the stock market. Some might call it a year in line with the historical long-term average total return (including dividends) of 9.5-10.5%. But even 9-11% for the S&P 500 has happened only TWICE in the past 40 years. By employing the above framework and a consistent approach to selecting companies, an active portfolio manager should be able to demonstrate outperformance over a longer-term period.
3. ***Lastly, most investors overreact to bad news*** (i.e., sales and earnings misses during quarterly results season). Conversely, this same type of investor ***underreacts to favorable news*** or earnings results that exceed expectations. These two types of reactions allow a prepared investor to more effectively prevail.

Our focus is on investing in a stock before others fully realize its powerful prospects, then selling the stock before it becomes too overvalued or fundamentally weakened. Investment management is less about swinging for the fence for only homeruns and more about avoiding the landmines. If you can sidestep two to three pitfall stocks each year (ones that could drop 20-70% in a non-recessionary environment), then ***you can win by <u>not</u> losing***. The market will stall or correct occasionally, but disciplined investors can leverage that "On Sale" opportunity in their favor by increasing their allocation to higher quality companies demonstrating the aforementioned characteristics.

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