"The most important thing to me is figuring out how big a moat there is around the business. What I love, of course, is a big castle and a big moat with piranhas and crocodiles."

- Warren Buffett, 1994

Analyzing Businesses - Determining the Attractiveness of a Franchise

Tuesday March 25th, 2014

Thoughts on Value Investing & Business Quality

- **Value Investing**: Buying securities for less than their intrinsic value
- *"The term 'value investing' is widely used to imply the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics…are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics — a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield — are in no way inconsistent with a 'value' purchase."*
  - Warren Buffett, 1992
- You can pay a low multiple on an absolute basis and overpay. On the flip side, you can pay an high multiple on an absolute basis and get a bargain. It depends on the quality of the business you are buying.

Business Quality and Economic Moats

- The purpose of a company (from an investor's point of view) is to take capital from investors and put it to use in projects that generate a return on that capital
- Good companies will generate high returns on the capital it takes from investors and bad companies will earn poor returns – a lot will be average
  - *(It is worth noting that any of these can be good investments depending on the price you pay for them. Terrible companies can be great investments if you can buy them for less than they are worth)*
- Returns and 'mean reversion'
  - There are few companies that can sustain high returns on investors' capital for extended periods of time
  - High returns attract competition which will lead to excess returns being competed away and the company ending up with average returns – simple economics
- If a business generates high returns it becomes a 'good' business if it can defend those returns over a long period of time
- There are structural characteristics to look for that inform an investor to know if a business can defend its returns – these are called '***Economic Moats***'
- It makes sense to pay more for a business that can compound capital for an extended period of time

Business Quality and Economic Moats – cont’d

- Great businesses with economic moats typically are harder to buy for less than intrinsic value

- The best time to buy them is when earnings are temporally depressed for some short-term issue (either having to deal with the business itself or Mr. Market’s irrational behavior)

- If you know a moat is solid, temporary issues provide long-term investors with opportunities to buy (or buy more) on ‘sale’
  - You can call this the ‘Psychological Backstop’

How Can You Tell if There is a Moat?

- Show me the money!
  - It **must** show up in the financial characteristics of the business
  - This is measured by ROA, ROE or ROIC
  - These measure how good a company is at taking investor's capital and earning returns on that capital
    - *"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for that forty years, you're not going to make much different than a six percent return - even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one [heck] of a result."* (1)
      - Charlie Munger

- Determine what moat(s) is(are) in place
  - Intangible Assets
  - Switching Costs
  - Network Effects
  - Cost Advantages
  - Size Advantage / Scale

(1) Note: Purchase price matters a lot! I include this quote not to show that you shouldn't care about purchase price but that it points out that companies that can compound capital at high rates of return for extended periods of time can earn an investor great returns.

Moats

- *"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage."*
  – Warren Buffett

- **Intangible Assets**
  - Brands
    - Only valuable if customer is willing to pay more or reduce a customer's search costs
      - Search costs are relevant when product is complicated, customized and/or crucial (Boarder Free)
      - Company can charge higher price for same product
      - Bad Example: Sony DVD Players
      - Good Example: Tiffany & Company, USG Corporation, Carter's
  - Regulatory Approval
    - Can create scarcity of good or service and/or near government sanctioned monopolies
      - Rating Agencies and "Nationally Recognized Statistical Ratings Organization" (i.e., Moody's Investor Service), TransDigm
      - Collection of smaller approvals can also be powerful (i.e., NIMBY - SBAC Communications / Crown Castle International)
  - Patents (Least Favorite)
    - Competitors are legally prohibited from selling the same product
    - Patents have a finite life so be careful – look for portfolios of patents and a demonstrated ability to develop more
      - 3M, Merk / Eli Lilly

Moats – cont'd

- **Switching Costs**
  - If the cost for a consumer/customer to switch from one company's products or services to those of a competitor is greater than the benefit from doing so, odds are the company will be able to charge higher prices and earn excess profits
    - Especially true in niche/specialty software (Intuit, Tyler Technologies, Adobe, Autodesk)
    - Critical products that are a small part of total cost (Sensata)
    - Watch out for product lifecycles as they provide a natural point where a switch can be made
      - The exception to this is incompatibility with interoperability (Motorola Solutions)
    - Consumer goods and retailers almost have no switching costs
    - Competitors will practically give products or services away to entice customers to switch (Apple & Pages, Numbers and Keynote; OpenOffice)

Moats – cont'd

- **Network Effect**
  - Occurs when value of product or service increases with the number of users that use it (one of the best moats)
    - Microsoft (PC Manufacturers, software developers, corporations/users)
    - Interconnectivity Rich Datacenters (Equinix, Telecity, Telx)
    - Visa / Master / American Express
    - Beware of fast growing markets (eBay and Yahoo! Japan)

- **Cost Advantages**
  - Process advantages – Doing something better than someone else (least durable)
    - Replicated over time (i.e., offshore outsourcing)
  - Location – Being closer to the source
    - Look for situations where the weight/value ratio is high → expensive to ship (Aggregate quarries and cement plants)
  - Access to unique assets – mainly in commodity industries
    - Focus on cost curve (i.e., Marcellus & Utica Shales for Natural Gas)

Moats – cont'd

- **Size Advantage / Scale**
  - Spread fixed costs over more and more units so cost per unit is much lower than competitor (Intel vs. AMD)
    - Example of fixed costs: Staff, sales force, R&D, marketing/advertising, etc.
  - Scale in a distribution network – high upfront cost but extremely low marginal cost for each additional unit (MarkWest Energy, Cable operators)
    - Tend to have regional domination
  - Scale does not mean big. Scale means having more scale than your competitors to keep them from breaking even to cover upfront cost
  - Scale in Niche Markets - some markets are only large enough to 'feed one beast'
    - Niche software (Blackboard)
  - Beware of growing markets - it can bring the death to scale players

What is not a Moat? Common Pitfalls of Investors

- **Great Products**
  - Can it be copied? If so and it is popular, competitors will come (Lululemon and yoga pants)

- **Strong Market Share**
  - Leadership can be gone in a hurry without a moat (IBM and PC)

- **Great Execution**
  - If a company's success is based on being 'leaner and meaner' than its competitors than it probably operates in a competitive industry. 'Best practices' can be copied

- **Great Management**
  - Management comes and goes – high turnover. Smartest manager will struggle with a bad business. The structural characteristics are what matter.
    - One caveat: Capital allocation is important. You don't want 'kingdom growers.' You want management that thinks about ROIC
    - Also, management should know why it is running a good business and focus on maintaining the moat

Calculating ROIC

Return on Tangible Invested Capital

	EBITDA
	Less: Depreciation
	EBITA
	Less: Normalized Tax Rate
A	**NOPAT**
	PP&E, net
	AR
	Inventory
	Other Current Assets
	Less: AP
	Less: Accrued Expenses
	Less: Other Current Liabilities
B	**Tangible Captial**
A/B	**ROTIC**

Leases Adjusted Return on Tangible Invested Capital

	EBITDA
	Less: Depreciation
	EBITA
	Less: Normalized Tax Rate
	NOPAT
	Less: Lease Expense (a/t)
A	**Adj. NOPAT**
	PP&E, net
	AR
	Inventory
	Other Current Assets
	Less: AP
	Less: Accrued Expenses
	Less: Other Current Liabilities
	Tangible Captial
	Add: Capitalized Leases
B	**Adj. Tangible Captial**
A/B	**Lease Adj. ROTIC**

Note: There are various ways to calculate ROIC – this is just one example.

Other Books to Learn More

- Competition Demystified: A Radically Simplified Approach to Business Strategy by Bruce Greenwald & Judd Kahn

- The Little Book That Builds Wealth: The Knockout Formula for Finding Great Investments by Pat Dorsey

- Competitive Strategy: Techniques for Analyzing Industries and Competitors by Michael Porter