Exclusive Outlook

West Coast Asset Management
The Entrepreneurial Investor™

AUGUST 2007

Great First Impressions: Ten Signs of a Strong Company

By Paul Orfalea, Lance Helfert, Atticus Lowe and Dean Zatkowsky

Warren Buffett once explained that "price is what you pay, value is what you get." Naturally, an entrepreneurial investor seeks companies that offer a lot of value for a low price, but prices fluctuate. Thus, price helps determine *when* to buy, but a host of other factors influence *what* to buy. We look for ten specific strengths when evaluating a company. This is not the same concept as "valuation," which estimates the financial value of a company. Rather, here we're talking about the factors that suggest a company of quality and cause us to fire up our valuation assessment tools. Few companies master all ten areas, but the following areas comprise the first set of hurdles a company must face before they get our full attention:

1. **A Simple Business Model**

The very first issue of our Exclusive Outlook newsletter sang the praises of simple companies. We refuse to invest in something we do not understand, and observe that over the years Wall Street has also tended to reward simple, focused companies. Simple companies are easy to understand for customers, coworkers, management and investors, easing alignment of interests. When considering a company, expect to quickly understand how it makes money, and how it makes money for *you*. In that first issue of Exclusive Outlook, we could not explain what JDS Uniphase sells, and we still cannot. Wal-Mart, on the other hand, makes instant sense to us. Wal-Mart offers everyday goods at steep discounts and manages its supply chain to maintain profits.

2. **A "Wide-Moat" Competitive Advantage**

Competitive advantage comes in many forms, but usually comes from a cost management edge or market differentiation. Just as in a medieval castle: the wider the moat, the greater the barrier to entry. We prefer unassailable companies because by definition, they possess a long-term profit advantage and gain both pricing and buying power. Although competitive advantage may be less tangible than real estate or cash in the bank, it is nevertheless an essential element in a stock's margin of safety. Although we've been reading for years about Microsoft-killing companies and products, the company's nearly complete market share keeps competitors at a safe distance. Cisco Systems, on the other hand, lacks the market dominance, cost advantage or unique positioning to keep competitors at bay. Cisco has done fine over the years, but without a compelling competitive advantage, that could change in a heartbeat.

3. **Recurring Revenue**

As we often say, cash flow is the lifeblood of business, and a company with any form of annuity revenue steams is more attractive than a company without them. These may appear in

This material is for informational purposes only. No recommendation to purchase or sell securities is made, nor does this constitute an offer of any kind. Data were obtained from publicly available sources which we believe are reliable. West Coast Asset Management makes no warranty or representations as to the accuracy or usefulness of this information. The principals, co-workers, directors and clients of West Coast Asset Management may or may not own shares in the companies discussed. A list of companies recently reviewed in our audio recordings, presentations, newsletters and other publications is available on request. Third party trademarks or service marks are the property of their respective owners. Prospective investors should always remember that past performance is no guarantee of future results.

the form of long-term contracts for services, or in the form of ubiquitous products used every day, such as chewing gum, shaving razors or soft drinks. Lamar Advertising's billboards produce advance bookings and long-term monthly revenues from repeat clients, whereas Toll Brothers home building business depends on large, one-time purchases.

4. **Low Inventory Risk**

Any product that can go out of style or become obsolete presents inventory risk. Even a costly item that sells slowly results in additional opportunity costs for whoever holds the inventory. Dell Computer's early success came from managing the inventory risk caused by the rapid evolution of personal computers. By building to order from "just in time" parts, Dell minimized what had been a costly challenge for PC makers. Not all types of inventory are bad, of course. Retailers like Lowe's and Home Depot need massive inventories as part of their market strategy, but a fashion retailer like The Gap has to discount inventory virtually every season as styles change. We prefer companies with highly liquid inventory that turns quickly and reliably, such as Hershey's chocolates or Coca-Cola.

5. **Alignment of Interests**

Look for evidence of aligned interests in what people do, not what they say. Capital allocation, compensation standards, and other visible fiduciary duties paint a clear picture of management's attitude toward owners, including you. We like high levels of insider ownership, but that does not tell the whole story. Devotion to per-share value and long-term strategic planning, including succession planning, are more important. Consider the case of National Home Health Care, where high inside ownership did not equate to alignment of interests, because the entrenched management sought to sell the company at a price other shareholders considered too low, but in a deal that ensured many benefits for themselves. On the other hand, ATP Oil and Gas designed incentive programs that rewarded coworkers with new cars for achievements that benefited shareholders, aligning interests at every level of the organization.

6. **A Healthy Culture**

As Jim Collins observed in his book, *Good to Great*, the best leaders tend to be workhorses, not show horses. They have great ambition, but for the company rather than for themselves. This helps a company withstand change and builds zealousness in coworkers. Ruthless cultures tend to attract or produce workers more interested in managing their careers than the business. Adelphia faced allegation after allegation of ethics violations and questionable business practices, and its leaders have recently been sent to jail. Contrast the morale of Adelphia employees with that of Johnson & Johnson coworkers, whose company credo makes them feel part of a visionary, honest, ethical and loyal team.

7. **A Flat Organizational Structure**

Frankly, nothing complicates a business quite as much as people, especially management. Look for companies that get the job

Less Desirable Company	< Factor >	More Desirable Company
JDS Uniphase	Simple Business Model	Wal-Mart
Cisco Systems	Wide-Moat Competitive Advantage	Microsoft
Toll Brothers	Recurring Revenue	Lamar Advertising
The Gap	Low Inventory Risk	Hershey
National Home Health Care	Alignment of Interests	ATP Oil & Gas
Adelphia	Healthy Culture	Johnson & Johnson
Tribune Company	Flat Organizational Structure	Contango Oil & Gas
Apple	Low Reinvention Risk	Wrigley
General Motors	Low Capital Requirements	Google
EMI Music	Favorable Demographics	Johnson & Johnson

10 SIGNS OF A QUALITY COMPANY

As described in the article, these companies illustrate the range of possibilities when considering the ten criteria. Any single company that leans to the "more desirable" side on most of these factors is a strong contender for our attention.

done with as few people as possible, in as few layers as possible. A quick "cocktail napkin" comparison of revenue or market capitalization per coworker tells us much about the labor efficiency of companies in the same industry. High revenues per coworker suggest truly engaged and frugal management. Of course, one mustn't trade effectiveness for efficiency, so labor costs cannot be considered out of context. For example, it makes sense for a company with ambitious growth plans to be "overstaffed" in anticipation of future work loads. The Tribune Company, and most other newspaper publishers, historically depended on high head counts to cover local, national and international news, but that business model no longer works and many daily newspapers laid off workers or announced layoffs over the last three years. Can these businesses survive without the human talent that defined them? On the other extreme, oil and gas exploration company Contango, with a market cap of almost $600 million, manages its entire operation with a staff of only 6 people.

"Contango Oil & Gas, with a market cap of almost $600 million, manages its entire operation with a staff of only six people."

8. **Low Reinvention Risk**

Why go looking for trouble? We love Apple's products and are huge fans of Steve Jobs, but our stomachs cannot bear the thought of investing in the company, which must continuously innovate, and must hit a towering home run (iMac, iPod, iPhone?) every two or three years – without fail! On the other hand, we often joke about the Wrigley annual meeting, where we imagine a tough decision every year is whether to change the color of the chewing gum wrapper.

9. **Low Capital Requirements**

As Groucho Marx might have said, "All else being equal, math class wouldn't be so hard." Well, all else being equal, we like companies with lots of cash, but we don't like companies that *need* lots of cash. Very high capital requirements did not kill manufacturing and the automobile industry in this country, but they sure weigh heavily. Many of us don't understand why Detroit resists new fuel economy standards when it seems so simple to make fuel-efficient cars, but such changes are not as easy as they may seem. Redesigning and retooling would cost Detroit a fortune, and even though it's the correct long-term strategy, no one likes to spend that kind of money. Generally, high capital requirements make companies less agile and, ultimately, less competitive. Google, on the other hand, needs comparatively little capital (compared to its humongous market capitalization) to try a lot of new ideas and execute the best.

10. **Favorable Demographics.**

The world is constantly changing, and while the most dramatic changes cannot be predicted, many trends can be recognized and acted on. For example, wealthier countries' populations are aging, which bodes well for diversified healthcare companies like Johnson & Johnson. On the other hand, music companies like EMI seemed completely unprepared for new technologies and the changing needs of consumers.

A company that looks good in these ten areas would seem a strong company indeed. But certain factors weigh more heavily in certain situations, so we cannot consider any of these attributes in a vacuum. When is simplicity more important than recurring revenue? When is alignment of interests more important than inventory risk? Each company must be measured in context, considering its industry, regulatory environment, demographics, price, and other factors. Checklists and formulae may help to order our thinking, but choosing companies worth owning still requires artful judgment. ▲

★ **Please e-mail info@wcam.com to receive Exclusive Outlook (specify mail or e-mail preference), it is free to everyone.** ★

Please feel free to copy and distribute the *Exclusive Outlook*

West Coast Asset Management is a private independent money manager serving individuals, families, trusts of all kinds, & businesses. We pride ourselves on our focus, commitment, and integrity, but also on our availability. Please don't hesitate to call us with any questions or comments.

OUR PHILOSOPHY- *West Coast Asset Management's investments are focused in a small number of companies that we thoroughly understand. In our experience, this lowers the risk of losing capital and enables each investment selection to have a meaningful impact on results. We believe the stock market is driven by fear, greed and conflicted interests, which create exceptional buying opportunities for vigilant and nimble investors with a long-term horizon. Our experience has taught us to believe what we see, not what we hear, which is why every investment decision is based on our own hands-on research. We do not limit our investments to companies of a specific sector, size or valuation category – we simply seek the best opportunities to increase wealth and minimize risk. We believe investing is part art, part science, and all craft.*