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## Top 10 habits of companies investors love

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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 10 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 assessments tools. The following factors 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, co-workers, 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.

### 2. A 'wide-moat' 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**

Cash flow is the lifeblood of business, and a company with any form of annuity revenue streams is more attractive than a company without them. These may appear in 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. 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 co-workers 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 zealotry in co-workers. Ruthless cultures tend to attract or produce workers more interested in managing their careers than the business. Adelpia faced allegation after allegation of ethics violations and questionable business practices, and its leaders have recently been sent to jail. Contrast the morale of Adelpia employees with that of Johnson & Johnson co-workers, 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 done with as few people as possible, in as few layers as possible. High revenues per co-worker 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 past 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 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. Resilient demographic/industrial positioning**

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 such as 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 acquits itself well in these 10 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.



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