THE GURU'S CORNER

Entrepreneurial investing

Commentary: You're not just an investor, you're an owner

By Lance Helfert, West Coast Asset Management
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VENTURA, Calif. (WCAM) **-- People often quote Benjamin Graham's famous comment that "investing is most intelligent when it is most businesslike," but less often follow that advice to its logical conclusion: investing as if one owned the company.**

This idea forms the center of our book, The Entrepreneurial Investor: The Art, Science and Business of Value Investing.

An entrepreneurial investor views the portfolio -- and the companies in it -- from the perspective of a business owner. As Warren Buffett said, "There is no formula... You have to know the business."

Our experience provides a list of 10 factors that help us quickly identify the type of business we might like to own.

We want to know if the company has:

1. A simple business model
2. A wide-moat competitive advantage
3. Recurring revenues
4. Low inventory risk
5. Alignment of interests
6. A healthy culture
7. A flat organizational structure
8. Low reinvention risk
9. Low capital requirements
10. Favorable demographics

A company that looks good in all 10 areas would be strong indeed, but such finds are rare.

Still, many firms exhibit a compelling number of these traits. Two examples from our own portfolio that we feel are also undervalued include Noven Pharmaceuticals (NOVN) and ATP Oil & Gas (ATPG) .

Noven

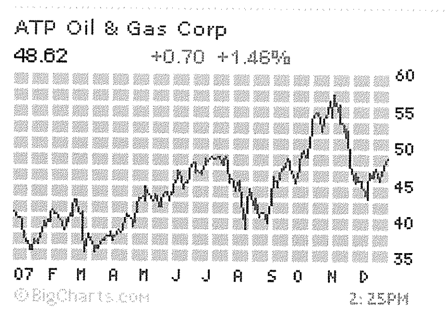
We like Noven because it is deeply undervalued based on its underlying assets, and it offers numerous high impact potential catalysts. With a market cap of $360 million and net cash and working capital of $85 million, the company's enterprise value is just $275 million, but we estimate its intrinsic value to be roughly $750 million.

Noven specializes in drug delivery, and its proprietary patch technology is "best in class", providing it with a clear competitive advantage and outstanding growth potential. Its patches are much smaller than the competition, and they stick better with virtually no irritation.

Demographics favor Noven as well. Its services are of great value to aging big pharmaceutical companies, as patches are often preferred by patients and offer extended patent life and product differentiation with little development time or capital required. Patches also improve care for two growing groups: children and the elderly. Better still, Noven's simple business model generates recurring revenue with little capital requirements, as partners typically pay for development and marketing while Noven receives milestones and royalties.

ATP Oil and Gas

ATP Oil and Gas created an interesting competitive niche by acquiring and developing neglected and overlooked properties in the Gulf of Mexico and North Sea. You might think of them as engaging in the scrap oil and gas business, but we assure you it is a big business with plenty of remaining potential. ATP adds value by applying its technical development expertise and building critical mass in difficult operating areas, such as deep water or harsh environments.



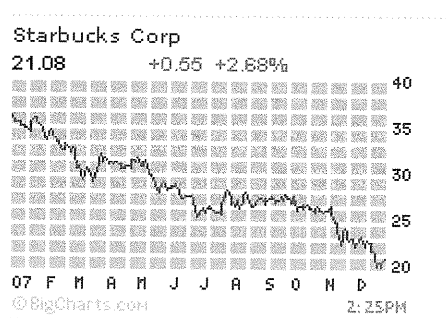
But in addition to its simple business model, competitive advantage and favorable demographics, ATP also features a very strong company culture and alignment of interests (insiders own roughly 25%).

As we illustrate in Chapter 9 of The Entrepreneurial Investor, ATP created a remarkable incentive plan for the year 2005, offering every employee a brand new Volvo S60 upon attainment of company goals. As you can imagine, the company met or exceeded all goals, and this worked out very well for shareholders as well. The enterprise value stands at about $2.8 billion, but we estimate intrinsic value closer to $4.7 billion.

On our radar

One firm on our radar compares favorably on all 10 signs of a strong company, and is almost too obvious to mention: Starbucks (SBUX) . The company's wide-moat competitive advantage is easy for anyone to see: the lines are long, even after they raise prices. Currently the market cap is about $16 billion, and within a couple of years this company will be generating $1 billion in structural free cash flow.

With strong recurring revenues, little inventory risk (because of "liquid" turnover), strong cultural components (including interest alignment and flat structure), minimal reinvention risk (just add a new flavor every few months), low capital requirements, and favorable demographics in the form of growing middle classes worldwide; when the price is right, Starbucks will be hard to resist.



Based on 15 times our estimation of structural free cash flow for Starbucks, which is just shy of one billion in 2008, we feel SBUX shares are worth around $19.

Starbucks should trade at a premium because it has created such a strong brand, possesses a healthy balance sheet and is well positioned for international growth. Having said that, our valuation does not take future growth into consideration as it only values the existing business.

Lance Helfert is President and co-founder of West Coast Asset Management and co-author of The Entrepreneurial Investor. Helfert and WCAM own shares in NOVN and ATPG through separately managed accounts and a hedge fund managed by the firm. (wcam.com)