



Investment Analysis

Sound investment analysis seeks to eliminate confusion by using simple, easy to follow, guidelines. We focus on two specific rules that can be used to assess the quality and valuation of any business.

- #1 Identify companies with internal returns on capital that exceed their cost of capital.
- #2 Invest only when the market value of a company is less than or equal to its intrinsic value.

#1 Identify companies with internal returns on capital that exceed their cost of capital.

The focus of rule #1 is to identify quality business models with effective and attentive management that respect the return expectations of all investors. Anyone supplying capital to a business, be it a bank, bond investor, or equity shareholder has a return expectation. For banks and bondholders, it is defined by a specified interest rate that can be affected by covenants, security, and seniority on the balance sheet. For shareholders, return expectations (also known as the cost of equity), is derived from long-term general equity market returns adjusted for related company risks such as earnings volatility, specific industry risk, and the historical correlation of the company's stock price to market returns. By blending these rates together on the balance sheet, we can calculate what is called the weighted-average cost of capital (WACC). This is the aggregate average return required by all investors of capital in the company. From the company's perspective, WACC must be a considered a mandatory cost of doing business. This is as true of a small company with one shareholder as it is for large companies with millions of shareholders.

The return component of this rule is simply a measure of operating profit before interest expense but after taxes. We adjust it to remain free from one-time charges and other accounting distortions. Measuring operating profit in this way defines what the company can distribute to investors or reinvest in the business for future growth. If taken as a percentage of total capital invested, we can compare whether it is enough to satisfy the annual return expectation of all investors. Here is a formula to help illustrate:

$$\frac{\text{Operating Profit After Taxes}}{\text{Total Capital}} \text{ must be greater than } \frac{\text{Cost of Capital}}{\text{Total Capital}}$$

If the formula is true, then there will be excess return. These excess returns, representing what is known as Economic Value Added¹ (EVA[®]), stand to benefit equity shareholders. When buying stocks, we recognize that we are truly owners of the business and excess returns contribute to the value of our investment. To define the companies we want to own, we only include those that consistently generate EVA. The remaining question is what to pay for those businesses in order to receive an appropriate return.

#2 Invest only when the market value of a company is less than or equal to intrinsic value.

“In the short- run, the market is a voting machine but in the long-run it is a weighing machine”

-Benjamin Graham

This quote from the mentor and graduate professor to Warren Buffett captures the essence of making investments in financial assets via public markets. Varied investor expectations, shifts in the near-term business cycle, and market dynamics that relate to fluctuating levels of investors’ appetite for risk all contribute to volatility that often misrepresents the value of long-run earnings. Our goal is to invest only when market movements create opportunities to confidently own EVA- producing companies at proper valuations. So what is a proper valuation?

As discussed in rule #1 above, equity shareholders should be rewarded by companies with operating profits that exceed the cost of capital. If a company only meets the cost of capital and provides no excess return, a proper intrinsic equity valuation would be the value of capital recorded on the balance sheet less what is owed to lenders. When the return on capital exceeds the cost, those excess returns flow to shareholders and must be reflected in the value of equity. Therefore, for EVA companies, intrinsic equity value is the present value of future EVA, plus capital, less what is owed to lenders. Here is a formula to illustrate this:

$$\begin{array}{c} \text{Present Value of Future EVA} \\ + \\ \text{Capital} \\ - \\ \text{Debt} \\ = \\ \text{Intrinsic Equity Value} \end{array}$$

Key drivers of future EVA are the growth rates for operating profit and how those profits are either reinvested or distributed to shareholders. We carefully analyze historical trends and tendencies of every company we consider for investment. Combining that data with information we compile from sell-side research, company presentations, and direct discussions with company executives gives us reasonable estimates for growth over various time-frames. We are then able to make rational decisions about buying or selling a stock when it deviates from its intrinsic value.

¹ EVA is a registered trademark of Stern Stewart & Co. and is used to define returns in excess of the cost of capital. The concept of return on capital, however is a standard and common measurement used to analyze internal financial performance.