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LETTER OF VALUE

Ruminations for investors seeking to enhance their wealth using the principles of VALUE INVESTING

TO OUR BUSINESS PARTNERS:

Return on invested capital, or ROIC for short, is one of the most important financial metrics that we evaluate when analyzing companies. This is because of the strong link over time between ROIC and stock price performance.

ROIC is the amount of money a company makes relative to the amount of capital invested in the business. It is calculated by taking net operating profit after-tax (NOPAT) and dividing this number by the sum of debt plus equity (invested capital).

A company is creating value when its profitability – ROIC – is greater than the cost of the capital it employs, which is what a business pays to fund its operations. This includes the interest paid on debt (cost of debt) and the return a company expects to make for its equity investors (cost of equity).

Our research process begins with calculating the ROIC of a company. We then strive to understand why its profitability is either above or below its cost of capital and endeavor to determine whether returns will remain stable, increase, or decrease in the years to come.

ROIC that exceeds the cost of capital typically indicates that there is a "moat" around the business. A moat represents a competitive advantage or set of advantages that help a company protect its profitability and market share, such as the following:

- Network effect. This is where the greater the number of people who use a product or service the more valuable this product or service becomes. Example: Amazon.

- Intangible assets. An intangible asset like a strong brand name typically reflects loyalty among a company's customer base, which in turn gives it pricing power. Example: Coca-Cola.

- Cost advantage. A lower cost structure enables a company to price its product or service below that of the competition and drive its competitors out of business. Example: Walmart.

- High switching costs. It may be too costly and/or disruptive for a customer to switch suppliers, thus entrenching a company's position in its marketplace. Example: Oracle.

- Economies of scale. The larger the size of a company, the lower its cost structure tends to be. Example: Procter & Gamble.

However, it is important for companies, as well as us as investors, to avoid becoming complacent, because businesses that generate attractive ROICs can tempt others to enter the market and compete these profits away.

An example of such a business that has changed for the worse is Intel. What was once considered to be an unassailable company is now losing a lot of market share and suffering from a significant degradation in its profitability. This in turn has led to a 60% decline in the stock price from its 52-week high.

Therefore, our analysis includes determining whether it is more likely than not that the moat is durable and will not be competed away.

In addition to evaluating the business itself, we must assess the capital allocation policies of managements and boards of directors.

Does the company invest internally in projects that are expected to generate returns above its cost of capital? If not, will they destroy shareholder value by doing so anyway, or will they instead return excess profits to stockholders in the form of a dividend and/or share repurchase program?

Likewise, if a company chooses to allocate capital externally and buy other businesses, will the projected return on this sort of investment exceed its cost of capital? More often than not, acquisitions, especially those that are larger sized in nature, turn out unsuccessful.

It is important that we do not simply take a management team at its word but rather assess their "say-do" ratio, which is the propensity for them to follow through on their commitments.

This process involves us combing through several years-worth of annual and quarterly reports and conference call transcripts. It also entails reading the proxy statements to see if executives are compensated on profitability metrics like ROIC or simply growth just for growth's sake.

Now, it is important to recognize that a good company does not necessarily mean it will be a worthwhile investment if the positives are already reflected in the stock price.

For instance, Walmart is recognized to be an excellent company, with an ROIC of around 20%, yet it is priced at a significant premium to what we estimate to be its value, with its price-to-earnings (P/E) ratio north of 35 times.

The same can also be said for the other four companies mentioned above, with the P/E ratios for the respective businesses as follows: Amazon – 48 times, Coca-Cola – 25 times, Oracle – 40 times, and Proctor & Gamble – 28 times.

In fact, many of the companies on our "watch list" are trading at well above their estimated values, which explains why our cash position is at an all-time high.

Nevertheless, whereas many value investors have chosen to "play the game" and buy expensive stocks to remain fully invested in an effort to avoid "career risk," we remain steadfast in our adherence to an absolute, not relative, value-oriented philosophy.

We first focus on the preservation of your capital. In striving to protect you on the downside, the upside should take care of itself. As one of our clients likes to say, an investor cannot eat relative returns!

In the meantime, your business partners remain patient for buying opportunities to come our way. Certain money market funds that are surrogates for cash are currently yielding 4.3%, so unlike in prior years, we are getting paid to wait.

We are constantly turning over rocks in our search for investments and are adding to our list of stocks in the on-deck circle. That way we are ready to move when these companies meet our buy points.

We will not get our fundamental analysis right every time. We could certainly misjudge the durability of the moat around the business and therefore fall prey to errors of commission, not to mention errors of omission as well.

However, by investing in companies only when they trade at a substantial discount to estimated value, we strive to minimize the impact of any mistakes. In other words, heads we win, tails we do not lose much.

We thank you, our clients, centers-of-influence, and business associates, for your ongoing trust and confidence.

The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions.

-Seth Klarman

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