MOI GLOBAL

The Key Pillars of Our Investment Framework

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Our goal at Arevilo is to successfully invest in businesses by taking concentrated positions with long-term holding periods. Our goal is not unique and many value-oriented investors have similar approaches, but by breaking down our goal into pieces, we've created an investment framework that is unique to Arevilo. In this article I will share our investment framework. At best, I hope you gain some insight from our framework, and, at worst, that you read a refresher on several investment principles.

Business Profile

To successfully invest in businesses, we approach investing as private business owners would. For us, assessing the quality of a business is our most important job. If we are to invest in a business for five to ten years, why would we invest in a bad business? Even if we are able to purchase a business at a bargain price, our long-term horizon (5-10+ years) would not truly benefit us. If we purchase a bad businesses at a bargain price, we would need to sell the investment at (or close to) fair value as quickly as possible. Over the long-term, we would not consider our purchase price a "bargain" if the business' performance deteriorates – what one would expect from a bad business.

Few businesses are truly in the business quality hall of fame. Many of the businesses we invest in are in the "pretty good" camp and have the potential for strong long-term operating performance. When analyzing a business' quality, we mainly worry about the sustainability of the given business. As Warren Buffett recently said, "there is nothing that we own that doesn't have something in the future that might affect it." [1] The vast majority of businesses can face significant challenges over time, which is why it's important for us to understand the sustainability of a business over a reasonable timeframe.

A business' sustainability can be gaged by its competitive state relative to current competitors, potential competitors, suppliers, and customers. We ask ourselves: "who has the high ground?"; "who has leverage over the given business?" Consensus today believes (and rightfully so) that Amazon has the high ground in practically every new business segment it enters.

An assessment of a business' free cash flow profile adds further context to our analysis. We prefer to invest in businesses that can easily generate high-margin free cash flow, especially if cash flows are growing rapidly. However, we are willing to invest in businesses with high capital expenditures or in businesses that are investing significant capital to grow. As long as we believe those expenditures create value for shareholders, we are patient enough to wait for higher levels of free cash flow in the future.

The last question we ask in assessing a business is, can this business become more meaningful? It's a question that we ask in order to think about a business' upside. When asked why Time Warner once viewed Netflix as a weak competitor,[2] Reed Hastings, Netflix's CEO recently said: "what happens to people is that they associate you as you are, not as what you can become." [3] We at Arevilo are not fortune tellers, and we probably wouldn't have forecasted Netflix's potential any better than Time Warner, but we certainly believe it's important to attempt to estimate a business' upside potential. If a business' best case scenario does not provide a huge upside for shareholders, "a base case" scenario probably won't be attractive enough for us to invest.

Management / Board of Directors / Major Shareholders

If we concentrate our portfolio in a few businesses that we expect to hold for five to ten years, should we risk our clients' capital on businesses with bad CEOs? Excellent CEOs still make mistakes and our assessment of their performance will not be perfect, but investing in A-grade CEO's is at the heart of our investment framework. Our long-term horizon brings a CEO's capital allocation ability front and center to our analysis. In Berkshire Hathaway's 1987 shareholder letter, Warren Buffett writes about the importance of a CEO's capital allocation ability: "After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business."[4] The longer you own a business, the more important a CEO's capital allocation ability becomes. Assessing a CEO is almost as important as determining the quality of the business.

Many investors understand the power of incentives with management teams. We agree that incentives are extremely important for manager-shareholder alignment, but we also look for "shared downside." Many of the companies we invest in have large influential shareholders with board representation. If we suffer losses on our investment, these shareholders suffer as well and they will be highly motivated to preserve the value of their investment. Investing in these type of companies can add an additional margin of safety to our investment that doesn't manifest itself in the numbers or any businesses quality analysis. In the late 1970's, when Berkshire Hathaway made a large investment in GEICO, Warren Buffett viewed himself as the margin of safety if GEICO's financial performance deteriorated further."[5] This is why we always ask: can the CEO, board of directors, and/or a major shareholder be a margin of safety?

Capital Structure

A company's capital structure can be an immense source of value for long-term shareholders, but it can also lead a good business into bankruptcy. Businesses in the high quality hall of fame camp have to worry more about their "cash structure" versus "capital structure." However, that doesn't mean good businesses shouldn't use their capital structure to enhance shareholder value. We believe it's important to understand whether the capital structure can risk a business' equity value and, conversely, whether the capital structure can provide additional upside for shareholders. Management teams that tie a strategic mindset to their capital structure with a prudent capital allocation approach are likely to create value beyond market expectations.

Valuation

We don't anchor ourselves to strict valuation rules or methodologies. As business owners, the most important question we ask ourselves is, are we getting a good deal? It would be unusual to have the opportunity to invest in a business with the characteristics that I described above at a dirt cheap valuation. If the same opportunity is available at an adequate yield on future free cash flow, we believe long-term shareholders can earn above average returns. Our choice to invest in a company with an "adequate" free cash flow yield is contingent on an attractive upside scenario. As I mentioned above, if the upside scenario for the business does not provide very high returns, the said business would not garner our interest. In other words, we are willing to pay fair value, but we require potential upside "kickers."

Arevilo's portfolio contains businesses such as Charter Communications, Restaurant Brands International, and Liberty Media's Formula One Group. All three businesses contain the characteristics we find attractive to make long-term investments.