MOI GLOBAL

On Quality

This post is authored by Gary Mishuris, MOI Global instructor and managing partner of Silver Ring Value Partners. [Replay his session] at Wide-Moat Investing Summit 2017.

It can be tempting to leave the term "quality" without a precise definition. However, quality is too complex to rely on knowing it when you see it. Here are some attributes that I have heard referred to over the 15+ years of my professional investing career as implying "quality" when discussing companies:

- Well-known brand
- High return on invested capital (ROIC)
- Good free cash flow generation
- Strong competitive advantage
- Rapid growth
- High margins

Do some or all of these descriptions properly define what the term "quality" means in the context of considering a company as a potential investment? Maybe, but that is not the meaning that I have in mind when I use the term. Since it is an important component of Silver Ring Value Partners' investment process I thought it would be helpful to elaborate on what I mean when I speak about a company's quality.

For my investing purposes, **I define a company's quality as the degree to which its future economic characteristics are predictable.** Since valuation is a lens on long-term expectations of company fundamentals and some companies are more predictable than others, it is only factors which increase predictability that affect my assessment of quality. Everything else can be taken into account in the valuation process itself.

The main factors that affect the predictability of a company's future economic characteristics are:

- **Industry Structure** – The slower the current and potential pace of change, the more predictable a business in a given industry is likely to be.
- **Competitive Advantage** (a company's ability to earn superior economic results that others cannot easily replicate) – Companies with stronger competitive advantages are better protected against unexpected adverse economic developments.
- **Management** – The degree to which management can operate and allocate capital in the best long-term interests of the shareholders reduces the risk of competitive position erosion and destruction of value through the misallocation of capital.
- **Balance Sheet** – The ability to withstand temporary financial adversity guards against unexpected circumstances that could force the company to take financial actions that could reduce its intrinsic value.

Here are two examples from my past investing experience of when quality was low and I failed to realize it sufficiently in advance:

1. About fifteen years ago, as a young equity analyst, I recommended that the large investment firm that I worked for invest in a company's stock. It was a cyclical business, and I carefully analyzed the past financial statements and made what I thought was a well-

reasoned estimate of the future mid-cycle earnings power of the company. Over a decade hence and with the full benefit of hindsight, I realized that I had been off… by a factor of 10x!-

- How is it possible to be off by so much? Well, it turned out that the future was quite different from the past that I was relying on in my analysis. While this is always a risk, the magnitude of the deviation from past financial results was driven by the low quality of the business – its operations were in tough industries in which it had only very marginal, if any, competitive advantages. This made it unable to cope with the negative changes that the industry experienced after my investment recommendation, and caused the earnings of the business to permanently collapse.
- The lesson learned? A business with no competitive advantage can have future economic characteristics that are drastically different from those it had in the past. What is worse, the direction of any unexpected changes in profitability is likely to be negative. This can make estimating the value of such unpredictable businesses an exercise in overconfidence and futility, and is thus better avoided barring extremely unusual circumstances.

2. Also at the beginning of my investing career, I was recommending the purchase of another stock. This company had a somewhat stretched balance sheet, but not so much so that I thought it was going to be a problem given that the then current credit metrics were OK. Right before Christmas, the company pre-announced a major earnings disappointment due to weakening demand trends, suspended its dividend, and announced that its expectations for next year’s results were now substantially below last year’s profit levels. With this revised view, the credit metrics were no longer OK at all.

- That night, I woke up in the middle of the night very agitated, and I kept repeating just one word: “EBITDA! EBITDA!” (Earnings before Interest, Taxes, Depreciation and Amortization.) As I fully woke up, I remembered the dream that I was having – the bank group which had lent this company money was considering forcing it into bankruptcy due to non-compliance with the loan covenants, and I had been arguing with them for forbearance based on the company’s future levels of profitability.
- The lesson learned? When the balance sheet of a business with no competitive advantage carries what seems like an appropriate amount of debt in a benign business environment, it leave no margin of safety for adversity which can quickly impair the company’s profitability and cause the balance sheet to become unhealthy quite rapidly.

Investing in quality companies quite literally allows me to sleep well at night, and us to reduce the probability of permanent capital loss.