

Start with the Customer

This article by Fang Li is excerpted from a letter of Baleen Capital.

We've done a lot and learned a lot over our first five years at Baleen. One of the most important things we've learned is to start with the customer.

As investors, we naturally focus on revenue, profits, and returns – ergo “value” investors – but the customers are the ones actually paying the bills, and customers pay based on the value they receive from the company. In other words, customer value (the problems the company solves for them, how much their lives are improved) is what leads to economic value (the revenue, profits, and returns that we care about as investors). We need to understand the customer in order to really understand a company.

Further, when a company goes above and beyond for its customers – delivering “insanely awesome” experiences, products, and service – great things can happen. Examples include internet companies like Amazon, Apple, or Google, as well as offline businesses like Costco, Home Depot, or In-N-Out.

Over the years, we've seen this personally. We've seen our companies that deliver exceptional customer value keep growing and growing (e.g. Interactive Brokers). We've seen how things are harder for companies delivering good but not exceptional customer value (e.g. Atlas Financial). And we've seen how companies with mediocre customer value are left at the mercy of their markets (e.g. SMTC).

Through our investments in younger companies, we've seen firsthand how customers react to products that really make a difference vs. those that are just nice to have. We've seen what happens when management empathizes deeply with their customers and care about their well-being, and the impact that makes. And we've seen how changes in customer value affect business health and prospects over time.

We've become convinced that delivering outstanding customer value is the first step to building the rare, amazing company that keeps growing and growing, leading to sustainable long-term value creation.

Improving customer value over time is a way to build a business's moat. Or, as Henry Ford wrote, “A business that makes nothing but money is a poor business... A business absolutely devoted to service will have only one worry about profits: They will be embarrassingly large.”

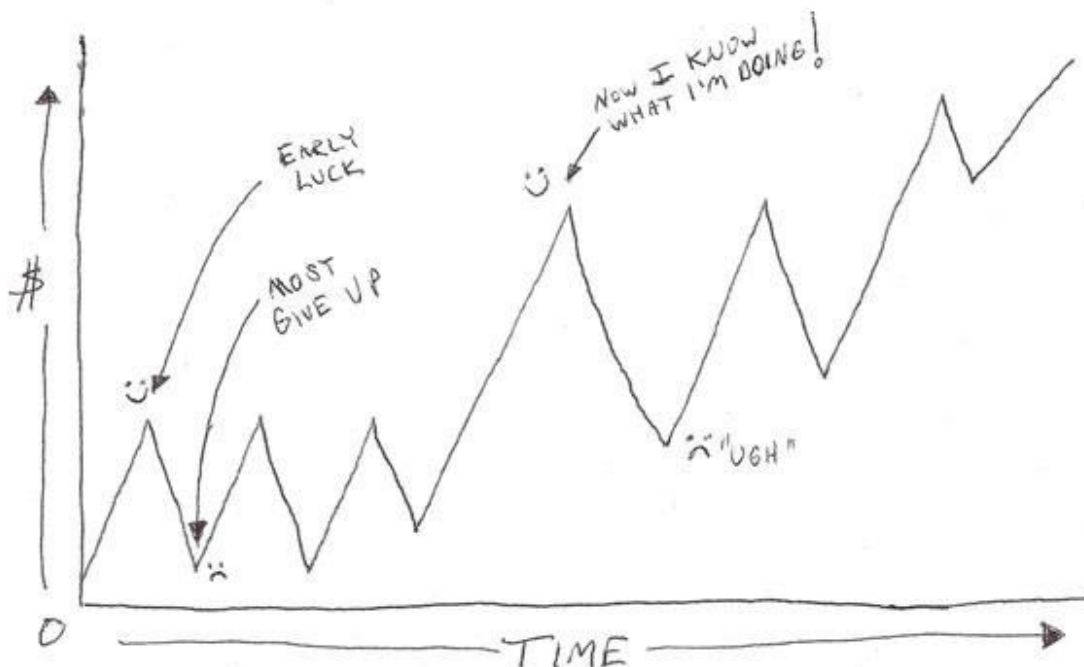
We're looking for exceptionalism: companies that make a difference, that make their customers' lives so much better that they wonder how they lived before it (to paraphrase the CEO of a recent investment).

As for Baleen, in addition to exceptional customer value, we're also looking for high growth and profitability potential, as well as honest, capable, and customer-centric people. We're also more and more looking for companies that can be leaders in their market or niche. When combined with a reasonable valuation, we think this is a recipe for long-term investment success. We're looking for great companies that will grow to be many times bigger with time.

We've started paying higher headline prices for some of our investments. As value investors, this makes us shudder a little. However, the math works out that over the long-term, it's better to buy a growing company at a higher price than a stale company at a cheap price. Our experience backs this up. Our worst mistakes have been buying companies that looked cheap at first but were mediocre underlying businesses. We have yet to regret buying a great company, because even if the stock has dropped, it's been temporary (and often an opportunity to add).

Price is what you pay, value is what you get. Our goal at Baleen is to maximize long-term value for our investors. Decades, not years.

To sum, I think that we are starting to hit our stride. Of course, whenever I think this, I am reminded of the below whimsical chart that a friend sent me:



You may guess where on the chart we currently stand! Kidding aside, this chart has been surprisingly accurate in describing our experience at Baleen so far (and perhaps any environment that involves learning under uncertainty). My takeaway is that no matter what happens, we need to stay humble and hungry, and keep learning.

With that said, in the years to come, I would be surprised if we waver very far from our recipe of strong customer focus, great products, high profitability, big growth prospects, and good people. It is a good recipe.