MOI GLOBAL

The Considerably Challenged

This article is excerpted from a letter to partners of Boyles Asset Management.

Having already discussed our Mastermyne exit in relation to the capital cycle, we also wanted to discuss our experience with the company as it relates to one of our investment category mental models. Earlier in the year we presented our "Temporary Trudgers" model. Here we discuss a model we've come to refer to as "The Considerably Challenged."

> The "considerably challenged" investment category mental model can typify some of the most challenging business and investment operations. Companies meeting this model are navigating a battlefield dotted with landmines.

There are unique challenges with owning companies that fall into this category. As we've alluded to, these positions can ultimately become quite taxing before the ultimate prize is realized. As our quote highlights, investors have to be aware that they and the business are traversing a battlefield dotted with landmines. You have to realize that the landmines are there; you just don't know where they are or when the company will hit one. These ideas require a type-specific investment approach and mental awareness.

When we refer to "The Considerably Challenged," in the context of our operations at Boyles, this does not refer to balance sheet stress. We specifically avoid that particular challenge. We seek other challenges, including: severe cyclical downturns, poor operational decisions, significant customer issues, etc.—anything that is likely to severely depress, or even eliminate, current earnings.

Investment and Portfolio Management Considerations

Given our focus on little or no downside in these situations, the balance sheet must be quite strong, not just acceptable. Given the challenges being endured and the landmines likely to be triggered, the company must be in a position to absorb them, a fact that will likely weaken the balance sheet during one's holding period. In addition to allowing for survival, a strong balance sheet, both absolutely and relatively, can be key to capitalizing on the upside envisioned.

You can be patient in share accumulation. After the company hits a landmine, you are likely to be presented with wonderful buying opportunities.

Purchasing well below book value is a good place to start. Given what may transpire, starting to get excited at book value or above is likely to prove less productive than it may seem at the time.

An ability to generate cash, if not earnings, is particularly important. This may come in the form of working capital release, ongoing operating cash flows, asset sales, tax recoveries, etc.

If such an idea presents itself in a small-cap name with limited liquidity, the changes in sentiment and stock prices can be quick and significant.

Mental Considerations

Owning such ideas can be mentally taxing. It may require you to show a large unrealized loss at some point during your holding period. Not only may you look silly for owning it, but also you must be prepared to avoid the behavioral challenges associated with such a situation, and make the appropriate decisions when something you own seems to go down in a straight line.

When it really hurts to buy more shares, it may very well be a good sign.

One must recognize that after owning such a company for a substantial period of challenging times, you may be in a better position than others in the marketplace to make significant sums on the idea.

When we exited Mastermyne, we earned a total return, including dividends, of 122% in U.S. Dollars during our approximate three-year holding period. The IRR on the capital deployed was 40%. In AUS Dollars, the total return was 127% and the IRR was 42%. While we made money on all share purchases based on our exit prices, developing the mental model outlined here allowed us to make significant returns on capital deployed after our initial purchase—when that initial purchase looked poorly made. While our initial small purchases would have produced a mid-to-upper-single-digit IRR during our holding period, our lower subsequent average cost produced a much more attractive outcome.

During the period we owned shares, the company hit plenty of landmines. Large long-term customers were lost, specific business expansion opportunities that looked promising failed to materialize, environmental challenges pressured the industry, commodity prices suffered even further, an acquisition didn’t perform to expectations in its first two years, cash flows deteriorated beyond our expectations, customer asset sales disrupted relationships, maintenance work was deferred beyond anyone’s expectations, and the list goes on. Despite all the landmines, with the right purchase price(s), and the right mental model, we achieved an acceptable return.