

## Equity Investing

The OKIS equity investment process involves fulfilling Warren Buffett's goal for investors:

**“Our goal as investors should simply be to purchase at a rational price a part interest in an easily understandable business whose earnings are virtually certain to be materially higher 5, 10 & 20 years from now. Then, put together a portfolio of companies whose aggregate earnings march upwards over the years” Warren Buffett**

**To achieve this objective we need to identify and invest in businesses that, through the successful execution of a competitive strategy, have created a sustainable competitive advantage from which materially higher earnings are near certain to eventuate in the years ahead, as they beat the competition for customers.**

We start with the business discovery process with the customer.

1. What motivates the customer to buy the product or service in the first place? The customer will determine the appropriate strategy the business needs. If the customer buys mainly on price the successful business will need to operate a **low cost strategy**. If the customer buys mainly on product or service features then the business will operate a **strategy of differentiation**.
2. Identify why the customer buys from one particular company as compared to another? Here we are **looking for the business best able to execute the appropriate strategy** by servicing the customer best. Successfully executing a low cost strategy means the business sell goods and services at the lowest price available and/or with the largest range of choice or offers additional incentives (competitors can't) while selling at the same price as others. This business must have an identifiable low 'cost of doing business' advantage that is passed back to the customer creating additional turnover and high returns on capital; such as a retailer being able to operate with lower rent than competitors who then charges lower prices. If price is not the key driver behind the customer's decision to buy then to achieve superior returns the business must successfully execute a strategy based on differentiation. It must sell a superior product or service for which customers will pay a higher pricing point per unit of sale compared to a competitor's product. The higher relative price and greater relative turnover enables a high return on capital compared to competitors. The superiority may be derived by either R&D spending or a psychological attachment for which competitors are not capable of replicating. The stronger and more durable the reasons for the customer buying from the superior operator (either cost or differentiation) the more likely future earnings will rise as it continues to out-compete other participants for customers. Sustainability means that the advantage is not fleeting or due to short term circumstances but can be exploited for years to come.
3. The businesses historical financials should support the existence of a competitive advantage. The low cost strategy will see the successful business operate with a low profit margin and high operating leverage (sales to assets) while the business successfully executing the differentiation strategy will operate with a higher profit margin and moderate operating leverage. Executing either strategy well will result in **sustained superior returns on incremental equity**. Earnings and dividend per share growth should flow without a singular reliance on financial leverage or engineering. For superior results to exist now and into the future the business must be able to retain the financial advantages (profit margins) created from its competitive position by **avoiding any profitability leakage** as it deals with Porter's five forces of competition.
4. Management must be observed executing on the appropriate competitive strategy. If the business must compete on price and have the lowest costs then management must always be talking and acting with regard to **lowering costs** of the business. If the business competes on a basis of product or service differentiation then management must be talking and acting with regard to **enhancing the customers experience**. Failure by management to be able to focus on what is important by either cross referencing or blaming external events does not bode well for the businesses long term success and is evidence of a lack of a sustainable competitive advantage.

5. Identify what have been the **key drivers of revenue** by which company growth can be tracked. This will be particular to each company like new stores, car unit sales; price increases etc and often will be the centre piece of management discussion. For a low cost strategy market share is important.
6. How big is the **market/industry potentially**? Often a company will provide some idea of what it is possible long term, for example what they may be budgeting for in sales or store openings in 5 years time internally.
7. Assuming a sustainable competitive advantage can be identified what price the stock. Via a multi period variable payout dividend discount model we can price for reasonableness in value. Here we are checking the growth assumed and the implied incremental return on capital resulting (and subsequent payout ratios) meet a **test of reasonableness** with regards to future revenue expectations and capital requirements. We are trying to buy future dividends and earnings growth economically that have a high certainty of eventuating. It is important not to be too heavily influenced by immediate supply and demand variability as supply and demand of goods and services can fluctuate in any given period in an unpredictable manner. We are relying on managements continued exploitation of the businesses sustainable competitive advantage within their market opportunities to deliver valuable and near certain growth and when a market price is available that **meets our investment return expectation** we buy.

Once the long term competitive position of a company is understood we can examine current reporting to understand the present value proposition.

1. Has the most recent report highlighted any structural changes to the competitive position of the company? If yes, look to another opportunity.
2. What is the company doing and saying now with respect to its future growth and competitive position to improve both?
3. Understand the businesses operation leverage and where we are within the business cycle.
4. How is the business placed in relation to its valuation situation – stretched, normal or an opportunity?