

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 beat the competition for customers through the successful execution of a competitive strategy and in doing so create a sustainable competitive advantage from which materially higher earnings are near certain to eventuate in the years ahead.

We start the process of identifying suitable business candidates 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 if the business is successfully able to execute the appropriate strategy thus 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/or greater relative turnover enable 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. Is the business focused on being a leader in its category of operation? Leaders have advantages because in the mind of customers they have the best offering. Leadership comes from specialist operators because customers think specialists know more than generalists who cover many business operations. The chance to lead a category comes from being first in the mind of the customer. A business that leads a category is at risk of a subcategory developing as the original category divides putting any competitive advantage built at risk. The corporate imperative for continuous sales growth takes companies away from a narrow focus to a broad selection of opportunities for which specialisation and leadership isn't possible. To be the leader you need to be narrowly focused on your category or sub-category and generate a dominate market share.
4. Does 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.

5. 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 strategies, blaming external events or pursuing un-focused ideas does not bode well for the businesses long term success and is evidence of a lack of a sustainable competitive advantage.
6. 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.
7. 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. Be mind full of the potential for category division in the companies offering. A category starts of as a single entity usually dominated by one company. But over time the category divides into two or more categories and new leaders emerge.
8. Assuming a sustainable competitive advantage can be identified what price the stock. The starting point in determining a rational price for a stock is to establish a range of returns the investor requires for their money. For example an investor wanting a 12% annualised return is a 6 year (72/12) double.

Next step is to look for stocks that can meet those return expectations via a combination of dividend yield and earnings growth (resulting in justified capital appreciation). It doesn't matter what combination the dividend yield or growth comes in so long as the combined number meets the return expectation and, of course, that it occurs – hence our concentration on businesses likely to deliver. The earnings growth rate to focus on is the long term sustainable growth rates which acts to smooth out cyclical earnings associated with businesses that deal with customer demands that ebb and flow. What is essential here is that the growth estimated must materialise over time not that it comes evenly, hence the concentration on those businesses with sustainable competitive advantages virtually certain to produce materially higher earnings 5, 10 & 20 years from now. Whatever growth rate is estimated it needs to be shown to be conservative and tested for reality.

We can test for both conservatism and reality in the long term growth rate estimate in two ways. First we can check a three way metric involving return on equity, payout ratio and implied growth rate for historic correctness. It makes sense that over time a company's future earnings growth rate represents the percentage return it makes on any capital invested multiplied by the amount of capital actually used – usually from retained profits.

The second and more thorough test involves considering specifically what the anticipated growth rate implies need happen i.e. how and why will the business sell more goods and services to more people and for more money while containing costs and using an appropriate amount of capital in line with expectations. So we set about understanding exactly what needs to happen. Obviously this is not an easy task so again the need to restrict any assessment to businesses for which there is a higher than normal hope of materialization.

The final step given a conservative and a realistic earnings growth expectation is to identify what sustainable dividend yield is needed to bring the combined return to the investors desired level. This is where the stock price comes into play. Therefore it is a combination of an investors required return, future earnings growth expectations and dividend yield that sets a rational price for a stock.

Of course we can also reverse the process and back out the necessary growth rate having identified the current available yield and then decide if the growth is achievable.

The simplification of the above process glosses over the need for the companies to work tirelessly in such areas as market share, manufacturing, distribution, product innovation, changing market conditions etc but those considerations and others are dealt with before a company even gets to the pricing stage. Remember a company has to be capable before it is priced. If someone is then happy with the equation that the current price presents then the price supporting the dividend component is a rational price to pay.

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?