Bernzott Capital Advisors

PERSPECTIVES

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The Quality Question

It has long been our motto at Bernzott Capital that we buy quality companies at a discount to fair value. We want to buy high quality companies because we believe, as Warren Buffett said, "It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price." Consequently, we are willing to pay a bit more for a company that we consider has all the traits of a "quality company."

Webster defines "quality," among other things, as "superior birth or station; high rank; elevated character." But how do we define quality? We define it by the attributes of the company we either own or are considering. Those attributes include a competitive advantage, market leadership, recurring revenue, a large amount of predictability, reasonable debt and limited government regulation. Some have observed that the ability to continually raise prices is a good indication of a quality company.

Of course, many would wonder what is so special about our strategy. Certainly nobody wants an inferior company within a highly competitive industry with no competitive advantage, no predictability, crushing debt and low returns on capital. However, experience tells us that many investors buy exactly those types of companies. For many investors, as long as the projected growth is high enough, many of the other qualities become less important. For instance, Amazon has razor thin margins, exists in a highly competitive environment and trades at a ridiculous multiple of earnings. Yet millions of shares are purchased every day, indicating that plenty of people consider Amazon a good buy. Think of all the companies that are in brutally competitive environments (retailers), have crushing debt (utilities), have limited transparency (banks) or are highly correlated with an impossible-to-predict commodities (oil & gas companies). Yet all of these industries have several companies that many investors are buying in great quantities. And you can bet the investors in these companies would all claim that they are of high quality.

It is not enough for a company to appear attractive for a short period of time. Economics tells us that any company enjoying high margins in a cushy market will have their advantages taken away by others entering the market. The landscape is littered with companies that were sitting on top of the world for a period of time only to have a competitor swoop in and steal market share. Remember when Nokia cell phones were in every pocket or purse? Apple and Samsung put an end to that. Sears was king of retail for many years before more agile competitors like Wall-Mart (many years ago) and Amazon (more recently) have relegated Sears to the "Where Are They Now" file.

In 1999, Warren Buffett wrote, "The key to investing is determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors." The concept of a moat is now ubiquitous in financial jargon. We know moats in the architectural sense as a ditch, usually filled with water, surrounding a castle, which serves as a line of defense from attackers. The metaphorical moat in the investing sense accomplishes the same goal: providing a defense from outside companies who want to take away business.

What are the factors that provide a company with a moat, or otherwise, a long-term competitive advantage? It is not a one-size-fits-all answer. Some companies have an advantage due to intellectual property. Many large companies, such as Proctor & Gamble, have intangible assets such as brands or customer relationships (could you imagine a grocery store that did not carry Tide or Crest?) Switching costs provide a competitive advantage for many companies. For instance, Synopsys (a company in our portfolio) provides software to their customers that would be very disruptive if a change were made. Scale is another competitive advantage and it is something that Microsoft has in spades. It is tough to think of an office without Microsoft products and it provides them with a wide moat to their business. In fact, Microsoft enjoys several attributes of a quality company mentioned above: intellectual property, brand name recognition, high switching costs and scale. That may be why Microsoft is only one of two AAA-rated balance sheets left (the other being Johnson & Johnson, who also has most of the important attributes).

Having a moat around the company now certainly does not guarantee it will remain there. Looking back just 20 years ago one could certainly argue that Kodak had a comfortable moat around itself. But a flat-footed management team was overwhelmed by technology and Kodak has essentially disappeared. How do we avoid the same fate with the companies in our portfolio? We can look at our investment in Outerwall (OUTR) as an example.

When we first bought OUTR (formerly known as CoinStar), it had a product in Redbox that essentially put Blockbuster out of business. The kiosk of DVDs provided cash flow by the millions to OUTR and once they were entrenched in the best locations, nobody could compete. The stock soared and we were feeling pretty good about their continued success. Then the technology of "Streaming" emerged along with On-demand videos through your cable or satellite provider. This new technology gained popularity. Outerwall tried a partnership with Verizon that was not successful. Rentals started to trend downward. The attributes we loved about the company – recurring and predictable revenue, market leadership and a wide moat – had essentially disappeared. In an internal memo, our investment team concluded that OUTR had become "one of our toughest companies to model" because they had lost what had made them attractive. We sold the position in September, 2014 and avoided a Kodak moment.

We examine each company we own constantly. We set a fair value for every stock in the portfolio every quarter after earnings are released. The investment team assesses the quality of the company which includes maintaining a competitive advantage. We want to make sure the moat remains intact, and as a result, revenue remains transparent and predictable, the balance sheet is strong and competitive threats remain at bay, allowing for healthy margins and continued success.

Finding quality companies at the right price, and then determining when either the price has gone too high or the quality has gone too low, is our goal in portfolio management. Entire books have been written about the concept of quality and moats. Each attribute of a quality company could consume an entire chapter. The key is understanding that while traders may not care about the underlying characteristics of a company, a long-term investor needs to focus on how the company retains its competitive advantage and how it will maintain it over a significant period of time.

We love to hear comments or questions about how we are doing. If your personal or financial situation has changed, or if you have questions about your portfolio, feel free to contact us.

About the Firm

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