Monday, March 25th, 2019

"Durability: Judging Risks to the Status Quo"

To Focused Compounding Free Members:

In my last memo, I talked about *"cigar butts"*. These are bad businesses you don't want to stay in. It often makes sense for a value investor to buy a cigar butt. But, it rarely makes sense for him to hold a cigar butt for long. I gave the example of Warren Buffett's investment in Berkshire Hathaway in the early 1960s. His original plan was to make a quick 50% or so return in the stock and then sell his shares back to the company. Buffett ended up staying in the stock too long. It's that staying in a bad business for 20 years – reinvesting in it and diverting cash from more productive uses that drags down your return in a cigar butt. In this week's memo, I'd like to make a distinction between a "bad" business – one that's likely to earn low returns on capital for a long time – and a good business with "durability" risk. A couple years back: when **NACCO (NC)** spun-off its small appliance business, **Hamilton Beach Brands (HBB)**, leaving it as just the operator of coal mines for "mine-mouth" power plant customers – I bought shares of NC. Sure, the stock looked cheap. But, the business also looked good. It produced high returns on equity. And it sold for a low price relative to that equity. NACCO was a good business at a good price.

But, was it a ***durable*** business? Here, we have something that's different from a cigar butt – though many people conflate the two. A business like NACCO is demonstrably – mathematically – good last year, this year, and in terms of what it's guiding for next year. That's different from Berkshire Hathaway's textile business. A company like NACCO isn't a cigar butt – but that doesn't mean it isn't risky. There's a huge risk: the company's customers, U.S. coal mines, could shut down. This would dry up the streams of free cash flow now passing to the stock. The question with a company where there is durability risk is not how good or bad was the business in the past, is the business now, or will it be in the future. The question is: how long will this business exist? How entrenched is the status quo? The Buffett stock that best illustrates this "durability risk" isn't something like his purchase of Berkshire Hathaway in the 1960s – it's something more like IBM in the 2010s. When Buffett bought IBM, it was a good business. It had high customer retention. The returns on capital were good. The conversion of reported earnings into actual free cash flow was good. IBM clearly wasn't any kind of cigar butt. Its recent past and its present both provided evidence of a "good" business. So too even did a stock like NACCO at the time of that spin-off. So, why were those stocks – IBM and NACCO – cheap? Because they were risky. When you buy a stock based on its price-to-free-cash-flow, you are paying for that stock's future. A FCF yield of 15% may sound cheap. But, remember, it will still take you 7 years to make back your entire investment in a stock with a 15% FCF yield. You need to believe the status quo will extend beyond 7 years. Because all of your profits – even in a stock that cheap – will be driven by results in years 8 and after. Buffett eventually sold his shares in IBM. He realized he couldn't judge the changes "the cloud" was making to the status quo. He couldn't see far enough beyond year 7.

That doesn't make IBM a cigar butt. It'll still show up on screens of good businesses. The question Buffett had to answer wasn't a quantitative one. It was a qualitative one. Not "how good is this business today?" But, "how long will the status quo last?"

Sincerely,

Geoff Gannon