Checklist

2 May 2019

Investment decisions should be based on understanding the value of a business through *in-depth research*. There are many mistakes that we make as investors. Even the greatest investors have made simple mistakes. Unfortunately, our brains are designed to take shortcuts and arrive at answers too quickly.

Checklists have proven to be a very effective tool in e.g. “the intensive care units” field, where infection rate decreased dramatically after the introduction of checklists. These checklists contain “basic” instructions like:

1. Wash hands with soap.
2. Clean patient’s skin with chlorohedixe antiseptic.
3. Put sterile drapes over entire patient.
4. Wear a sterile mask, hat, gown and gloves,
5. Put sterile dressing over catheter site after line in.

But also a company like Boeing introduced checklists for takeoff, flight, landing and after landing successfully.

In the business of investing such a checklist is actually a stress test or an attempt how to “kill” the investment thesis thoroughly. While no business will pass the checklist with perfect mark, the goal is to alert the investor to potential pitfalls. The brain is simply not designed to work with meticulous logic through all of the possible outcomes of our investment decisions.

By now, you should know that I “clone” or “copy” almost everything. So I copied a lot from existing investment checklists from Phil Fisher, Chris Browne, Michael Mauboussin, Michael Shearn and many others. Imitation is indeed the sincerest form of flattery. Here is the list. You should at least be able to answer the first 21 questions, but the best is to answer them all.

1. Is the annual report of the company clearly written and do I understand it? And that includes <u>all</u> the footnotes.
2. Do I have a clear picture of the long-term competitive dynamics of the industry? Who are the main competitors (market leaders and challengers) and have I read their annual reports as well. Are there leading industry specific reports available?
3. What are the unique competitive advantages of the company and is the company well positioned to exploit those advantages for many years to come?
4. Does the company have favorable long-term prospects and what are the drivers for long-term growth? Is there evidence that the short term prospects are favorable as well (e.g. a solid order intake, backlog & bidding pipeline).
5. Is the company a “monopoly” type of business and why is that?
6. How does the business make money and how has the business evolved over time?
7. Does the company have a consistent operating history, strong cash flows and consistent high return on capital?
8. Does the company have a strong and solid balance sheet? Debt is the most important thing to look for. The second most important thing to look for is a significant cash position. And then don’t forget to check the pension obligations.
9. Do I understand the long-term business economics of the industry? Is it a good or a bad industry and how has the industry evolved over time? And what is the current market share of the company?
10. Is this company really providing an attractive value proposition for the end customer? And what do I know about customer experience, satisfaction, loyalty and retention?
11. Does the company have pricing power (the ability to enjoy price inelastic demand for their product) and the capacity to reinvest (opportunities to deploy incremental capital at high rates)?
12. What is the most important business threat that will cause the existing moat to (slowly) evaporate?
13. Is there a risk of financial shenanigans? Check the Howard Schilit criteria and avoid companies with aggressive revenue recognition, like percentage of completion (PoC) accounting.
14. Is the company “family owned" and do I like the management of the company? Family owned businesses tend to do better than the market.
15. Does management care about sustainability & ethical leadership and does management have a track record of integrity and high performance? Can you identify a moment of integrity for the manager?
16. Is management shareholder friendly and rational with its capital?
17. Are there disruptive industry forces to reckon with, e.g. technology changes or new regulatory requirements? What is the catastrophe risk of the business?
18. Is there a superstar investor with a substantial ownership position in the company?

19. Will this company be around and doing well 25 years from now? Great companies have great entrepreneurial cultures. Do I really want to "own" this business?
20. On a scale from 1 to 10, how "exceptional" is this investment? There is this famous quote by David Swensen: "Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom." How "exceptional", or even better, "uncomfortable ideosyncratic" is the investment opportunity?
21. What is the value of the business and can it be purchased at a significant discount to its value (margin of safety)?
22. What is the outlook for pricing for the company's products and services? Can the company raise prices?
23. Does the company have an above-average sales organization?
24. Is it a franchise business and can it be expanded internationally?
25. In what foreign markets does the business operate, and what are the risks of operating in these countries?
26. Can the company sell more? The simplest way to raise the bottom line is to sell more products and services. Assuming that costs remain the same, every increase in number of units sold improves the bottom line.
27. Can the company increase profits on existing sales? What is the outlook for the gross profit margin as a percentage of sales?
28. Can the company control expenses? What is the outlook for selling, general, and administrative costs/margin as percentage of sales? Have there been any changes, and, if so, what are they?
29. What does the company expect its competitors to do and how is the company going to outperform competition?
30. Does the company have one-time expenses that will not have to be paid in the future?
31. Does the company have unprofitable operations they can shed?
32. How much can the company grow over the next 5 years and how will the growth be achieved?
33. What will the company do with the excess cash generated by the business?
34. How does the company compare financially with other companies in the same business?
35. What would the company be worth if it were sold?
36. Does the company plan to buy back stock?
37. What are insiders doing?
38. What is the current and prospective regulatory climate?
39. How good are the company's cost analysis and accounting controls?
40. Is it a cyclical industry, and if so, what do I know about the cycle?
41. What unique insights do you have about the industry?
42. Is there a risk of low cost producer disruption? Can the product be made more cheaply by a competitor in another country?
43. Is management appropriately aligned with the interests of the shareholders, e.g. by holding a "reasonable" percentage of the outstanding shares?
44. Does the company generate free cash flow? Ahold, Enron, SunEdison and Toshiba did not generate any substantial free cash flow at all over a 3 to 5 year period before collapsing. Huge red flag.
45. What about debt? Just try to use the total liabilities relative to EBIT and relative to operational cash flow. You would have found terrible results for Valeant, Enron, Imtech, SunEdison and Toshiba. Huge red flag.
46. Is the company profitable? Before crashing, Valeant was not (GAAP) profitable at all for 3 out of 5 years and SunEdison for 5 out of 5 years. That's a huge red flag.
47. Does operational cash flow lag way behind net income? With this simple "quality of earnings" test you would have identified Royal Imtech easily. Red flag.
48. What about financing future growth? If the cash flow from investing substantially exceeds the cash flow from operations, that's not a good sign. Imtech, Valeant, Enron, SunEdison and Ahold used way too much debt to finance future growth. Huge red flag.
49. Does the company have products or services with sufficient market potential to make possible a sizeable increase in sales for at least several years?
50. How effective are the company's research and development efforts in relation to its size?
51. What type of relationship does the business have with its suppliers?
52. How does inflation affect the business?
53. Does the company have a worthwhile profit margin and what is the company doing to maintain or improve profit margins?
54. Does the company have outstanding labor and personnel relations?
55. Does the company have outstanding executive relations?
56. Does the company have industry specific depth to its management?
57. Does the company have a short-range or long-range outlook in regard to profits?
58. Does the management talk freely to investors about its affairs when things are going well and "clam up" when troubles or disappointments occur?
59. What are the operating metrics that I need to follow?

60. What is its competitive advantage "niche"? (i.e. low cost producer, network effect, innovation, distribution, economies of scale, brands, patents, switching costs)
61. Have I monitored the market for entrance of new competitors?
62. Is the company part of a cartel? Who is the low cost leader if the cartel breaks down?
63. What was the composition of earnings' growth over the past five years? (organic, buy-backs, M&A).
64. What headwinds do the earnings face?
65. If the company is enjoying regional success, can it be extended nationally?
66. How will economic recession hurt the business?
67. Have I considered potential overvaluation of underlying currency behind the stock?
68. Are inventory levels of finished goods increasing in an abnormal manner vs. economic conditions? Is inventory build-up occurring faster than sales? Watch for inventory write-downs!
69. Is the company operating in a dangerous geographic area with corporate governance and/or political issues?
70. Does the CEO have a good track record (M&A and operational)? Check past history.
71. Has the management fulfilled past promises? Check annual letters.
72. Do the insiders own a significant portion of shares in the business?
73. How has the management allocated capital in the past? Have they announced changes to their capital allocation strategy?
74. What is the tone of the management in corporate media? Do they appear to be over confident? If they can't properly manage expectations, it's likely they can't properly manage the business.
75. Are there frequent write-downs? If not, have I added back one time charges?
76. Has there been constant share dilution?
77. Are there irregularities in management turnover? Is upper management leaving at high rates?
78. Were past share buy-backs executed at attractive levels?
79. Is there a special share class to prevent a takeover or to promote special management interests?
80. Are current earnings at a trough, mid-cycle, or peak?
81. Have I checked for hidden value in properties? If so, when were they booked?
82. Have I checked composition of long-term investments to find hidden value?
83. How has the tangible book value evolved? What is the TBV excluding goodwill?
84. What expectations are priced into the company's shares? (This question is useful to think of when shares are at highs and at lows.)
85. Have I checked for equity in affiliates? (An area of hidden value)
86. Is the company involved in any significant lawsuit(s)?
87. Does one party hold majority of the shares?
88. Is the business becoming unregulated? This may cause the niche to evaporate quickly–regulated businesses have high cost structures which are disastrous if competing with peers in an unregulated landscape.
89. Is the company benefiting from exceptional items that may vanish in the future?
90. Is the company dependent on only a few customers?
91. Is an abnormal tax rate artificially boosting the earnings?
92. Is the company "diworsifying" into unrelated areas?
93. Does the company have unions? Have I checked for union issues?
94. Does the company have an abnormal amount of operating leases that may endanger it financially?
95. What is the company's exposure to possible macro-economic shock? (indirect or direct, e.g. US housing)
96. Can another retail channel endanger the business model? (e.g. the internet business model hurt various brick and mortar based companies).
97. Have I checked to see any changes to "summary of significant accounting" policies?
98. Is accounts receivable increasing faster than sales? (company may have trouble collecting from customers)
99. Is the cash flow from operations increasing in line with net income?
100. Are doubtful account receivables rising in line with total accounts receivable?
101. Have I checked the discount rates currently in use for pension assumptions? What if interest rates suddenly increase? The assumptions will change!
102. Have I checked for significant pension obligations? Are pension plans over or underfunded?
103. Is there a significant tax benefit from exercising employee options? This may disappear if markets drop and employees stop exercising the options!
104. CFO-Capex-(Dividend + Buybacks) should not be negative on a regular basis otherwise the company is living beyond its means.
105. Are gains from investments and/or pension related items boosting net income?
106. Has the company regularly incurred environmental fines? (i.e. bad risk management and subsequent disasters)
107. Has the company changed auditors? Why, and how often?
108. Have I made public announcements regarding the company that may result in emotional attachment to the stock or am I emotionally attached to the company due to past success(es)?
109. Am I holding a bias against a company due to past experience(s)?
110. Are my investments too concentrated on one industry?
111. Is there a trend in "retained earnings" and do I understand this trend?

112. Does the company have enough liquid assets after liabilities to qualify for a potential “liquidity mismatch”? (e.g. is value of the company’s assets listed at cost? Important to check as some assets may have appreciated over time).
113. Can the EBIT cover interest expense for the next two years?
114. Have I checked key debt metrics such as EBITDA/Interest and Net Debt/Equity?
115. Have I checked for the date of loan maturities? Is the interest fixed or floating?
116. Have I checked the covenant levels of the debt? How much cushion does the company have under its maintenance covenants in the largest agreements?
117. Is the company’s long-term capital structure different from the industry average?
118. What is the forex profile of debt?
119. Have I checked the ratings pressure, especially for firms rated BBB/BBB- with a large Gross Debt who cannot afford a downgrade to High Yield?
120. Check the amount of “unbilled receivables”. If it grows quickly, that’s a severe RED FLAG.
121. Are the earnings “normalized earnings” or “boom earnings”?
122. Is this company in the retail business? If so, don’t buy it.
123. Does the stock has tradeable options available?
124. What’s so very special about the business model and the CEO?
125. Is the investment decision simple and safe? There is plenty of money to be made in the center of the court. So just keep it there.
126. What are the top 3 downside risks? What are the consequences if these risks become reality? And what are the chances that these risks become reality?
127. Will this company be around 25 years from now and doing well?
128. Where is the distress. Or in other words, what makes this company look cheap?
129. Tell me about the CEO. What makes him/her exceptional? Does he/she has a track record of high performance. Is he/she there for the shareholders or for his/her big ego?
130. Did I read the bios of all the members of the leadership team?
131. Has the leadership team previously done anything self-serving that appears to be dumb?
132. Is the company providing a win-win for its entire ecosystem?
133. What you look for are companies like Mastercard or Precision Castparts. These are companies with exceptional business models that will endure , exceptional management teams and the capacity to reinvest and expand their businesses. You could also argue that these are businesses with consistently high return on capital and a strong growth in the free cash flow per share. Is that the case?
134. What you want to do is to find these companies in their early stage. You want to buy them when they are small and obviously at a price that makes sense. What stage of the competitive life cycle is the company in?
135. How could the company be affected by changes in other parts of the value chain that lie beyond the company’s control?
136. Is the company currently earning a return above its cost of capital? Are returns on capital increasing, decreasing, or stable? Why?
137. What is the trend in the company’s investment spending?
138. What percentage of the industry does each player represent?
139. What is each player’s level of profitability?
140. What have the historical trends in market share been?
141. How stable is the industry? How stable is market share? What do pricing trends look like?
142. What class does the industry fall into—fragmented, emerging, mature, declining, international, network, or hypercompetitive?
143. Can companies pass supplier increases to customers?
144. Are there substitute products available?
145. Are there switching costs?
146. What are the entry and exit rates like in the industry?
147. What are the anticipated reactions of incumbents to new entrants?
148. What is the reputation of incumbents?
149. Is there excess capacity in the industry?
150. Is there a way to differentiate the product?
151. Do incumbents have precommitment contracts?
152. Do incumbents have licenses or patents?
153. Are there learning curve benefits in the industry?
154. Is there pricing coordination?
155. What is the industry concentration?
156. How similar are the firms in incentives, corporate philosophy, and ownership structure?
157. Is there demand variability? Supply/demand dynamics.
158. Are there high fixed costs?
159. Is the industry growing?
160. Are the accounting standards that management uses conservative or liberal?
161. Does the business generate revenues that are recurring or from one- off transactions?
162. To what degree is the business cyclical, countercyclical, or recession-resistant?
163. To what degree does operating leverage impact the earnings of the business?
164. How does working capital impact the cash flows of the business?
165. Does the business have high or low capital-expenditure requirements?
166. How are senior managers compensated, and how did they gain their ownership interest?

167. Have the managers been buying or selling the stock?
168. Is the business managed in a centralized or decentralized way?
169. Does the business grow through mergers and acquisitions, or does it grow organically?
170. How does management make M&A decisions?
171. Have past acquisitions been successful?
172. Does analysis of the value chain reveal what activities a company does differently than its rivals?
173. Does the firm have production advantages? Is there instability in the business structure? Is there complexity requiring know-how or coordination capabilities? How quickly are the process costs changing?
174. Does the firm have any patents, copyrights, trademarks, etc.?
175. Are there economies of scale? What does the firm's distribution scale look like? Are assets and revenue clustered geographically? Are there purchasing advantages with size? Are there economies of scope?
176. Are there consumer advantages? Is there habit or horizontal differentiation? Do people prefer the product to competing products? Are there lots of product attributes that customers weigh? Is there customer lock-in? Are there high switching costs?
177. Is the value of the pie growing because of companies that are not competitors? Or, are new companies taking share from a pie with fixed value?
178. Do customers want to "hire" the brand for the job to be done and does the brand increase willingness to pay?
179. Do customers have an emotional connection to the brand?
180. Do customers trust the product because of the name?
181. Does the brand imply social status?
182. Can you reduce supplier operating cost with your name?
183. Wall Street is good at pitching stories, and investors tend to get excited by what they believe is an "important new trend". However, many of these exciting major trends turn out to be fads that are based on speculation, rather than fundamentals. Is there a risk that I am buying into a so called "important new trend"?
184. Is this a company that got a stock listing via a "reverse listing"? If so, don't buy it.
185. If the stock price recently declined, what was it that caused the decline? Most stock price drops are due to some type of uncertainty about the business, and there are many possible reasons: litigation fears, accounting irregularities, accusations of fraud, health concerns (such as swine flu), execution problems due to a flawed strategy, management concerns, executive departures, government intervention or regulation, loss of a customer, technological changes, credit rating downgrades, competitor announcements.
186. Do I understand all the latest quarterly financial results updates, press releases and company related news?
187. Who is shorting the stock and why?
188. And finally, you want the investment opportunity to be the best one relative to the investments in your current portfolio and relative to at least 3 other attractive investment opportunities on the table.

"You need a different checklist and different mental models for different companies. I can never make it easy by saying, 'Here are three things.' You have to derive it yourself to ingrain it in your head for the rest of your life." – Charlie Munger