***"I think you judge management by two yardsticks. One is how well they run the business, and I think you can learn a lot about that by reading about both what they've accomplished and what their competitors have accomplished, and seeing how they have allocated capital over time."*, WARREN BUFFETT**

Judging Corporate Management

Having spent several decades in the investment management industry, I realize that no two investment professionals will agree completely on the steps necessary to judge the management of a company being considered for purchase in client portfolios. Unfortunately, no one way appears superior to others and all methods combine elements of objective and subjective evaluations to reach a conclusion.

Without attempting to enumerate all the criteria in order of importance, let's begin the discussion by looking at the more common *objective* elements that play an important role in the process. Many Wall Street security analysts and sophisticated investors focus on return on equity (ROE) as do many corporate executives. Admittedly, there are other quantitative measures such as IRR, CFROI and DCF but for a variety of reasons, ROE has stood the test of time. ROE has some appeal because it emphasizes the return to shareholders as a result of day-to-day management decisions. However, ROE has some built-in potential problems that can distract investors from looking more deeply into the financial statements. Unfortunately, corporate management can pursue financial engineering to maintain a stable ROE while increasing debt leverage and hiding a weakening in business fundamentals. Share repurchases also has a salutary effect on ROE but may represent a poor use of corporate cash.

Given the possible problems with the ROE metric, another metric that has merit is return on assets (ROA). ROA analyzes the long term profitability of a company and avoids some of the problems with ROE. In brief, ROA takes into account the assets used to support business activity. Furthermore, it indicates whether a company is able to generate an acceptable return on the employed assets rather than looking at a figure like return on sales. In summary, ROA may present a better understanding of business fundamentals including asset utilization.

In addition to the above metrics, other measures of management strength include an analysis of long term sales and earnings growth, dividend growth, financial leverage, competitive position in its industry and something as simple as stock price performance.

When all is said and done, the quality of management shows up in other ways and investors would do well to focus on assessing how closely management's interests are tied to shareholders' interests. To begin, management compensation should be tied to the interests of shareholders. Managers who have an extraordinarily high compensation package relative to their industry peers should be closely monitored to be certain that their long term goals and objectives are consistent with the mission statement of the corporation,

Another area to consider is insider buying of company stock. While this could be a positive sign, it is also important to examine how long shares are held by key executives. In a similar vein, share buybacks can also be positive but, again, it is important to consider when the buybacks occur. With the markets currently having extended valuations, buying back shares at elevated prices is a poor use of corporate cash. However, if the company stock is truly undervalued relative to its past history and its peer group, then share repurchases can be a wise use of excess funds.

With respect to corporate debt, it is important to consider the company and its industry in making any judgments. If the company has a high amount of debt relative to its industry, this is a potential warning sign that management may not be doing what is best for shareholders. On the other hand, many companies in a mature industry could have some debt as it lowers the firm's cost of capital and produces a higher return on equity (ROE).

In examining any company, a strong management should have a clear mission statement that sets forth the goals and objectives of the enterprise. Importantly, the statement should be concise and easily understood by management and shareholders alike.

Management tenure is another important factor that should be evaluated in assessing the management team. The CEO and top management ideally should have a long association with the firm or with a prior firm that lends credibility to their ability to work together as a cohesive unit. Proof of their ability can be seen in the efficient allocation of capital over the past few years and holds promise for wise decisions in the future. Here again, various quantitative measures such as ROE, ROA, ROIC that are better than industry norms are a very positive sign that management is managing the business well for the benefit of its shareholders.

In attempting to evaluate a management quality, it would be good to ask yourself questions such as the following:

- Does the company have the appropriate dividend & buyback policy
- Does the company have a history of cost overruns or operational missteps
- Does the firm have a history of taking large impairment charges
- Have investments & acquisitions been strategically wise
- Do management's decisions build shareholder value
- Does the company have an appropriate amount of debt
- Has management been candid about mistakes and challenges
- Has the Board established an appropriate management incentive plan
- Would you invest your own funds in this company

Lastly, as Warren Buffett has said on many occasions: "In evaluating management, you should look for three qualities: integrity, intelligence and energy. If you don't have the first, the other two will kill you".

In conclusion, it is important to remember that there are no established guidelines for evaluating a company's management. However, the above guidelines are a good start and, over time, astute investment managers are usually able to discern the good management teams from the less able ones. Experience, analysis and judgment are essential tools in judging corporate management, all of which contributes to reaching an investment decision. Always remember that at Metis Value Partners, "*knowing what you own*" guides our investment process in finding the very best values for our three, concentrated value strategies.

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