



# The Imperative of NO: The Luxury of Patience

Texas Lutheran University

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# The Abominable “No”-man





## Understandability

- **Technical Understandability**
- **Understandability/Attractiveness of Long-term Business Model**
- **Political or Societal Understandability**

## Business Quality

- **Capital Structure**
- **Profitability**
- **Accounting Integrity**
- **Management Quality**
- **Unit Economics**
- **Returns on Incrementally Invested Capital**

## Price

- **Fall in Love with the Great Company, Not the Stock**
- **Why Price Matters**



# Understandability: “Too Hard Pile”

Understandability

## Technical Understandability

- Ex: Pharma
- Ex: Certain technologies

Business Quality

## Understandability/Attractiveness of Long-term Business Model

- Understanding durability and margin structure
- Margin expansion/contraction
- What kills this?
- What has to happen for a company to lose money in a given year?
- Ex: Amazon vs. Costco

Price

## Political or Societal Understandability

- Rule of law
- Ex: Societal tendencies in Japan



# Business Quality: “Addicted to Loans”

## Capital Structure

- On-balance sheet and off-balance sheet
- Performance throughout cycles

### GE in 2007

- Assets: \$795B
- Equity: \$116B
- Debt: \$514B\*
- Cash: \$16B
- Earnings: \$22B
- Market Cap: \$370B

### AIG in 2007

- Assets: \$1,060B
- Equity: \$96B
- Debt: \$176B\*
- Cash: \$2B
- Earnings: \$17B\*\*
- Market Cap: \$148B

### BRK in 2007

- Assets: \$273B
- Equity: \$121B
- Debt: \$34B\*
- Cash: \$44B
- Earnings: \$13B
- Market Cap: \$219B

*\*Excludes SPE's, off balance sheet swap liability, and capitalized operating lease liability*

*\*\*AIG earnings exclude a -\$11B mark to market adjustment for swap portfolio*

- We all know what happened next...

Understandability

Business Quality

Price



# Business Quality: “Accounting Red Flags”

Understandability

Business Quality

Price

- Aggressive revenue recognition
- Ballooning working capital metrics
- Aggressive pension assumptions
- Large pension size, relative to firm assets
- Large, consistent write downs and write-offs
- Large, consistent litigation charges
- Material stock compensation
- “Adjusted EBITDA”
- Off-balance sheet liabilities, SPEs, offshore accounts
- Insider ownership and leaseback of company assets
- Recurring “non-recurring” charges
- Management loan guarantees
- Related party transactions
- CAPEX to maintain position at lower returns
- Asset/liability, revenue, expense
  - Estimates or results don’t match the industry
- Complex business arrangements
- CFO revolving door
- Pollyanna CEO: MD&A/CEO Letter
- Consistently close expected vs. actual results
- Late quarter shipping
- Accounting differences vs. industry
- Use quarterly measures to smooth earnings
- Board composition
- New accounting standards
- Changing R&D and CAPEX



# Business Quality: “Profitability”

Understandability

Business Quality

Price

- Gross margins
  - Pricing power (or lack thereof)
  - Not being able to achieve scale pricing of raw materials
  - Industry specific
- EBITDA Margin
  - Preferred measure for private equity
- Operating margin
  - SG&A not achieving scalability
  - Out of control R&D spend
- Net Margin
  - Pre-tax and after-tax
  - Preferred measure for Semper Augustus
- ROE
  - Hurdle rates for business quality
  - Important indicator of future investment prospects
- ROC
  - Effects of leverage
  - Decreasing profitability of incremental investments will pressure this
  - Will showcase poor capital allocation



# Business Quality: “Management Quality”

Understandability

Business Quality

Price

- Poor performance-based comp metrics
  - Revenue growth
  - Adjusted EBITDA/growth
  - EPS growth
  - Lacking tie to capital
  - Anything else that rewards short-term thinking
- Rich stock option programs
  - Tech companies of the early 2000’s
- Insider dealing
  - Loans to members of management
  - Asset sale and leaseback by management
- Executives or board members with lack of experience or questionable pasts
- Executives not understanding their business
  - Stumbling through quarterly Q&A
  - Dodging the “tough” questions during investor meetings



# Business Quality: “Pay for Performance”

Understandability

Business Quality

Price

## Cummins

- Chairman and CEO: Thomas Linebarger
- Total compensation: \$17.3m
- Base salary: \$1.4m
- Cash bonus: \$3.2m
  - Performance metrics: ROANA using EBIT
- Target Long-term Incentive: \$7.8m for 2018-2020 period
  - Performance cash (34%), ROIC at 80%, EBITDA weighted at 20%, 3 year term, \$3.5m in 2020
  - Performance shares (33%), ROIC weighted at 80%, EBITDA weighted at 20%, 3 year term, \$2.6m in 2020
  - Stock options (33%), Share price appreciation, 3 year cliff vesting, 10-year term, \$2.4m in 2020
- Deferred income plan: \$4.7m
  - Change in actuarial present value of pension plan and non-qualified deferred compensation

## General Mills

- Chairman and CEO: Jeffrey L. Harmening
- Total compensation: \$8.0m
- Base salary: \$1.2m
- Cash bonus: \$1.1m
  - Organic revenue growth target of -1.4%
  - Segment operating profit target growth of 1.1%
  - Adj. diluted EPS target growth of 2.3%
- Long-term incentive: \$4.7m
  - 2016-2018 PSUs 66% of target (33.3%): \$1.5m
    - 3-year average organic sales target growth of 1.4% (50%): 0%
    - Cumulative Free Cash Flow target of \$6 billion (50%): 132%
  - Stock Options (33.3%): \$1.7
    - 4 year cliff vesting
  - RSUs (33.3%): \$1.5m
    - 4 year cliff vesting

# Business Quality: “The Good, the Bad and the Ugly”

*“If you save your breath, I feel a man like you can manage it. And if you don’t manage it, you’ll die. Only slowly, very slowly old friend.”*



Understandability

## Unit Economics

- Do the unit economics make sense for expansion?
- Ex: JC Penny vs. Macy’s vs. Costco

## Incremental Return on Capital

- Can the business invest retained capital at acceptable rates of return?
- Are incremental returns growing due to scale?
  - Long-term compounding business
- Are incremental returns declining?
  - Indicative of cannibalization or increasing competition



Business Quality

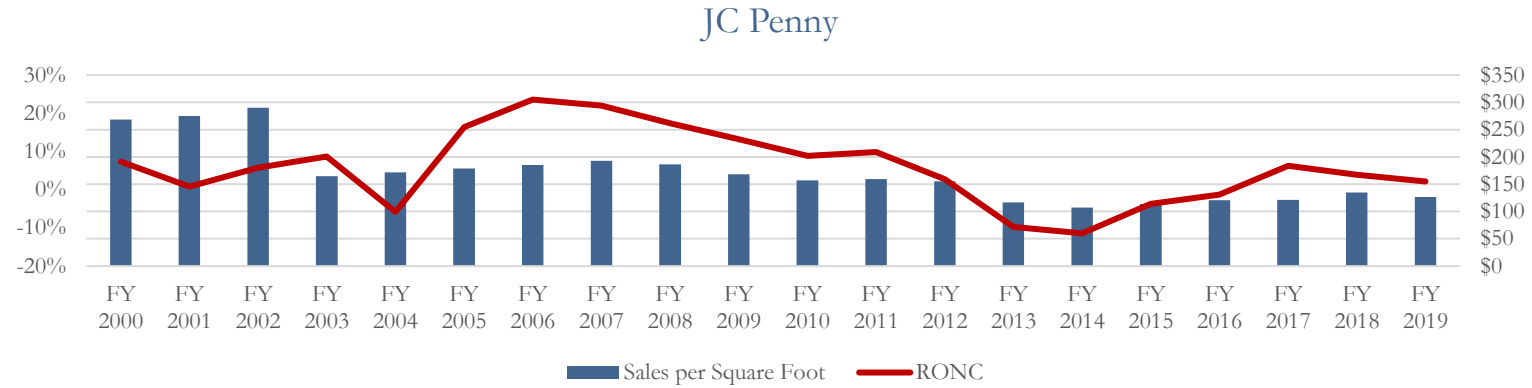
## Tools of Capital Allocation: “Go ahead, make my day.”

- Internal Spending in the Business – Capex, R&D, Advertising
- Pay / Increase Dividends or Reduce / Suspend Dividends
- Pay Down Debt or Take on New/Additional Debt, Including Shifting Terms
- Make Acquisitions Using Company Stock, with Cash, with Debt, or with a Combination
- Repurchase Shares in the Open Market
- Issue Shares / New Capital
- Increase Wages
- Increase Executive Compensation (favored by many – though they don’t highlight it)

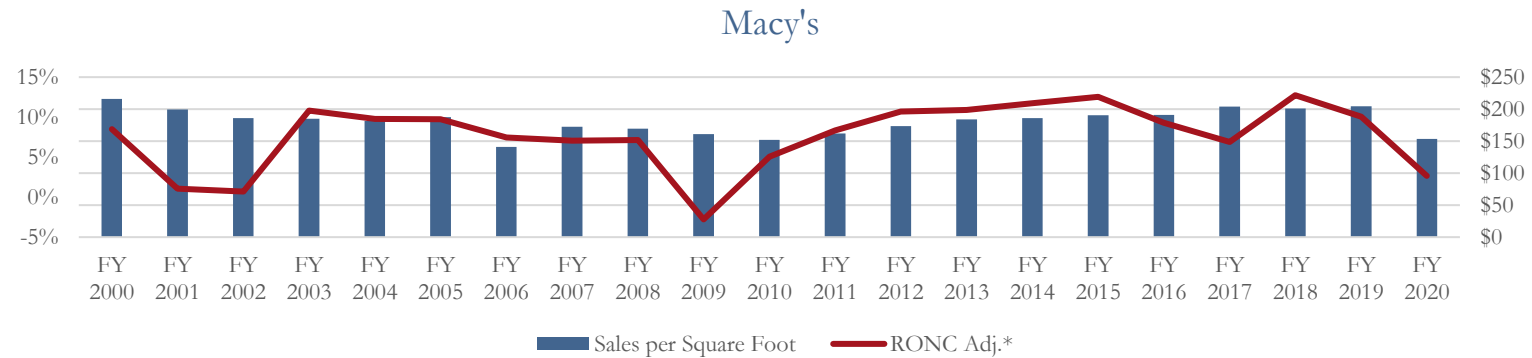
Price



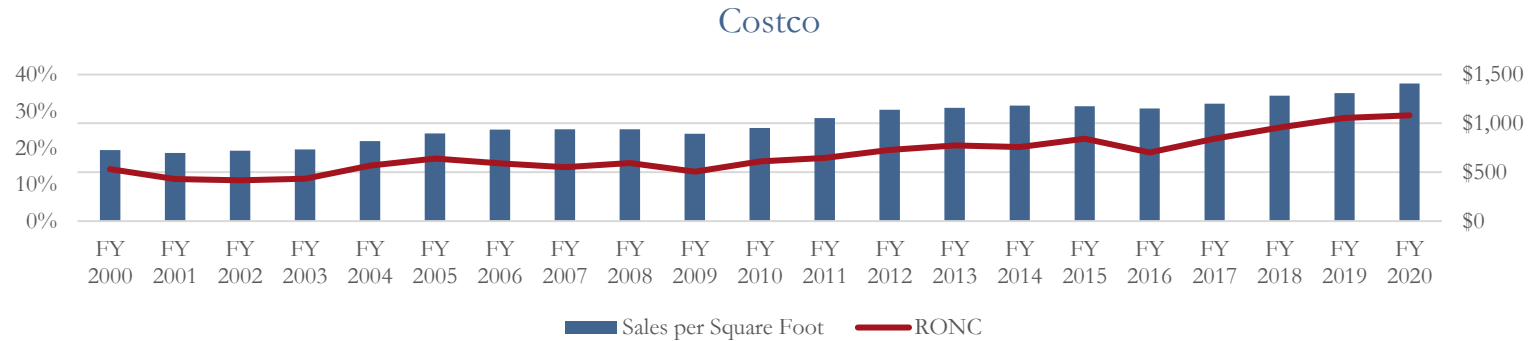
Understandability



Business Quality



Price



\*Excludes impairment loss in '09 and restructuring costs in '20



# Price: “Last but Not Least”

Understandability

## Don't Fall in Love with the Stock

- Only ~5% of companies make it this far in the research process
- Can not let amount of work done on a name sway an investment decision

Business Quality

## Economics of a Wonderful Business

- Virtual monopoly with extremely sticky products
- Sales: \$20 billion
- Gross margin: 86%
- Operating margin: 50%
- Net margin: 39%
- Net cash: \$17 billion
  - Zero leverage
- ROE: 27%
- RONC: 70%
  - Total Capital minus \$17 billion in cash

Price



# Price: “Last but Not Least”

Understandability

## Wonderful Businesses Don’t Always Make Wonderful Investments...

- “You can turn any business into a bad deal by paying too much.”- Warren Buffett, Berkshire Hathaway 2019 Annual Meeting

Business Quality

## Wonderful Business

- Sales: \$20 billion
- Gross margin: 86%
- Operating margin: 50%
- Net margin: 39%
- Net cash: \$17 billion
  - Zero Leverage
- ROE: 27%
- RONC: 70%
  - Total capital minus \$17 billion in cash

## Let’s Consider Price...

- Market cap: \$620 billion
- Price/sales: 31x
- Price/ earnings: 80x
- Price to cash flow: 62x
- Price/book: 22x

Price



# Price: “Last but Not Least”

## Predictions: SAI 2000 Year-end Letter

Understandability

Business Quality

Price

1. Microsoft shareholders will see returns compound at no greater than 0% for the next fifteen years.
2. Many of today’s pure internet stocks will crumble as the companies run out of the cash raised in recent IPO’s.
3. Today’s beneficiaries of the cash raised in internet IPO’s will be tomorrow’s failures.
4. Aggregate U.S. profit margins will remain bound by historic standards.
5. U.S. Gross Domestic Product, basically the total output of final goods and services in America plus net exports, unadjusted for inflation, will grow somewhat slower than historical precedent.
6. The valuation of the U.S. stock market will equal between 30% and 60% of GDP at some point in the next fifteen years.
7. Interest rates, as measured by the 30-year U.S. Treasury Bond, may fall as low as 3% over the next fifteen years.
8. Despite current government projections from both political parties, the U.S. government will not eliminate the federal debt.
9. Unbelievably, the tax code will become more complex.
10. Defense spending will increase as a percentage of GDP, having fallen to 3.9% in 1999 from 7.5% in 1987, 12% in 1960, and 25% during WWII.
11. Education will continue to privatize, particularly at post-secondary levels.
12. The commercial nature of sport will decline.

Q&A





# Biography

- **Christopher P. Bloomstran, CFA**, is the President and Chief Investment Officer of Semper Augustus Investments Group. Chris has more than 30 years of professional investment experience with a value-driven approach to fundamental equity and industry research. Semper Augustus manages concentrated, all-cap portfolios with typically long holding periods and a general benchmark and geographical agnosticism. The investment process maintains business quality at a high level and stresses the importance of price below intrinsic value. The approach is eclectic, resulting in ownership in some businesses ideally held forever, now fashionably compounders. They own some things cyclically, will own the long side of merger arbitrage, and occasionally have the chance to opportunistically put money to work in oddball special situations with extremely low risk and high upside.
- Chris received his Bachelor of Science in Finance from the University of Colorado at Boulder, where he also played football. He served as President of the Board of Directors for the CFA Society of St. Louis and has been a Director on the Board since 2001. Chris has judged the local CFA Institute's Global Investment Challenge for many years and has been honored to judge the Regional and the Global Finals since 2016. A member of the CFA Institute, he earned his Chartered Financial Analyst (CFA) designation in 1994.
- Chris writes extensively on Berkshire Hathaway, and more broadly on thematic topics related to the stock market and the economy. His annual year-end letter is widely read among the value investing community. Recent interviews include an Invest Like the Best podcast episode and an interview with the Investment Masters Class in Australia. He very much enjoys giving back through mentorship and loves speaking regularly at many colleges and universities. Most recently he was honored to speak at Columbia Business School's Heilbrunn Center for Graham & Dodd Investing.



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