MEAD CAPITAL MANAGEMENT

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"Your margin is my opportunity." – Jeff Bezos

MARGINS DON'T MATTER (SORT OF)

The trouble with analysis of a single variable is the loss of context. Take profit margins. Higher would seem to be better, right? Not necessarily. Let's consider the following hypothetical companies. Which one would you rather own?

	Company A	Company B	Company C
Operating margin	27%	35%	2.6%

As you might have guessed, this is one of those examples where the "obvious" answer is not the correct one. It's not Company B, you say, let's go with Company C. Final answer?

The correct answer turns out to be 'we don't know'. We're missing crucial information. We don't know how much capital each business requires to operate.

	Company A	Company B	Company C
Operating margin	27%	35%	2.6%
Revenues/avg. capital	n/a	$0.13	$7.22
Return on capital*	Infinite	4.5%	18.8%

*Pre-tax

Armed with more information we can see Company B generates a large margin but very little by way of revenues compared to the capital required to run the business. Company C, by contrast, has a huge turnover that takes its miniscule profit margin and turns it into a quite-satisfactory return on capital. What about Company A? What is this magic company that doesn't require any capital and therefore generates a theoretical infinite return? Let's pull back the curtains:

	AAPL	EQR	KR
Operating margin	27%	35%	2.6%
Revenues/avg. capital	n/a	$0.13	$7.22
Return on capital*	Infinite	4.5%	18.8%

*Pre-tax

- Company A is Apple, the tech giant.
- Company B is Equity Residential, a lessor of primarily apartment units.
- Company C is Kroger, a supermarket operator.

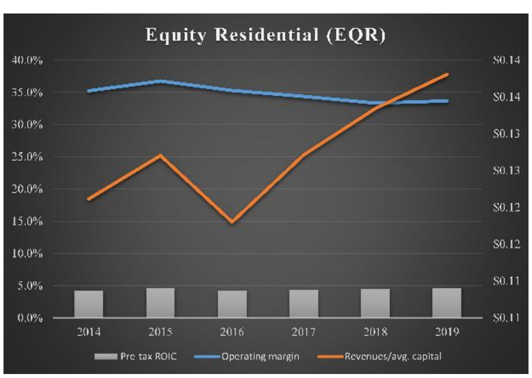
The figures above are the five-year average of each metric.

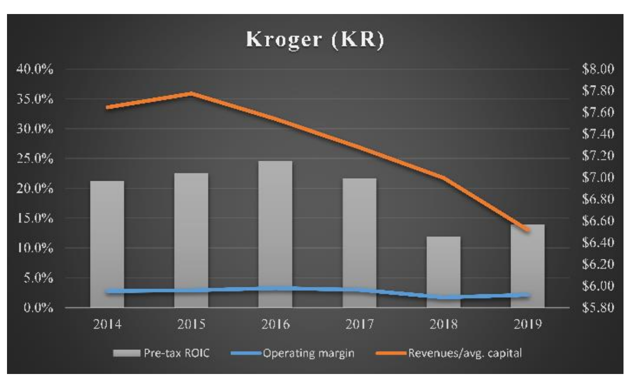
Apple requires no net tangible capital to operate. It has long-term debt on the balance sheet but far more in surplus cash. It's not surprising Apple is valued at $2 trillion. The company has the holy-grail combination of high absolute profit margins, high and historically growing revenues, and no capital restraints limiting growth. (Which brings up yet another variable: how do you value such an enterprise?)

Combing back down to earth, Equity Residential represents one end of two extremes of more typical companies. Profit margins, by themselves, are insufficient data to judge the attractiveness of a business. A company like EQR naturally requires a higher profit margin to make up for the huge investment in fixed capital required to run the business. Its return on capital is low because the market competes it to that level. (Its owners can generate a satisfactory return on *equity* by using lots of debt – allowing debt investors first claim to the historically-consistent net operating income generated by a commodity product, housing.) The seemingly-high margin EQR "enjoys" is therefore already competed to the margin. Until/unless housing can be built more cheaply, margins will need to remain high to attract capital.

Kroger is the other end of the extreme. It generates very low profit margins, as we would expect from a low-value-add type of business operation. It serves as a middleman aggregating supply and demand and is paid for this service by a small profit on each item. It does a huge volume of business, turning over capital employed enough times to generate a good return on capital.

Most other businesses are somewhere in between.





Key Takeaways – Profit Margins

So, what to make of profit margins? The first thing is to recognize they are industry/business model dependent. You can't compare a real estate company with a grocer, it's an apples-to-oranges (okay bricks-to-oranges) comparison. But we can compare competitors within industries, and we can compare trends over time.

Analyzing profit margins in the context of return on invested capital is more optimal. Using return on capital removes the financing component to view business operations in isolation. It then allows a view into the key drivers of the business and sets up natural questions such as:

- Profit margins:
  - How have profit margins changed over time?
  - What is happening in the industry that might change margins either temporarily or permanently?
  - Does the business in question have a competitive advantage that shows up in higher-than-average profit margins?
- Capital requirements:
  - How much capital is required to run the business?
  - What are the key components of capital for this business/industry?
  - Might changes in working capital cause a higher required investment, and therefore a lower return?
  - Can suppliers or customers dictate how much capital is required (i.e. Amazon or Walmart requiring inventories to be held at the manufacturer and not the retailer)?
  - Do capital requirements attract or repel competition? (Is it easy to enter? Is it a 'sexy' industry that naturally attracts investors?)
  - When, if at all, could economies of scale in fixed assets cause revenues/capital to go up? If that happens, would profit margins go down and negate such an advantage? Might that become the new industry norm leaving no real economic advantage?

GENERAL ECONOMIC COMMMENTARY

I'm going to go against the grain of most analysts, commentators, etc. in saying the upcoming US Presidential election is of little importance. At least as it pertains to the long-term value investor. Doubtless many investment newsletters this month are filled with commentary about whose tax policy will result in which winners, the odds of either side winning, and the multitude of tactics/strategies/hedges to protect or take advantage of certain outcomes, etc. In my view this is mostly noise to avoid, and a mistake to participate in.

Over the course of an investing lifetime one is sure to see pendulum swings of every kind. Most markets are efficient. One might correctly bet on a direction this political season only to experience a reversal next time. Over the long run one is out the cost of the hedges at best, and at worst suffered the anguish of uncertainty and distraction. The outcome of such events over many iterations is unknowable. Better to spend time trying to identify good businesses that will prosper no matter what comes economically or politically. Over the course of the last 50 or 100 years we’ve lived through wars, famines, pandemics, and myriad tax/business policies. No one (to my knowledge) found themselves on the Forbes 400 for correctly betting on the outcome of an election. That list is, however, full of business *owners*.

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Until next month.

Warmly,

Adam

Important Disclosures:

Mead Capital Management, LLC is a registered investment adviser based in Derry, New Hampshire. Adam J. Mead is its principal, CEO, Chief Investment Officer, and managing member.

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