AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

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Idiot Proof Companies

"I try to buy stock in businesses that are so wonderful that an idiot can run them because sooner or later, one will." W. Buffett

Investors are constantly forced to assess the sustainability of company business models when looking at adding new stocks to their portfolios or critically evaluating the companies that they currently own. Indeed an institutional investor may be exposed to the management teams from several hundred companies in any given year. Amongst those companies they will find large variations in both management and business model quality. During bull markets with supportive business conditions it can be quite difficult to separate management quality from the positive tailwinds the business is currently enjoying.

In this week's piece we are going to look at the characteristics of 'idiot proof' companies and the reciprocal which are companies that typically need both supportive market conditions and a strong management team to prosper. Obviously the conditions of strong management teams and a sympathetic business environment are rarely permanent.

The plan was idiot-proof. Unfortunately, someone came up with a superior idiot.

A Tale of Two Companies

A few years ago I met with two management teams one after the other as their head offices were located close to one another. The first was a chemical company that operated in a highly competitive global market on very tight margins. Its head office was austere and it was clear that the bright and focused CEO was constantly battling to take costs out of the business to maintain profits and that the prices for the company's products were set by global markets. Following this meeting I met with a liquor company that had roughly the same market capitalisation. In their palatial fortress-like offices, the CFO ran through the very fat profit margins even after taxes the company made per case on its iconic beer brands[1]. Large profits, stability of demand and the ease of manufacturing allowed the

[1] Per case of beer the fixed costs were packaging ($5), malted barley, hops, yeast, water and heat ($4) plus taxes ($12).

company to make some significant missteps in purchasing wine businesses, the bulk of which were subsequently written off.

Ultimately the second company had a sustainable competitive advantage and could be considered 'idiot proof', as its business model could withstand the impact of poor management decisions and continued to grow. However for the first the chemical company, a A$1.2 billion write-off on a failed acquisition (whilst keeping the associated debt) could potentially have crippled the company.

Changing Management

Amcor is normally held up to be a shining example of an Australian corporate becoming a market leader in the packaging of food, beverages and tobacco and prospered under the long-term leadership of recently departed CEO Ken MacKenzie. As a long-time observer of this company and former significant shareholder in Amcor, in 2004 this was a company in crisis embroiled in price fixing scandals, a CEO leaving in disgrace and declining margins. Amcor operates in a highly competitive industry, on thin profit margins with a few large, knowledgeable and well-resourced customers (***Cadbury, Nestle***, and ***Pepsi***) and has benefited from competitor disarray (***Alcan Packaging***) and an extremely timely sale of its European PET business in 2007 for $676 million moments before the GFC started. We see Amcor as a company that requires consistently competent management.

Economic Moats and Glamour Industries

When looking for an idiot proof company we view that it would be best to avoid high growth glamourous industries that both attract competitors and may have low barriers to entry. Whilst it is possible to quickly build-up a tech or fintech company, just as one could buy base metal mining tenements in Western Australia in 2005 and swiftly build a mining company to be listed on the ASX, companies in glamourous or hot industries with minimal barriers to entry typically face a raft of new competitors seeking to enter into their industry.

Today many investors would view ***Google*** and ***Facebook*** as blue-chip investments with strong investment moats, but in 1998 the now-defunct Netscape held 90% of the browser market and Facebook predecessors Friendster and Myspace (sold to ***Newscorp*** in 2005 for US$580 million) ruled social media. Ultimately these companies are rarely "idiot proof" as small changes in technology or new ideas can allow competitors to swiftly usurp the position of market leaders.

Financial Strength and limited Capital Requirements

Idiot proof companies rarely have significant ongoing capital expenditure requirements as expensive capital requirements to grow or even maintain the quality of a company's assets reduce financial flexibility and the ability to weather the impact of poor decisions. A great example of this are the domestic steel companies ***BlueScope*** and ***Arrium***, which both require consistent investment just to stand still. Indeed over 2015 when Arrium was heading towards difficult times the company spent $426 million after spending a similar amount in 2014, all whilst reporting a net loss after tax of $7 million. This is how a company can end up with a market capitalization of $100 million and debts of over $2 billion when market conditions turn sour. Conversely over the same period the capital-light ***CSL*** had capital expenditure of only $414 million and bought back $900 million of its own stock on the ASX, despite being a multiple of the steel twins' size.

What about the Australian Banks?

Typically one would not think of a major bank as being "idiot proof" as they are complex financial companies with tens of thousands of employees that borrow tens of billions of dollars at wholesale rates and then lend this money out at a higher margin to corporations and individuals. Arguably the strength of the Australian bank's domestic retail franchises, the cozy oligopolistic market structure, implicit government backing and the consistent profits allows bank CEOs to weather missteps that would send many industrial companies into insolvency.

Over the past thirty years we have seen ***Westpac*** lose $1.6 billion in 1992 on bad corporate loans. In 2001 ***NAB*** incurred losses of more than $3 billion as a result of mistakes in interest-rate calculations in the US venture Homeside, more recently during the GFC NAB incurred losses of $1 billion from naïve investments in complex credit securities linked to US mortgages and earlier this year NAB ended the ongoing capital drain from their UK adventure after spinning off Clydesdale and Yorkshire Bank. Over the last five years the UK adventure has cost around $7 billion.

The magnitude of these losses would have crippled most industrial or mining companies, but the strength of the domestic banking franchises, the dearth of competitors and increasing capital moats would tend to suggest that the big four banks are close to “idiot proof”.

Our Thoughts

The basis of this piece is not to label individual CEOs as idiots *per se*, but rather recognize that certain businesses are inherently more difficult than others to manage through an investment cycle. As investors we look for companies that have the ability to withstand the impact of less than stellar management teams. We also acutely recognize that fund managers like companies make mistakes when investing, though in a fund an investment is generally a small part of the portfolio and the ASX allows us between the hours of 10am and 4pm to recognize that a mistake has been made and begin exiting a position. CSR management did not have that option when looking to reduce their exposure to glass manufacturing after over $1 billion in capital was deployed.

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