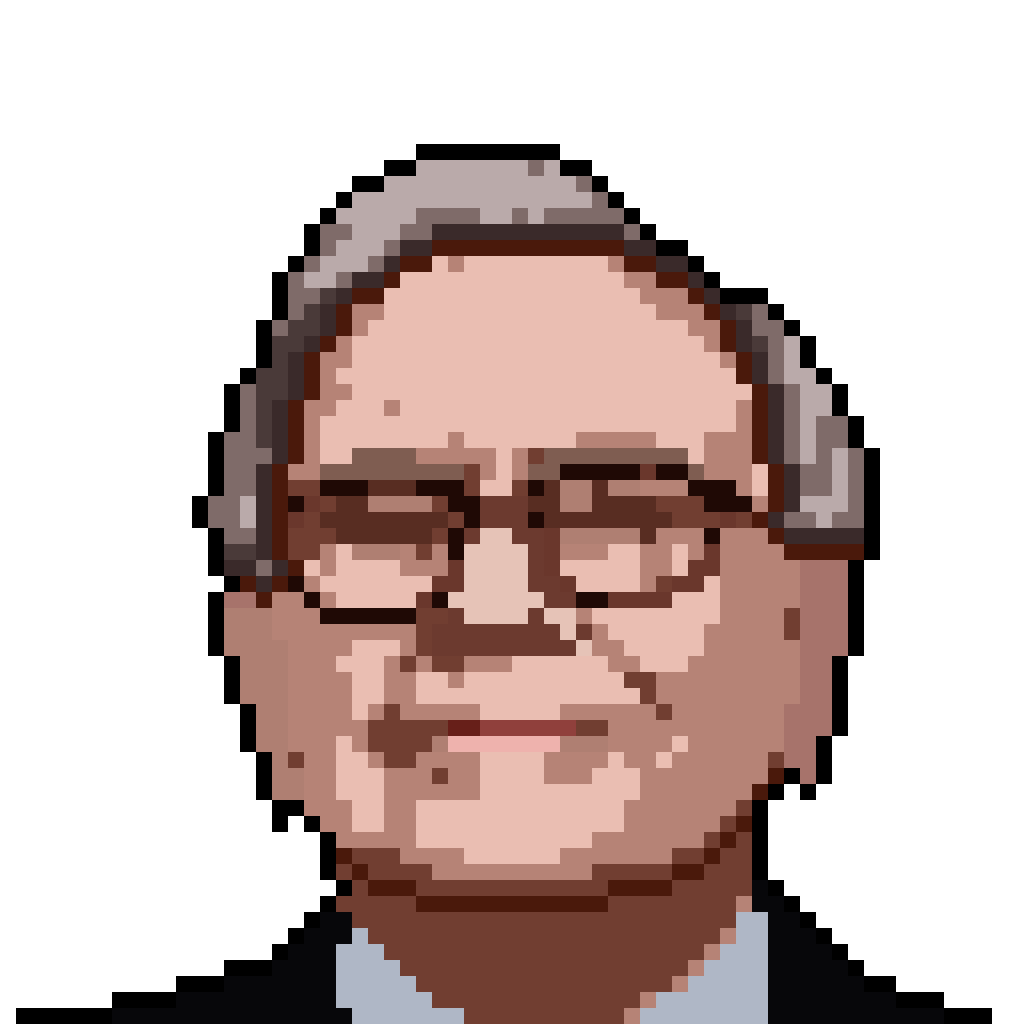
**What Does Buffet Look for in a Company?**

**A Sage’s Way of Selecting a Wild Horse**



What primes the sage of big-money investment today and brands the name“Warren Buffet” and “Berkshire Hathaway” is his persistent discipline of applying the same set of stock selection principles over the past 60 years. These principles were once crafted by the Father of Value Investing, Benjamin Graham, then later spun by the sage himself into proven criteria for identifying companies with a durable competitive advantage, businesses that have the economic power to pull themselves out of most bad-news situations; the opposite are price-competitive companies, those that are not able to do so.

**Durable-Competitive vs. Price Competitive Companies:**

On one hand, a company with a durable competitive advantage has a wide economic moat. It is typically a brand monopoly that sells products and services with grand household names and faces little to no competition as it has the freedom to raise prices and still produce higher earnings. As long as such a company exists, barriers to market entry are especially high; this, in turn, implies a great potential for its long-term economic growth. In most cases, if you want this particular product or service, you must

purchase it from one of such companies and no one else, resulting in high switching costs. Other properties of a company with a durable competitive advantage are conservative debt amount, strong cash position, and effective management. In general, companies of this kind have fewer ups and downs, and they possess the fundamental ability to sustain the storms that a shortsighted stock market will overreact to. On the other hand, a price-competitive company has a narrow economic moat. It typically manufactures a generic product or service that many businesses sell and competes for customers solely on the basis of price. Many price-competitive companies carry a substantial long-term debt because they are constantly upgrading their plant and equipment to stay competitive. These are why price-competitive companies have lower profit margins and lower inventory turnover. Such a company may benefit during a business boom through an increase in profit margin. However, once the bust hits, these companies may likely take a hit or might never recover from the economic ruin.

**Choosing the Wild Horse:**



Borrowing an analogy from *The New Buffettology*,

Consider two racehorses. One, called Healthy, has a great track record with lots of

wins. The other, called Sickly, has a less-than-average track record. Both catch the flu and are out of action for a year. The value on both shrinks because neither is going to win any money this season. Their

owners, intending to cut their losses, offer them up for sale. Which would you want to invest your money in?

Of course Healthy, because you know that it is inherently a strong horse that has a better chance of recovering from the flu. In a financial context, it represents a company with a durable competitive advantage that can recover from temporary setbacks. Conversely, Sickly is inherently weak and is less likely to recover from the flu. In a financial context, it represents a price-competitive company that falls prey to short-lived panics and market corrections.

Let’s dive into how we can select horses like Healthy!

Criterion #1: Return on Equity (ROE) > 12% consistenly for at least 5 years

ROE measures the profitability of a corporation in relation to stockholders’ equity. Companies that benefit from some kind of durable competitive advantage typically have ROE > 12% consistently for at least 5 years. If ROE < 0%, then check if Net Earnings > 0 and Shareholder's Equity <0. These may be companies that borrow at a low rate to pay dividends to shareholders, namely McDonald’s, Domino’s Pizza, and Yum! Brands.

Criterion #2: Return on Total Capital (ROTC) > 12% consistenly for at least 5 years

Some companies have purposely shrunk their equity base with large dividend payments or share repurchases in order to make the ROE more appealing. Hence, some price-competitive companies, such as General Motors, can “cheat” their way to a higher ROE. To solve this problem, ROTC is used. Companies with a durable competitive advantage typically yield ROTC>12% and ROE>12% consistently for at least 5 years. To accommodate loan-operating businesses like banks, investment banks, and financial companies, look for a consistent Return on Assets (ROA) >1% instead.

Criterion #3: Consistently increasing Earnings Per Share (EPS) for at least 5 years

EPS indicates how much money a company makes for each share of its stock and is a widely used metric to estimate corporate value. A higher EPS indicates greater value because investors will pay more for a company's shares if they think the company has higher profits relative to its share price. Historical per share earnings that are both strong and show an upward trend indicates a durable competitive advantage. Historical per share earnings that are wildly erratic indicate a price-competitive business. Look for consistently increasing EPS for at least the past 5 years.

Criterion #4: Long-term debt burdens less than 5 times current net earnings

Long-term-Debt-to-Earnings Ratio estimates how many times its long-term debt exceeds its current earnings. Large long-term Debt impedes a company's ability to survive a business recession or calamity. When a company has a durable competitive advantage, there is usually a lot of money in the bank and little or no debt, which means that the company has the financial firepower to solve almost any problem the business might suffer. A company with a ton of debt relative to what it can earn may not have the financial power to get itself out of trouble, which is certainly not good for the stock's price or for your pocketbook. These are mostly price-competitive companies. Look for a long-term Debt-to-Earnings Ratio < 5. An exception is made for banks, banks, investment banks, and financial companies because they use debt to finance their businesses.

Criterion #5: Sell goods and services that people have repetitive needs for

The kind of goods or services that stores have to carry to be in business. These are mostly brand-name products that suites longevity and give businesses a durable edge. The key here is that a consumer, an individual, or an enterprise, ends up buying the same product many times in a year. This repetitive buying makes a competitive advantage profitable. A strong indication of durability would be if the company can keep producing and selling the same product, without modifying it, with the same manufacturing facility, year after year.

Criterion #6: Strongly stand amid organized labor force

You will seldom find a durable-competitive-advantage company with an organized labor force. These businesses have the economic might to make it through any strike that labor could throw at them. Also, since these businesses are typically more profitable, they can afford to pay their employees more to keep them happy. Price-competitive businesses are the opposite, they are financially weaker to stand against an enormous labor power, causing their profits to be eaten away by the union.

Criterion #7: Immune to inflationary pressure

Inflation leads to higher prices for raw materials and labor With a price-competitive business, the cost of production may increase with inflation while the price it can charge for its product decreases to stimulate demand. With a business with a durable competitive advantage, it is free to increase the prices of its products right along with inflation without experiencing a decline in demand, which helps them retain a good amount of profit.

Criterion #8: Immune to inflationary pressure

Companies that have a durable competitive advantage usually don't have to spend a high percentage of their retained earnings on maintaining their operations. In turn, the retained earnings can be utilized to expand business operations, invest in new businesses, or repurchase shares, which yield a positive effect on the companies’ per-share earnings. A price-competitive business would need to spend its retained earnings on maintaining its business in the face of fierce competition from other companies in the same line of business, leaving little or nothing to invest in new operations or buying back its shares.

Criterion #9: Consistently implement a share repurchase program

Companies with a durable competitive advantage have the economic power to earn the money they need to buy back their own shares, reducing the number of shares outstanding and increasing EPS. Price-competitive businesses seldom have the excess capital necessary to buy back shares and would rather issue more shares to raise cash for their businesses.

Criterion #10: Consistently increasing Book Value Per Share (BVPS) and stock price for at least the past 10 years

A company with a durable competitive advantage often makes good use of its capital and keeps adding to the company’s net worth. This will grow the book value (total assets - total liabilities) and the trading value of its stock. This is not true for a price-competitive business, where it can retain earnings for years and still never show a real increase in the value of the company's stock.

**A Wild Horse is Chosen, Next Step Is to Buy it!** 

Now that you have selected a company with durable competitive advantage, the next step is to find the right price and time to pocket your shares. Entering your position when the stock price is undervalued forms the fundamental basis for a discounted deal. The idea is kind of like jumping off to a spring for a thrust towards the sky, to acquire the shares at a price below its intrinsic value and wait for it’s value to compound over a long hold position. This works because historically, a durable competitive-advantage-campany always have the might to rebound from temporary pullbacks. However, methods for stock valuation will be saved for another blog. Presently, do remember that the wild horse you’ve selected using Buffet’s way has the strength to overcome an interim illness and can wing off to the moon in no time.

**References:**

# [Link to The New Buffettology](https://www.amazon.com/dp/B00AE8Z814/ref=dp-kindle-redirect?_encoding=UTF8&btkr=1)

**In case you are into tales, what does this sign have to do with Warren Buffet?**

