Quality Investing Presentation

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Fred Strauss

WATERWAYS CAPITAL

Waterways Investment Approach

- Our goal is to achieve solid returns for clients, while minimising the risk of large losses
- We want to be confident that our investments are strong enough to ride any major economic downturn out and recover rapidly when the situation improves
- The portfolio process should act like a building built to withstand earthquakes
- Investments fall in value in tough times, but strong investments are not damaged or destroyed
- Irrecoverable losses come from paying too much, poor quality investments or specific economic situations

Waterways Investment Approach

- To ensure the right psychological discipline our approach involves:
  - A sceptical approach to investing, in particular avoiding investment where optimistic predictions of the future are already built into the price
  - Our asset valuations should always be based on conservative assumptions about the future
  - Where the range of potential outcomes is too wide, you cannot make conservative assumptions or if you do you would not be able to get the price you require. These investments are to be avoided
- **The Waterways investment process focuses on "Quality" and this is core component in achieving Waterways' investment objectives. We want to buy quality assets at reasonable prices (or cheaper if possible)**

Introduction to “Quality Investing”

- The crux of Waterways’ investment philosophy is that we only invest in high-quality businesses (and other high-quality assets)
- The reason is threefold:
  - high quality businesses should survive any economic downturn and then thrive in a stronger position as the weaker competition succumbs
  - over the longer term, the share prices of higher quality businesses outperform the market
  - investing in high quality businesses significantly reduces investment risk and in particular irrecoverable losses

Definition of a High-quality Business

- A high-quality business meets certain quantitative and qualitative criteria
- Quantitative criteria are easily measurable because they are typically based on numbers and ratios
- Qualitative criteria are less easily defined, but just as important to consider as they provide valuable input when considering the outlook for a business

Seven Quantitative criteria for a High-quality Business

1) **Financially Strong** (this is a core requirement and is the first stage in screening out low-quality investments)

- A quality business should be able to survive an economic downturn
- A high percentage of businesses fail during a downturn because they are not financially strong, that is, they typically have taken on too much debt
- We consider a business to be financially strong if it has a gross debt to equity ratio of less than 50%, and an interest cover ratio of more than 4 times
- In exceptional circumstances, a quality business may have a debt to equity ratio of more than 50% but no more than 100%. For example, infrastructure businesses with stable cash flows and long-life assets

Seven Quantitative criteria for a High-quality Business

2) High Returns on Shareholders' Equity

- There is a significant correlation between businesses with high ROEs and outperformance of share prices
- A business that generates high returns on equity has sufficient profits to retain for future growth, and to return some to shareholders by way of dividends and/or share buy-backs
- It is important for a business to retain sufficient profits to fund growth; else growth will be funded by increasing debt

Seven Quantitative criteria for a High-quality Business

3) Consistent Growth in Earnings

- Over the medium to long term, Growth in Earnings = Increase in Share Price
- A business must deliver consistent earnings growth to deliver acceptable returns to its shareholders
- This is preferable to trying to predict the ups and downs of cyclical businesses, which is notoriously difficult
- Where earnings are highly volatile it is very difficult to make any earnings assumptions for valuations and unless prices are extremely depressed, too much of the outcome is left to chance

Seven Quantitative criteria for a High-quality Business

4) Generates Free Cash Flow

- The value of any business is the present value of its future free cash flows
- A quality business generates significant amounts of free cash flow
- Capital-intensive businesses typically generate lower amounts of free cash flow as significant amounts of operating cash flow must be invested to replace diminishing fixed assets

Seven Quantitative criteria for a High-quality Business

5) Earnings = Free Cash Flow

- A business must generate high quality earnings, that is, accounting earnings should be fully converted to free cash flow within a relatively short time period

Seven Quantitative criteria for a High-quality Business

6) Predictable Earnings and Free Cash Flow

- The value of any business is the present value of its future free cash flows
- To qualify as a quality business, we must be able to have confidence about the range of future earnings and free cash flow of the business based on a reasonable set of assumptions
- If we cannot value a business with reasonable certainty, then we should not invest in it (if we do, we are speculating)

Seven Quantitative criteria for a High-quality Business

7) Profitable

- A quality business is profitable

Seven Qualitative criteria for a High-quality Business

1) Understandable business model

- We should only invest in businesses that we understand well
- If we do not understand a business, its competitive advantages, opportunities and the drivers of profit, as well as competition and risks, how can we value it and how can we be comfortable with the assumptions we make regarding the outlook for the business?

Seven Qualitative criteria for a High-quality Business

2) Favourable long-term prospects

- There should be favourable long-term prospects of a business, both in terms of long-term demand for the products or services and a suitable industry structure that is not too competitive
- A business in decline will lose value

Seven Qualitative criteria for a High-quality Business

3) High barriers to entry

- We must be able to define high barriers to entry that should prevent the quality business from being subject to loss of volume or pricing power due to increased competition

Seven Qualitative criteria for a High-quality Business

4) Competitive edge

- The business should have a sustainable competitive edge such as strong brands, low cost of production, advanced technology, or favourable location

Seven Qualitative criteria for a High-quality Business

5) Competent management

- Management should be competent, honest with a solid reputation and proven to add value

Seven Qualitative criteria for a High-quality Business

6) Not subject to disruption

- The business nor the industry it operates in should be subject to disruption
- Disruption of a business by competitors can destroy significant value that cannot be recovered
- We prefer to invest in disrupters of industry

Seven Qualitative criteria for a High-quality Business

7) Diversified customer/supplier base

- The business should not be reliant on a small customer or supplier base
- The lost of major customer or supplier can destroy significant value of the business

Quality Investment Process

- Each proposed equity investment must be rated against each of the Quantitative and Qualitative criteria
- The rating system consists of three traffic lights: Green for strong adherence, Orange for adherence and Red for fail
- A Red rating for any of the criteria will disqualify the proposal as an investment unless it can justify as a temporary breach that should be corrected within 12 months
- The attached Template that includes at least 7 years of historical financial information should be completed for each proposal
- Each proposal should also include a Valuation of the business based on either a discounted free cash flow model or a dividend discount model