Investment Framework: Guide to Researching a Long

**Industry Study**
- Is this a good business? What are the key success factors to superior performance in this industry?
- Define the market opportunity. How do competitive products address this opportunity?
- What are the barriers to entry (“moats”)?
- What is the relative power of:
  - Customers
  - Suppliers
  - Competitors
  - Regulators
- Who controls industry pricing? Does the company/sector have any pricing power?
- How (and how much) can a good company differentiate itself from a bad one in this industry?
- Do you understand this business? Test yourself and describe it to a ten year old.

**Business Model:**
- Describe the entire sales process – from order to fulfillment.
- What are the economics of the base business unit? How does it stack up against competitors?
- Why is the company good (or bad) at what they do? Can they sustain it?
- Is this company growing by acquisition? How sustainable is that?

**Management:**
- What is their background and reputation? Have they been successful in the past?
- How are they compensated? Are their interests aligned with shareholders?
- How good have they been at allocating capital?
- Are they buying or selling stock? How much as a percentage of their holdings, and why?

**Company/Cultural Issues:**
- Is this a great company? Is it built to last? What could change this assessment?
- Can you imagine holding stock in this company for twenty years?
- If you had access to unlimited capital, how would you feel about your chances of successfully competing against this company?
- Compare to a weak competitor in the same industry. What is the difference and why?
Financial Measures

First Step: Check against all the accounting shenanigans in Howard Schilit's book.

Balance Sheet

- What is the company's capital structure, and how does it compare to its peers?
- What are the trends in inventory turns, days payable/receivable, and working capital?
- What are its coverage ratios on interest payments?

Cash Flow

- What are the company’s capital requirements and cash flow characteristics?
- How is the company choosing to invest its capital? CapEx? Buybacks? Acquisitions?
- Does the company need to access the capital markets? How soon/often?

Earnings/Profitability

- Regarding the company’s sales model, how visible are earnings quarter-to-quarter, and year-to-year?
- Is this a fixed or variable cost business? How much cost leverage?
- Do earnings grow as a function of unit sales growth, price increases, or margin improvement? How sustainable is this growth?

Valuation

- Looking forward, what is the company’s valuation in terms of:
  - Market Value/Earnings
  - Enterprise Value/EBITDA
  - Free Cash Flow Yield (After-Tax Free Cash Flow/Market Value)
  - Market Value/Sales
- What are the company’s growth rates in terms of earnings, EBITDA, and FCF?
- What are consensus earnings estimates, versus your own expectations?
- What are the key leverage points in our own and the street’s earnings models? What has to go right, and where is the most chance for surprise?
- Are their accounting policies conservative and in line with their peers?

Risks

- What are the big unknowns? How much can the company control/influence these risks?
- What could cause this investment to be a total disaster? How bad could it be?

Other (Timeline/timing issues) DO A TIMELINE!

- What are the catalysts (triggers) for the company’s proper valuation to be realized?
- What good news, and what bad news, will affect the company in the coming year?
- Who owns the stock? Momentum Funds? Big Mutuals? Hedge Funds?
- How difficult is it to build a significant position (float, volume)?
- Draw a time line of expected events and dates. What might go wrong and when?
Investment Framework: Guide to Researching a Short

1. Is this a bad business?
   - Who has the power – customers, suppliers, competitors?
   - What are the barriers to entry?
   - What kind of reinvestment of capital is needed to grow?
   - How is the business changing?
   - What is the historic and current rate of success in this business?
   - What are the major risks to the business plan?

2. What is the major misperception?
   - Why does it exist?
   - Who is responsible for it?
   - What stakes do the various parties have in keeping the stock price high?
   - How popular is the industry? Rising tides lift all boats – for a while.

3. Assess management.
   - Industry reputation?
   - Past history of success or failure
   - Straightforward or cunning?
   - Check out insider ownership and selling

4. Ratios:
   - EBIT/EV as a percentage
   - (EBITDA-CAPEX)/EV as a percentage
   - Growth of inventories to cost of goods sold -- are inventories rising faster?
   - Growth of AR to sales and AP to sales (DSO’s, DSI’s)
   - Any accounting changes – smaller reserve for bad debt, revenue recognition, etc
   - Cash flow/Int. expense
   - Review Howard Schilit’s red flags

5. Sentiment: Are more people bullish or bearish on the stock?
   - Do full media search for articles. Make list of analyst recommendations
   - Short Interest? SIR (remember, the stock that is already short is potential buying power). Be careful if there is universal bearishness.
6. Timing
- What is the expected trigger on the misperception? Do a time line.
- Who owns the stock – long term or short term, momentum investors?
- Has the souffle already risen once?
- Can the rising stock price be self-fulfilling for awhile (financing opportunities, etc)?
- Where does the company stand in terms of the fantasy, transition, reality paradigm?

7. Risks
- Can this company reinvent itself? Are you short warrants on future businesses?
- How likely is it that someone might take them over? What type of premium might they pay?

8. Add when the story starts to unfold -- regardless of stock price.
- Watch for earnings warnings, excuses, etc. Where there’s smoke, there is often fire.
- Is the company or Wall Street analyst group in denial of the problem?
- Watch the ratios, insider selling etc.
- Even if the stock is down significantly from its high, if answering all these questions convinces you that it is still a short, do not cover and consider adding. See below.
- Does waiting for the new financials feel like waiting for Christmas?
  IF “YES” ----> ADD.
Presentation Guide

Here is a great way to learn how to give a presentation.

Name of Stock: Date of Recommendation:

Ticker Symbol:

Exchange Traded On:

Market Price:

* Begin your presentation with the phrase... "I think (company name) is a buy because..."

Description of Primary Business (What do they do?):

- (Business Model) – Product Manufacturer? Service Provider?

- Competitive Advantages / Disadvantages?

- From where will the growth come?

Industry Description (Business Environment):

- Consider: Major Competitors
  
  Substitutes for product or service

  Buyer Relationship – who holds the bargaining power

  Supplier Relationship -- who holds the bargaining power

  Entry Barriers – High? Low?

Management:

- Background -- Reputation

- Insider Buying/Selling?
Risks and Rewards:

- Are your Buy/Sell reasons already priced into the stock?

What is your favorite point about the stock?

- What is the best reason as to why we should buy this stock?

(Near term catalyst, great industry trends, new products, ????)

Financial Measures & Ratios to Consider (See the Analyst Handbook for formulas)

- Profitability – Return on Sales, Gross Profit Ratio, Return on Equity
- Activity Ratios – Inventory Turnover, Receivables Turnover
- Leverage/Liquidity – Debt/Equity, Times Interest Earned, Current Ratio
- Others – Dividend Yield

It is not important that you answer all these questions... but you should consider them as you evaluate your recommendation and make your presentation.
Key Investing Terms and Concepts:
For more investing terms visit http://invest-faq.com/articles/index.html#Stocks or www.investorwords.com.

What is a small cap, large cap etc?

Cap refers to the market capitalization of a stock, which is the price of the stock times the number of shares outstanding. The difference between large cap, small cap, etc. is in what their market capitalizations are:

Large-cap: Over $5 billion
Mid-cap: $500 million to $5 billion
Small-cap: $150 million to $500 million
Micro-cap: Below $150 million

This is an important distinction because in the last year small-caps have done well in the stock market while large-caps have not.

What is shorting?

Shorting means that an investor thinks that the price of a stock will go down and the investor wants to make money from this potential decline in price. To short a stock, an investor borrows shares of the security from a broker and sells the shares immediately. The investor then buys back the shares at a later date to return to the broker. The investor pockets the difference between the sell price and the buy-back price, as long as the buy-back price is less than the original sell price. Otherwise, the investor will lose money by buying the shares for a higher price than what was originally paid.

What is a short squeeze?

A short squeeze is important though because when the price of a stock begins to increase substantially, many investors borrowing shares from their brokers have to buy shares to give the broker back the shares. This can lead to a much greater increase in price and this can greatly benefit people who own the stock already.

What is a P/E ratio?

This ratio is the price of a stock divided by what the company earns per share outstanding. Often times, this ratio is compared to its annual growth rate. A stock with a large growth rate and lower P/E often looks attractive to investors.
**Recommended Reading:**

* A Random Walk Down Wall Street by Burton G. Malkiel
* Financial Shenanigans by Howard Schilit
* One Up on Wall Street by Peter Lynch
* Built to Last by Jim Collins
* The Art of Short Selling by Kathryn F. Staley
* The Intelligent Investor by Benjamin Graham