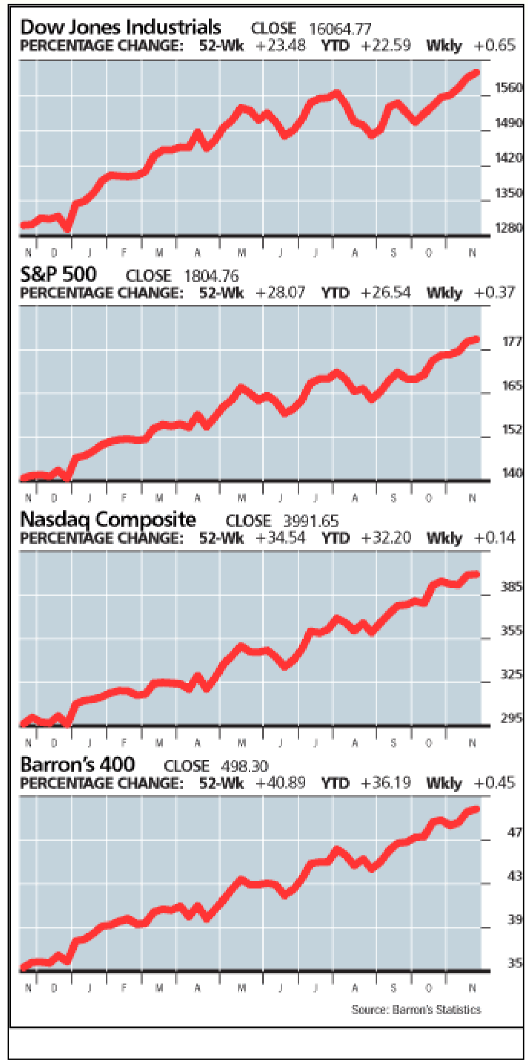
COMMENTARY®
by SULLIVAN & SERWITZ

ISSUE
292

The Market Place: Analysis & Comment

December 2013

If there were but one distinguishing protocol separating the authentic investor from the impostor investor it would revolve about analytical focus: that is, the *qualitative* vs. *quantitative* investment considerations. The authentic investor affords primacy to the qualitative data.



Source: Barron's Statistics November 23, 2013

Qualitative vs. Quantitative Investment Considerations

Imagine an investor who wished to review their portfolio holdings. If the review focused on scrutinizing the stock *price*, various ratios (e.g. price/earnings ratio), aggregate portfolio experience, etc., take heed. There is little worthwhile (i.e. *forward looking)* information communicated by a stock price, various ratios, or a portfolio return experience. The worthwhile information resides in the *qualitative* properties associated with the underlying holdings of a portfolio. A qualitative emphasis demands a thoughtful and thorough understanding of the underlying fundamental attributes that are driving enterprise value.

Conventional quantitative measures embraced by the impostor investor might include sales growth, market share, earnings growth, profit margins, etc. I am not suggesting these measures are useless; they are simply, when applied sans an appropriate context, inadequate. Furthermore, all these conventional measures are easily ascertainable from public sources. Often the impostor investor will subscribe to services that provide these measures in a prepackaged format; off the shelf portfolio analysis software is as ubiquitously available as it is widely employed.

I would additionally point out that such information is not only widely utilized, providing no competitive advantage, it is also *backward looking*. Backward looking data is rarely instructive in uncovering the future merits and/or prospects of an enterprise. Here's my point:

In the analysis of enterprise value one must *interpret* these conventional quantitative measures and other elements unique to the business, within the *context* of an enterprise and/or industry. Here is an example from my personal history by way of illustration.

The Corrugated Container Industry (More than you ever wanted to know)

(A disclaimer: The information I am about to share with you was accurate in 1979. Since I left the paper conversion industry in 1979 I have not set foot in a corrugated container factory and I expect many aspects of the industry have changed.)

When I assumed leadership of our family business in 1969 – we manufactured corrugated shipping containers – we required significant debt to finance our inventory and operations. A corrugated box is comprised of three separate layers of paper: the inside, outside, and fluted middle paper. The paper is referred to as "linerboard" which can be purchased in different grades/weights; rolls of linerboard weigh between one and two tons. The machine that combines linerboard into corrugated board is called, appropriately enough, a Combiner.

A Combiner produces continuous corrugated board. The front end of the machine combines the three rolls of linerboard; the middle section sets the adhesive, bonding the three layers together; and the back end of the machine employs a rotary knife which cuts the continuously emerging corrugated board into customer specific blank sizes. The "run" was the first step in creating a corrugated container. The run was effectively the instructions to the Combiner operator to assemble the correct grades of linerboard from our warehouse, and to set the scoring blades and rotary knife to manufacture the required blank sizes; each blank being unique, reflecting a customer's specifications.

We had two Combiners, a 78" wide machine and an 86" wide machine. Depending on the season our Combiners "cut up" between 30 to 45 million square feet monthly. Orders, when laid out on the Combiner, were always setup side by side to take advantage of the machine's width. The creation of a run began by aggregating recent orders of perhaps the past 10 days. Like a puzzle, the task of the run engineer was to assemble various orders from different customers (each requiring different size blanks) as efficiently as possible. The run was efficient to the degree the run maximized the machine's width but, equally important, minimized waste – and there was always waste.

There were two kinds of waste generated during the production process, "internal" waste and "customer" waste. Internal waste was waste for which the manufacture was responsible (i.e. internal waste directly impacted profits) and was largely the result of the different size blanks that were manufactured in parallel on the Combiner – in parallel to utilize the machine's width. Combiner waste was also generated by trimming the sides of the continuously emerging corrugated board to create a clean, straight edge. Each step of the manufacturing process resulted in some waste but most of the internal waste was generated by the Combiner. Customer waste, unlike internal waste, was paid for by the customer. An example of customer waste might be a requirement that the carton be die-cut to create a window, enabling the retail shopper to see inside the box to view the product. The die-cut window piece was immediately removed and became customer waste.

The corrugated container industry had at that time (and probably still does) razor thin profit margins. The difference between a profit or a loss for any month could easily be the result of the magnitude of internal waste. A *successful* firm's pretax profit margin was only 3%. Understandably, conversion facilities like ours were obsessive about their internal waste ratio. (This is an important point to which I will return shortly.) So, one of the most important measures of manufacturing efficiency in the conversion of linerboard into corrugated containers was the amount of internal waste generated during the manufacturing process.

My cousin Charlie was, justifiably, very proud that as a result of his runs we had one of the lowest internal waste ratios within the corrugated box industry. If we were a public company an analyst could look at this ratio and consider this a materially positive attribute, highlighting our manufacturing competence. To the technician this was an equally impressive accomplishment because in those days runs were calculated by hand using a Friden calculator – am I dating myself ☺? (I suspect computers do all this work today.) For me, however, this barometer – and conviction – that manufacturing efficiency was the primary driver of profitability was suspect.

A Different View of the World

Linerboard is (or at least was in those days) available for purchase from the paper mills in two inch increments (roll widths of 70”, 72”, etc.). If, I reasoned, we purchased our inventory in four inch increments, and sustained greater internal waste, I could potentially halve our inventory and increase our inventory turns. By so doing we might be able to materially lower our costs by reducing the amount of our then required bank financing for which we were being charged three points over prime[1] or about 10%.

When I proposed the idea to Charlie to purchase linerboard in four inch increments (Charlie was about 25 years my senior and my father’s partner of about 25 years) he looked at me like I had truly gone mad. The ensuing confrontation was intense, lasted for many months, and grew into something of a family legend. While we were both relentless in advancing our positions, I ultimately prevailed by agreeing to not let a potential loss exceed $100,000 – which was a ton of money for us in 1969. Charlie believed my experiment was reckless – although he expressed his dissatisfaction with me in more colorful terms.

Due to almost halving our inventory however, and ultimately achieving nine annual inventory turns annually rather than four, within about 18 months I was able to forgo all bank financing. Sans bank financing, while our internal waste ratio was climbing (although less than I anticipated) we gradually became more profitable. As a result of purchasing our linerboard inventory in four inch increments, and the following initiatives I will now explain, we ultimately realized 10% pretax profitability. To Charlie’s chagrin, I was just getting started.

Further Enhancements to Profitability

Enhanced profitability was additionally achieved by changing our manufacturing mix, and *reducing* machine utilization. Unused, or “surplus” machine capacity meant our fixed costs per square foot of production were rising – not normally a good outcome. By so doing, however, I was now able to target what the paper conversion industry considered to be highly undesirable customers as well as the most undesirable category of business – customers who required much shorter lead times and rush orders. (Charlie was growing increasingly irritated with my “idiotic tinkering.”)

From a manufacturing standpoint, rush orders can be costly and disruptive: runs had to be recalculated, there may be inadequate orders in the queue to create efficient runs, orders in process might have to be interrupted to free up manufacturing time which could further undermine production efficiency, etc.

From a customer’s standpoint, if a production line went down for any reason – a lack of packaging product in our case – the cost to the customer could be catastrophic: unfulfilled promises to the customer’s customer, lost sales, idle employees, etc. Here is how I was able to transform a characteristically unprofitable customer profile, and product segment, into an enviable profit center.

Footnotes

1. When I was running our family business the prime lending rate specifically indicated the rate of interest banks charged their most credit worthy customers. At three points over prime we were not considered a good credit risk. The term prime lending rate today has evolved, and is used to reference an interest rate used by banks as an index in calculating rate changes to variable rate short term loans. For example, the prime rate may be used as an index in calculating rate changes to adjustable rate mortgages (ARM), credit cards and home equity lines of credit.

Product Linkage

In many cases, those customers who required shorter lead times were enterprises with poor inventory control. As soon as I realized this I hired an assistant whose primary task was to monitor, at various customer's facilities, our shipped product that was now warehoused within the customer's facility. I never received push-back from a customer to permit my assistant to be an onsite ambassador performing quality control assessments of our own product. His most important function, however, was to provide me with real time inventory audits of our finished product now held in the customer's warehouse. I then built a 75,000 square foot warehouse to store finished product for orders *not yet received*. This finished product warehouse was exclusively for product where I could *reliably* anticipate rush orders to manifest – and we never miscalculated, mostly due to "product linkage" and, secondarily, by monitoring our shipped finished product now residing at our customer's facilities.

Product linkage was a term I coined to indicate a mandatory future requirement for product. Individual toy boxes, for example, ultimately *required* a master carton for shipment. (Perhaps six individual toy boxes were packaged into one master carton for shipment.) I knew – with certainty – the master carton had to be ordered if we already received orders for the individual cartons and the product was to be shipped. I was now able to manufacture, and inventory, these potential rush orders in advance, *and manufacture them when it was most expedient for us*. At this point I was able to simply wait for a panic call, make a delivery promise, and load one of our trucks from finished inventory. (There were many reasons a customer might place an order last minute beyond poor inventory control, e.g. inadequate storage, uncertainty of assembly schedules, inability to secure critical parts, etc.)

Surplus Capacity

By changing our manufacturing mix and reducing machine utilization, we created surplus machine capacity. By so doing I now had the flexibility to accommodate the rush orders I could *not* anticipate – orders that required delivery within 48 hours, rather than the standard lead time of two to three weeks. The premium price I was able to charge to provide rush deliveries, however, more than compensated for our equipment's underutilized capacity and resulting inefficiencies. A purchasing agent of a national, well-known toy company – and one of our best customers – once remarked to me in appreciation for getting him overnight product, "Marshall, there is no price you could have charged me that would have been too high to keep my line running." Bear in mind this was a remark made to me by a purchasing agent.

New Products

I began, almost immediately after assuming control, to experiment with new products. By far, my most successful initiative was to develop the ability to print on linerboard utilizing the rotogravure printing process – I will not bore you with my many failed undertakings. The rotogravure printing process is the method that prints high volume, high resolution, glossy magazines. Of equal note, I was assured by printing engineers and printing consultants that it would be impossible to print linerboard in this manner – but that's a story for a different day.

The rotogravure printing process is best suited to very high volume production. With high volume production the cost of rotogravure printed images over lithography – lithography being the competitive high resolution printing process – drops dramatically. Lithographed images, when applied to a corrugated container, required the lithographed sheet to be glued on top of the corrugated box. In addition to the lithographed sheet being a fourth sheet of paper the application of the lithographed sheet was a slow, labor intensive process. Lithography was a better fit for lower volume production – for orders of perhaps less than fifty thousand impressions – because lithographic printing plates were less costly to manufacture and lithography required less machine set-up time than rotogravure.

If a toy manufacturer, for example, anticipated selling 100 thousand units of a particular toy they would order, *and pre-pay*, for 100 thousand printed impressions. (It was not uncommon for a "hot" toy to sell well over 1 million units. In such cases we would typically receive pre-print orders of 250 to 500 thousand impressions. We would then warehouse the pre-printed linerboard.) Built into the cost of the pre-printed linerboard was *all* of our profit. Due to rotogravure product linkage I was able to create meaningful manufacturing efficiencies via "advance of order" manufacturing, while receiving a premium price for our high resolution printing capabilities as well as for potential rush orders.

An Unconventional Pricing Strategy

Lastly, I created an unheard of pricing strategy. When we were invited to quote on new packaging requirements, I would provide three prices (the industry norm was to offer only one price – the "best" price):

1. "Normal delivery" price (which meant delivery could be expected within two to three weeks of order placement.)
2. "Expedited delivery" or "rush delivery" price, and
3. "Insurance" pricing. Insurance pricing was priced between "normal" and "expedited." Insurance pricing meant a purchasing agent could fix their product cost and demand rush orders (expedited delivery) without paying the premium expedited delivery price. I truly did not care which pricing option was selected, although I do know it drove some purchasing agents crazy trying to determine which pricing alternative would be most beneficial to them[2].

The Outcome

What started as an attempt to reduce our bank financing (although we were able to eliminate it altogether), quickly expanded to include a strategy to alter our product mix (to service much more demanding – albeit more profitable – clients), which facilitated a more flexible and tailored (and profitable) pricing strategy, and culminated in developing the expertise to apply the rotogravure printing process to linerboard (for which we received multiple patents).

While highly unconventional, our strategic focus facilitated our profitability to advance to over three times the industry norm for well-run conversion facilities. *During this transition, however, our meager profitability turned into an operating loss*.

We also attracted a loyal customer base who valued and appreciated our specialized and nimble manufacturing capabilities. Even more surprising, in the highly competitive industry in which we operated, we were now receiving referrals from our competitors.

Our competitors laughed at us, believing "the kid" (that was me) was fast tracked to a bankruptcy petition. In effect our competitors retained the easy (but much less profitable) business while "dumping" on us the difficult (more profitable) business. (You know the expression, "One man's trash is another man's treasure.") Over time, because we specialized in providing magazine quality printing and "overnight" delivery service, we became a low cost provider for the products and services in which we specialized. I successfully transformed a "commodity" – corrugated boxes – into a premium priced "product."

Furthermore, as a high margin business (relative to our industry) we were afforded one additional but underappreciated completive advantage: when I assessed a strategic advantage in soliciting a particular potential customer (and we were highly selective in our customer solicitations) I would bid lower than my competition by deliberately offering the product at a loss. In other words, I was not opposed to offering a "loss leader" to "get my foot in the door" – although I always would acknowledge to the prospective new

Footnotes

2. I later learned that the election between "expedited" and "insurance" pricing often had more to do with company politics than rational business assessments.

customer that my bid was a "lowball bid" so we could prove ourselves as a potential vendor. I also promised the prospective customer to hold the lowball price if we became a vendor. But to justify retaining the lowball price into the future, I would require a minimum level of business – which *always* included linked products, like the master carton, that I could safely inventory in anticipation of rush orders.

Equally compelling, I occasionally would appeal to our customers to favor me with additional business whenever I required additional business – like during a slow period. Our customers were so grateful for the niche we created and serviced – they now had a vested interest in keeping us in business – they were always willing to help me when I appealed for assistance. While my competitors were experiencing a slowdown, we kept humming along…

If We Would Have Been…

If we would have been a public company consider how the impostor analyst would have likely viewed this transition by focusing on the quantitative aspects of our business: I very quickly turned our meager operating profits into an *operating loss*. Our per square foot cost of production was climbing – "soaring" according to Charlie – due to buying linerboard in four inch increments as well as our underutilized machine capacity. Profits "trapped" in inventory were being realized, generating a "preventable" tax (but these realized profits were quickly reinvested back into the business.) Our retained earnings were being diverted into "unnecessary" warehouse capacity. We were targeting the "worst" customers and/or product segment within the industry. And, we were squandering hundreds of thousands of dollars of potential profits and retained earnings in an attempt to acquire the knowledge to print on linerboard using the rotogravure printing process – an impossibility according to printing experts.

(Sidebar note: We did not modify the rotogravure equipment, or rotogravure process itself – I understood why the printing engineers and consultants believed it would not be possible to adapt rotogravure to linerboard. Rather, we modified the printing surface to accommodate the physics of the rotogravure (intaglio[3]) printing process. In modifying linerboard to accommodate the rotogravure process I agreed to not exceed $1 million dollars of R&D – and I came within a whiskers breadth of that number. Our success with this product, however, was a significant triumph and was the primary reason I was able to sell our business in 1976 at a premium price. At the time of our sale, private companies, like ours, were being sold for little more than inventory and equipment value.)

My sense is the impostor analyst would have been highly critical of my actions and, if we were a public company, I suspect our stock would have been hammered during this costly transition. The authentic investor/analyst however, who understood my strategic focus, could have purchased the stock of my company and been vindicated within about 36 to 48 months after we achieved sustainable peak profitability. (Notice Charlie, an accomplished technician and with vastly greater experience than I had, could not appreciate my initiatives even with the benefit of an "insiders" understanding of our strategic focus. I sometimes look back to those days and wonder how we did not kill each other.)

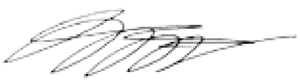
My point is simply this: conventional measures, viewed in isolation, provide little forward looking information. The authentic investor must first understand the

Footnotes

3. Intaglio refers to the actual printing technology in which the image is acid etched into the printing cylinder, creating tiny holes that can be filled with ink. When the paper comes in contact with the printing cylinder the ink is suctioned out from these tiny etched holes. If you look at a photographic image from a high quality magazine with a strong magnifying glass (referred to as a "loop") you will see the image is composed of a large collection of tiny dots. Each single dot is a dot of ink deposited onto the surface (the substrate) from each tiny etched hole.

industry within which they are plying their analytical expertise. Only then is it possible to begin to understand the relationship of the numbers within the context of the industry. Sans such an understanding it would not be possible to recognize the merits of what, in our case, proved to be a highly successful strategy and outcome. Outstanding analysis is not about P/E ratios, etc. Outstanding analysis is about understanding the implications of the qualitative elements of a business that have the potential to enhance enterprise value.

Working hard for you,



Marshall Serwitz

P.S. Thank you for your support

Thank You

We hope that in the course of conducting our business we might meet prospective clients with whom we share common values and investment philosophy. If you know of someone for whom the fit appears mutually beneficial, please pass along our name or provide us with contact information.

While our $3 million investment account size prevents us from assisting all the people we would like to serve, it is necessary to keep our roster of clients small. Because our overriding responsibility is to those who have already entrusted their financial resources to our care, we willingly forgo growth opportunities that may detract from our ability to serve you as you have come to expect. Careful client selection is an important element of our controlled growth objective of only six new clients a year. We never expect to be among the biggest, but our intention to be among the best is not subject to compromise.

Since our inception in 1989, Sullivan & Serwitz has grown almost exclusively through referrals. Your referrals are the best acknowledgement we can receive; Bob and I, along with all our staff, sincerely thank you for your support.

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Teaching and Lecture Activities

We have developed presentations for the following organizations: various county medical associations, medical conferences, and hospitals throughout California, California Society of Certified Public Accountants, Tri Valley Business and Estate Planning Council, Women United (United Airlines), Minnesota Mining & Manufacturing (3M), U.S. General Accounting Office (GAO), the Palo Alto Police Department, and many other organizations. Teaching and lecture activities are tailored to the group. Some of these courses have provided CPE credit. If you would like to arrange a seminar please contact the office.

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