A Great Business is not always a Great Investment

We are always looking for undervalued high-quality companies that we can purchase for a multi-year hold period. We are selective about what we buy, so we pass on most companies that we research. There are countless companies that we eliminate from consideration because they have low-quality businesses. Less frequently, we find a company with an excellent business, but we pass on it because its shares are overvalued. We can give several examples of high quality businesses with overvalued share prices, but before discussing those, we should explain what we mean by “high quality.”

Typically a high-quality business will have a strong competitive position in its industry. It may benefit from economies of scale, or it may have brands or intellectual property that set it apart. Ideally, it would have the ability to raise its prices over time to compensate for inflation. A high-quality business would also innovate to prevent new technology from making its products obsolete. We would prefer a non-cyclical business that benefits from consistent demand in all economic environments. We are asking for a lot, but we also like companies that have identifiable organic growth opportunities.

Three examples of business that we consider high-quality are Mead Johnson Nutrition Co. (NYSE-MJN), Stericycle Inc. (NASDAQ-SRCL) and Beam Inc. (NYSEBEAM). Unfortunately, other investors value them highly, so they are too overvalued to purchase using our methods. Mead Johnson produces children’s nutrition products. More than half of sales come from faster growing economies in Asia and Latin America. Net profit margins are in the mid-teens. Parents’ concern for their children’s health leads them to trust Mead Johnson’s established brands. Annual compounded earnings per share (EPS) growth over the next five years is likely to exceed 10 per cent. The stock closed at US$77.51 per share on April 12. With an analysts’ consensus EPS estimate for 2013 of US$3.29, the stock is trading at a price to earnings multiple (PE) on 2013 estimates of 24.

Stericycle is the largest provider of medical waste disposal in the United States. Net profit margins are in the mid-teens. Medical waste disposal is a highly regulated non-cyclical industry. Annual compounded EPS growth over the next five years is likely to exceed 10per cent. The stock closed at US$109.20 per share on April 12. With an analysts’ consensus EPS estimate for 2013 of US$3.70, the stock is trading at a 2013 PE of

30. Beam is one of the world's largest producers and distributors of spirits. Its brands inspire customer loyalty and include bourbons Jim Beam and Makers Mark. Net profit margins are in the mid-teens, and analysts estimate the company could earn US$2.63 per share in 2013. Annual compounded EPS growth over the next five years could approach 10 per cent. The stock closed at $62.13 on April 12, giving the company a 2013 PE of 24. One question we like to ask about any business is how easy it would be to compete with a billion dollars of start-up capital. With Mead Johnson and Beam, even assuming that we could formulate competitive products, it would take many years to create brand loyalty.

With Stericycle, there are regulatory obstacles to competing, and it would be hard to convince healthcare providers to switch to a startup. All three companies benefit from barriers to entry. We would be willing to pay some quality premium to invest in these companies, just not the premium that the market currently demands. If we were to buy them, we would expect mediocre returns, even assuming their businesses performed as expected. We believe their future prospects are "priced-in" to their share prices today. For now, we can only watch and wait for a time when their shares go "on sale". Due to market volatility, we would not be surprised to see that eventually happen.

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