MARKET MEDITATION
QUALITY · MACRO · PHILOSOPHY

MARKET MEDITATION · THE CHECKLIST

How to Tell a Great Business from a Good One

The 11 questions I ask

> **Buy world-class businesses, don't overpay, and let compounding work its magic.**

That is my whole approach in one line. And what makes a business world-class comes down to one thing above all: a long record of growing free cash flow per share — at a high rate and, more importantly, predictably — with a long runway still ahead. That predictability is what makes a business world-class, and it is why such businesses are seldom priced cheaply.

These are the eleven questions I put to every company before it goes anywhere near my portfolio. No single answer on the list below decides whether a business makes the cut. It's an overall judgement.

1 Is the business easy to understand, and is it likely to still be around in ten years?

If I cannot understand a business well enough to judge whether it will still be here in ten or fifteen years, it stays in the too-hard pile. That is about my understanding, not the industry label. Lam Research makes equipment for semiconductor manufacturing; it is technology, but its economics can be understood. Quantum computing, by contrast, I cannot judge.

2 Does it have a strong and durable moat? Can it raise its prices and still grow, or at the very least hold, its market share?

Brand, network, switching costs, patents — they matter only in so far as they show up as pricing power. A business that has to follow its competitors' prices has no moat, however good its product. And when gross margin starts to slip, or market share starts to go, that is usually the first sign the moat is weakening.

3 Is it a leader in its niche or its industry?

Leaders tend to set the terms, with customers, with suppliers and on price.

4 Does it earn high returns on capital, and are those returns likely to be sustained?

Not one good year — many. Munger made a point I have never been able to improve on. If a business earns 6% on its capital over forty years and you hold it for forty years, you will not do much better than 6%, even if you bought it cheaply. If it earns 18%, you will do well, even if you paid what looked like a high price. Over a long enough period, the return the business earns on its own capital becomes the return you earn on yours.

5 Do the numbers demonstrate sustained operating leverage?

Profits growing faster than sales, as fixed costs are spread over more revenue. When operating leverage starts to fall, as returns on capital decline, it is one of the warning signs I watch.

6 Is it capital efficient? THE CORNERSTONE

One of the most important factors behind long-term outperformance is what Buffett called economic goodwill — to me, the primary measure of a business's capital efficiency. In plain terms: a business that earns an unusually high return on the physical assets it actually needs, and does not have to keep spending heavily to keep earning it. I look for it in two places in the numbers. Capital spending stays flat or falls as a share of sales while free cash flow rises as a share of sales. And each dollar of capital spending produces more cash than it did five or ten years earlier. Fair Isaac (FICO), between 2015 and 2025: capital spending fell from 3% to 2% of revenue, free cash flow rose from 13% to 37%, and each dollar of capital spending went from producing about $4 of free cash flow to about $19.

7 Does it produce and grow free cash flow consistently?

Two companies each take their free cash flow per share from one to two over five years. The first gets there steadily, a little more each year. The second goes nowhere for four years and then leaps to two in the fifth. On a summary sheet they are identical. To me they are entirely different businesses. The first one I can plan around; the second I cannot. I call it quality linearity: how close the line of cash flow per share comes to a straight line rising over time.

8 Is the balance sheet strong?

Excessive borrowing is a red flag. Some borrowing is fine, provided it is affordable and manageable. A great business should never be one bad year away from its lenders.

9 Are management's interests aligned with shareholders', and does it allocate capital well?

I want managements that think like owners and build over years, not ones making decisions to flatter the next quarter. Two allocators I admire took opposite views of their own shares. Mark Leonard at Constellation would not issue stock. Henry Singleton at Teledyne used stock as currency to buy other businesses when it was expensive, and bought it back when it was cheap. Both were right.

10 Is there a strong likelihood of continued growth?

A business can earn superb returns on a small base and have nowhere left to put the money. What I am really hunting for is a young compounder: high returns, high growth, and years of road still ahead. A mature one can still be a good holding. But the outsized returns typically come from finding them early.

11 Am I overpaying?

Arguably the most important question of all, and the one people least like to ask about a company they admire. All investing is expectations investing: the multiple the market puts on a business's cash is simply the growth the market expects, built into the price. When that expectation is set too high, the slightest disappointment can cut the multiple sharply, even while the business is doing well. Coca-Cola in 2000 was one of the finest businesses in the world, and the whole company, debt included, was valued at around sixty times its free cash flow. By early 2006 it traded at under eighteen times. Nothing had gone wrong with the business. The price had simply been far ahead of it, and the investor lost about 40% over six years waiting for the business to catch up.

So my test is concrete. Because the businesses I look at are predictable, I can estimate their free cash flow per share three to five years out with reasonable confidence. I put a conservative multiple on that figure, compare the price it implies with today's, and ask whether the stock should comfortably double in five years — roughly 15% a year. The forecast itself I keep realistic. The caution goes into the multiple.

Buffett said time is the friend of the wonderful business. I would only add: not if you bought it at the wrong price.

What the questions leave out

I do not keep a list of exclusions; the checklist does the rejecting. But in practice some risks almost always get flagged: an over-leveraged balance sheet, where survival depends on refinancing being available; commodity producers, which take the price the market sets; profits that depend on government policy rather than on customers; the risk of obsolescence; and fashion, where taste changes and high margins have nothing to defend them. And a great business at too high a price has not failed the test. It is simply not an opportunity yet.

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