# Our 9-Step Investment Process

1. Our First Hurdles
    - Inexpensive valuation
    - Net debt / EBITDA under 3X
    - Growing earnings and cash flow
    - Potential catalysts

2. A Business Model that We Can Understand

    Q. Can we understand the business activities in detail?
    Q. What are the long-term drivers of revenues and costs?
    Q. Are we able to understand how money moves around?
    Q. Is it a great business?

    ✓ Move to next step
    × Discard the idea

3. Discussing the Idea with the Team

    Q. Are we able to explain the investment thesis?
    Q. Does the idea pass the brainstorming process?

    ✓ Move to next step
    × Discard the idea

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We have explained to you the four concepts that drive our ethos, which are Independence, Concentration, Transparency, and Performance. Following from those drivers, we then have our ongoing methodology for how we actually decide what stocks to buy and what to leave out.

We conduct our own deep research because it yields information and intelligence we can trust implicitly, and to do that, we have built a nine-step process, which we will take the next three letters to describe for you featuring three topics at a time. So, where do we begin? (And in order to help us with the technical terms used hereafter, I will provide links for certain words that you can click to read on Investopedia, our preferred resource for providing accurate, financial definitions.)

**1. Our First Hurdles**

In order to buy at a discount, in many instances, you need to find shares that have dropped in price, and particularly when everyone else is running away from the company under scrutiny. We regularly check for share prices that have dropped precipitously, i.e. the ten worst performers from the day or week before. We then dive into those hard-hit firms to determine why everyone is selling them. And to whittle down our search, we begin with the parameters listed above as “Our First Hurdles”. As we go through this explanation of our methods, you will learn that focusing on small, bite-sized steps can deliver powerful, workable results.

We want to find an Inexpensive Valuation, which means trying to determine the “value” of the company and its share price. This analytical process of determining the current (or projected) worth of a company involves various techniques. We derive the value of a company by looking at the business' management, the composition of its capital structure, the prospect of future earnings, and the market value of its assets, among other measures.

One such metric is the Price-to-Earnings ratio (P/E ratio). When a company’s stock is worth $100/share, and the company’s earnings are $10/share, we would say the company is trading at 10x earnings, i.e. Price/Earnings or $100/$10 = 10x earnings. Over time, it is possible to gauge the P/E ratio for an industry, which is then helpful for determining if the company is expensive or cheap compared to

other share prices in its industry. If we look at beer companies and see the industry average is 15x earnings, but SABMIller is trading at 40x earnings, that would make it expensive relative to its peers, ergo we would probably stop researching it then. But if SABMiller was trading at 8x earnings, when the others in the industry all trade at 15x their earnings, then that might make it economic and worth a closer look. The level of the P/E ratio will mostly be determined by business growth and sustainable competitive advantages, i.e. the overall quality of the business.

Net debt is just how much debt the company has, which is all the payments to creditors it is obliged to make. We do not like debt because it is a drag on earnings, i.e. the company always has to pay back the debt instead of keeping that money for itself. A company without debt is always preferred because they have less downside risk. Another way to look at how liquid and profitable is a company is to calculate the Earnings Before Interest, Taxes, Amortisation, and Debt, which is simply known by its acronym, EBITDA, and this is another measure of profits for a company. Using these two metrics together, net debt and EBITDA, gives a good estimate of the company's liquid health. One important comment is that no single variable or number gives you the definitive answer as to how a company is doing. Moreover, all of this information is constantly in flux, so you are only really working off news from the past, yet trying to ascertain a very uncertain future state. However, it is precisely by using a variety of measures that you can arrive at a fair understanding of how a company is positioned today and what are its likely prospective results over the short-term.

The next critical data points for us are growing earnings and free cash flow. To begin, Earnings typically refer to after-tax net income, sometimes known as the bottom line, which is basically the company's profits. Growing earnings are as self-explanatory as they sound, i.e. are the company's earnings getting larger or smaller? Free Cash Flow (FCF) is the cash a company generates after it pays its cash outflows to support operations and maintain its capital assets. Depending upon how you calculate the number, it is also considered a measure of profitability. And obviously, the more free cash flow a company has, the more attractive it is because the extra cash, like a money cushion, provides a buffer against adverse company challenges. And, as much as we like free cash flow, the opposite holds true for debt, which conversely is a brake on growth and opportunity for the company.

The last criterion is Potential Catalysts, which tend to be company and industry specific considerations, such as launching new Intellectual Property; or Barriers to Entry, which could be things like trade and fiscal laws, which favour one entity/industry over the competition; or even the possibility of being acquired by another company, which is generally a positive result for share prices. This is an amorphous category that requires a lot of research and speaking with many insiders and participants in the business. Alternatively, the Potential Catalysts might favour other industry players to the detriment of the stock we are investigating, hence these can be negative factors, too.

**2. A Business Model that We Can Understand**

For this next step, we have listed the sorts of questions we are trying to answer:

Q. Can we understand in detail the business activities?
Q. What are the long-term drivers of revenues and costs?
Q. Are we able to understand how money moves around?
Q. Is it a great business?

To explain, it might help to use an example of an industry that gives us fits: high tech. With the rise of the internet and its dotcom companies, many investors have made lots of money finding the right shooting star that delivers upon its dreams and promises. However, the harsh lessons of the 2001 Internet Bubble Crash remain clear and present in our thinking. We feel that when brand new industries are born, there is too much that is unknown for us to get comfortable with what the future will bring, which makes it difficult to evaluate the business value. Raising investor funds for a tech I.P.O. is one thing, but creating a sustainable, ongoing business entity that makes revenue and profit is something else entirely. Too many internet companies build business models that do not make money. Or rather, they pretend that "followers" and "Likes" are substitutes for making hard-earned cash. With our first question when

analysing internet firms, we can run into opacity and fiendish revenue practices that do not give us enough clarity into how the business will survive and grow. For example, websites track views and page visits, but these metrics have been falsified repeatedly and are not necessarily any measure of “success”, as per the measures used in Our First Hurdles section.

Moving to the next question, if the internet has evolved rapidly – and continues to do so apace – and the smartphone revolution is still in its infancy, then we have a very hard time determining where these sorts of tech firms are going to be in five years, let alone ten years, from now. One of my favourite examples of this short-sightedness was when Rupert Murdoch's News Corporation bought the social networking website, MySpace.com, in 2005 for $580m. By 2007 it had 300m registered users and was being valued at $12bn, but the social network was subsequently crushed by Facebook, which launched a year after Myspace. Finally, News Corp. sold MySpace for $35m in 2011. Astonishing to consider how quickly $12bn was permanently destroyed. This is the sort of anecdote which keeps us awake at night because our pledge is to avoid the permanent destruction of capital, but investing in the internet and tech stocks with such outsized risks is one of the fastest ways to do the absolute worst to your portfolio.

So, if the drivers of success are not easy to understand, and the business or industry is too new or too volatile to project going forward, then the chances are that we will pass on the stock and not buy it for our portfolio. As tends to happen with value investing, due to our risk aversion for destroying capital, we usually focus upon more mature industries and companies with longer standing track records. This means we also want to know about their sustainable competitive advantage and if there are any barriers to entry. What is the predictability of their results? Is it a commodity business and do they have any leverage or negotiating power with their suppliers? And a popular and powerful tool is Porter’s Five Forces, which the link will explain in further detail for you. It is within these fields that we find more insight into what the future is bringing to the business in question.

And our last point has to do with the company’s funding and self-financing, and how well the firm manages its own funds for driving the business forward, which can tell us if it is a great business or not. These questions are simple to ask, but take a long time and a lot of hard work to answer, or at least attempt to answer. We are always adding updated information to our investment thesis, and by now, you should start to understand more clearly how there is constant analysis to be done. Yet it is this straightforward approach with reasonable and achievable objectives that works so well for us, the value investor.

**3. Discussing the Idea with the Team**

This section also has a short tasklist of questions:

Q. Are we able to explain the investment thesis?
Q. Does the idea pass the brainstorming process?

You may have heard of groupthink, which is the herd-like decision making of people in groups, whereby everyone comes to believe the same ideas, without rigorous analysis or debate about the decisions taken. A more formal definition is “the practice of thinking or making decisions as a group in a way that discourages creativity or individual responsibility.” Typically, this psychological phenomenon is a consequence of all participants in a group striving for consensus at the expense of contradictory viewpoints. More or less, everyone wants to go along with the leader so as not to rock the boat, but sadly, this is how some of the worst ideas manifest themselves.

How do we avoid such decision-making failure? We work as a TEAM! Now, anyone can go out and make investment decisions for themselves. There are individuals doing their own work and research alone, think of “day traders”, and they are fine. And even the largest investment firms use Portfolio Managers, and while they will work in teams, the Portfolio Manager is ultimately the one person who makes the final decision – and with their reputation on the line. Yet it is by working in teams that the best decisions are derived. And that is how we work at Tonus Capital, with an investment committee of four experts working together for all.

Our first problem with financial decisions is the principle we already discussed about having our own skin in the game, whereby we are all invested in our fund so the decisions we make are about allocating our own wealth. As already described, the first problem in the investment business is when folks make decisions without having any consequence because they do not have their own money on the line. It never hurts losing other folks' money anywhere near as much as losing your own money hurts.

We host weekly research meetings whereby each analyst presents potential investments for the fund. The analyst will introduce their work to the others and begin a defense of why such a stock is a suitable investment for us. The other three analysts have to pick apart the idea and raise objections to moving ahead on it. For the champion of the stock, it is their job to convince the other colleagues why our collective money should be spent on this share. And it is precisely because all of us have our money involved in these decisions that our attention is acutely crystallised and sharp. And no one participant's voice carries greater weight than the others. Yes, at the end of the day, as with every investment team, there is one Portfolio Manager who finally pulls the purchase trigger. However, that only occurs after together we arrive at a group consensus instead of just doing what the boss tells us. We call this the "art of thoughtful disagreement" when the goal is to find the truth, not merely to determine who's right or wrong. We want to debate together to find the truth.