Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: Seeing it in the Numbers

Date: 8/15/2020

In last month's memo I mentioned I would be returning to writing more about our analysis process and individual investments. In this month's memo I'm going to share with you the first things I look at when a company hits my radar. The process itself only takes a few minutes, but in that time I usually know if it's a company worth researching further.

Our goal is simple, buy good businesses at fair prices. For us, a good company is one that has a sustainable competitive advantage, an ability to reinvest internally, and a runway that allows for compounding. These types of businesses can grow their value through their operations. While a lot goes into understanding a company in order to assess if it has the qualitative components that meet our standards of a "good business," there are little subtleties you can see in the numbers early in the analysis process.

Good Businesses at Fair Prices

To take you through this process, let's use Chemed Inc., a company we currently own. Chemed's the type of company we like… It's not a *sexy* business and you won't see it show up as a high flying trading favorite on any Robinhood app. Chemed purchases and operates businesses in two diverse industries, hospice and plumbing. VITAS, their hospice division, makes up two thirds of overall sales. Roto-Rooter, the plumbing division, makes up the remaining third of total revenue. Together these two divisions make Chemed into a cash flowing machine. We'll save the qualitative analysis and overall thesis for another memo, for now just focus on the numbers we would check initially in our process.

Revenue

The first thing we look at with any company is its historical revenue trend. We like to look at revenue numbers over a full business cycle to incorporate an understanding of how the business performs in economic expansions and contractions. Simply looking at the top line of a business can tell you a lot about the company. If revenue moves up and down in a smooth wave like trajectory spanning the cycle, the business is likely more cyclical in nature. If the revenue is growing but interrupted with jagged and sudden drops, the business model might lack stability from reoccurring sales or predictability in overall demand. If the revenue moves in inconsistent chunks up or down, the company is likely still figuring out their business model or their growth model. If revenue has stopped growing over the last few years, the business is likely pushing up against their current total addressable market. These aren't always the case, but you see the pattern. Perhaps one of the biggest takeaways from looking at revenue is we can decide if it is a business that we would rather avoid. As one smart investor out of Omaha is known to say, there's nothing wrong with putting things in the "too hard" pile.

Let's take a look below at Chemed's revenue from 2007 to 2019:

Chemed Inc. (CHE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	1,100	1,149	1,190	1,281	1,356	1,430	1,413	1,456	1,543	1,577	1,667	1,783	1,939

As you can see, Chemed has experienced pretty consistent revenue growth for this period. If you knew nothing else about the business you could likely conclude:

1. The business might be recession resistant based on how sales performed from 2007 through 2009.

2. The consistency of revenue likely indicates the operations are noncyclical, nor are they likely speculative in nature.
3. The business seems to have figured out how to grow sales consistently year over year.

Margins

After glancing at revenue, we move our attention to the margins of the business. Anyone can sell quarters for dimes, but what we want are profitable businesses. Even more importantly, we want them to remain profitable well into the future. Evaluating the margins of the business gives us the first clue to if the operations have a sustainable competitive advantage.

Gross margin is the difference between net sales and the direct cost that goes into producing those goods or services sold. We want high gross margins that are stable or expanding gradually. What we don't want is to see gross margins shrinking at an accelerating rate. Not always, but typically this means the business has lost its pricing power and its competitive advantage is in jeopardy. What we want are high gross margins that give the business plenty of cushion to bring the product or service to market. After gross margins, we look at operating margins. Operating margins tell us the profit of a business before paying interest on debt or taxes to Uncle Sam. Aside from stating the obvious, operating margins are important. In free markets, competition flows to excess returns on capital. To quote Jeff Bezos; "Your margin is my opportunity." Therefore, a company generating high operating margins typically attracts competition, and eventually has its operating margin deteriorate… unless it has some sort of competitive advantage. We prefer businesses with double digit operating margins and a strong record of stability (or expansion) over the years.

Let's take a look at Chemed's gross and operating margin percentages:

Chemed Inc. (CHE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Gross Margin %	30	29	30	29	28	28	29	29	30	29	31	31	32
Operating Margin %	11	12	11	11	11	11	9	12	12	11	12	14	14

As you can see, Chemed's gross margin has been fairly consistent over the last business cycle. In addition, the operating margins have consistently registered in the double digits with the exception of 2013. During this part of my analysis I would probably make a note to check what was happening with the company around the 2012 and 2013 timeframe. Perhaps the biggest takeaway, Chemed's operating margins have been expanding consistently giving us an early signal the company has some sort of sustainable (and perhaps growing) competitive advantage.

Shares Outstanding (or diluted EPS)

After looking at revenue and margins, I like to check what is happening at a per share level. If the company is diluting shareholders or being overzealous with management compensation in the form of share compensation, we want to avoid it. Typically my attention focuses on the year over year change in diluted earnings per share as this accounts for the impact of convertibles, preferred and other hidden components in the capital structure. For the sake of this memo, understand what we are prioritizing is verifying the company is not consistently diluting shareholders. We want to see consistent or decreasing overall share count.

Checking Chemed, we see the company has consistently decreased total outstanding shares year over year, retiring roughly 34% of total shares since 2007.

Chemed Inc. (CHE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Shares Outstanding	25.1	23.4	22.7	23.0	20.9	19.3	18.6	17.8	17.4	16.8	16.7	16.8	16.5

The 3 R's

If revenue looks good, margins look promising, and things look fair at the share level, I direct my attention to the three R's – Return on Equity, Return on Assets, and Return on Invested Capital. Each R is important and tells us different details. For this memo, let's focus on Return on Equity (ROE). Among other things, ROE can tell us how good a company is at profitably redeploying its retained earnings. Remember, we want a good business that has a sustainable competitive advantage, and the ability to reinvest those profits back into its "machine." To understand the concept of ROE let's use the example of a bank account. If you put $100 in a bank account and you earned $20 interest after year one, your ROE would be 20%. However, if in year two your account paid you $20 interest again but this time on $120 (original $100 plus year one $20), your ROE would go down to 16.6%. Play this scenario out again and in the third year ROE drops to 14.2%. For businesses it's not always easy to reinvest profits at the previous return levels. Therefore, if we see a company that is maintaining a higher ROE over an extended period, it's an early hint to us that not only might they have a sustainable competitive advantage, but they've also figured out how to clear our second requirement - the ability to reinvest internally.

As you can see below, Chemed's had a solid ROE over the business cycle growing it from 16% to 33% in 2019. We would have to conduct further analysis on the quality of that ROE but it appears Chemed has figured out how to generate better returns out of its business over the years.

Chemed Inc. (CHE)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ROE %	16	18	17	17	20	21	17	22	23	21	18	36	33
ROA %	8	9	9	10	11	11	9	11	13	13	11	22	20
ROIC %	11	12	12	14	14	14	10	12	15	14	21	24	21

Putting it On Paper

Again, this process takes less than a minute but can give us an early indication to if it's our kind of company. The best part of all this is when you put these numbers on paper the good companies jump out at you. Take a look at the numbers we went over for Chemed and how they stack up to GoPro. Full disclosure, I know nothing about GoPro other than it randomly appeared on CNBC when I was writing this memo.

Chemed Inc. (CHE)	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	1,356	1,430	1,413	1,456	1,543	1,577	1,667	1,783	1,939
Gross Margin %	28	28	29	29	30	29	31	31	32
Operating Margin %	11	11	9	12	12	11	12	14	14
Shares Outstanding	20.9	19.3	18.6	17.8	17.4	16.8	16.7	16.8	16.5
ROE %	20	21	17	22	23	21	18	36	33
ROA %	11	11	9	11	13	13	11	22	20
ROIC %	14	14	10	12	15	14	21	24	21
Stock Price	**$51**	**$69**	**$77**	**$106**	**$150**	**$160**	**$243**	**$238**	**$439**

GoPro. (GPRO)	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	234	526	986	1,394	1,620	1,185	1,180	1,148	1,195
Gross Margin %	52	43	37	45	42	39	33	31	35
Operating Margin %	17	10	10	13	3	-29	-13	-7	0
Shares Outstanding	129.5	131.3	131.3	123.6	146.5	139.4	138.1	139.5	144.9
ROE %				35	5	-69	-49	-43	-7
ROA %				35	5	-69	-49	-43	-7
ROIC %				59	12	-99	-44	-29	0
Stock Price				**$63**	**$18**	**$9**	**$8**	**$4**	**$4**

While GoPro only has five years of being publicly traded (2014 was the year GoPro went public), it's not hard to see why the market has rewarded Chemed's share price over GoPro during that span.

Until next month,

M. Carter Johnson

MCJ Capital Partners and accounts actively managed by MCJ Capital Partners has a long position in Chemed Inc. (CHE) and would benefit from overall price appreciation of the stock. We have no current position (long or short) or overall opinion on GoPro (GPRO).