Why We Invest in Companies

Remick Capital, LLC

How Does Investing Make Us Money?

- While everyone understands the concept of investing – ***making your money make money*** – it is important to understand how businesses profit, and why investing in companies or governments can be good for the economy and good for your pocket book.

- For this discussion, we will need to imagine a ***hypothetical company XYZ***:
  - The company has ***$120 worth of assets***
    - Let's assume these assets are a factory and inventory
  - The company has ***$20 in short term liabilities***
    - Let's assume these are accounts payables to suppliers
  - The company has ***$60 in debt/bonds*** that it owes to banks/investors
    - Let's assume this debt has an interest cost of 6.00%
  - The company has ***$40 in equity*** that was provided by investors

- As an investor, what else would you want to know about this company… ?

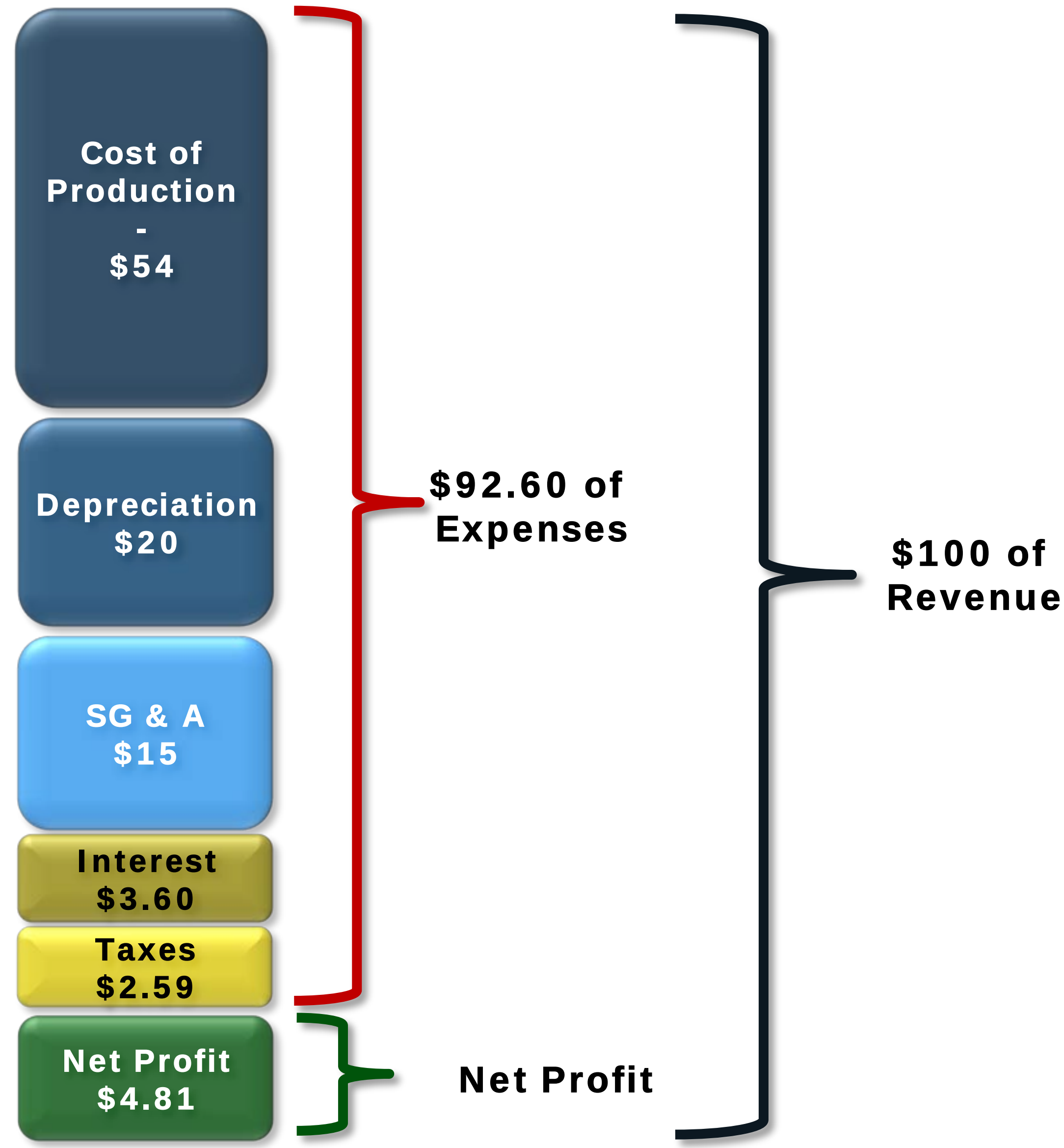
How Much Money Does the Company Make?

- Revenue -- $100
  - Cost of product – ($54)
  - Depreciation – ($20)
  - Salary and Administrative Expenses – ($15)

- Operating Profit ($100-$54-$20-$15) = $11
  - Interest – ($3.60)
  - Taxes (35%) – ($2.59)

- Net Profit to Stockholders -- $4.81

- ***Profits can be retained to grow the business or paid out as dividends.***



Why Does a Company Make Money?

- Company XYZ example of value creation:
  - Takes raw materials, fixed assets (factories, etc), labor, logistics and combines them together for $X and delivers them to customers who need the end result for $X plus a profit margin.
  - Banks and investors see the value creation potential and help to fund expansion to encourage the process (while they each take a cut of profits in exchange) with their capital.

- Investing in a company (either stocks or bonds) is simply a 'bet' that the company will create value, and you can participate in the ongoing profits ***and/or*** a sale of the assets
  - Investing in bonds is lower risk (because you must be paid first) but also lower return
    - In our company, the bond holders provided $60 in capital, and receive $3.60/year – 6.00% return.
  - Investing in equity/shares of a company is higher risk and hopefully a higher return as well.
    - In our company, the stockholders provided $40 in capital, and receive $4.81/year – 12% return, but stockholders get paid last and thus have the most risk.

Investing is about predicting the future and paying the right price.

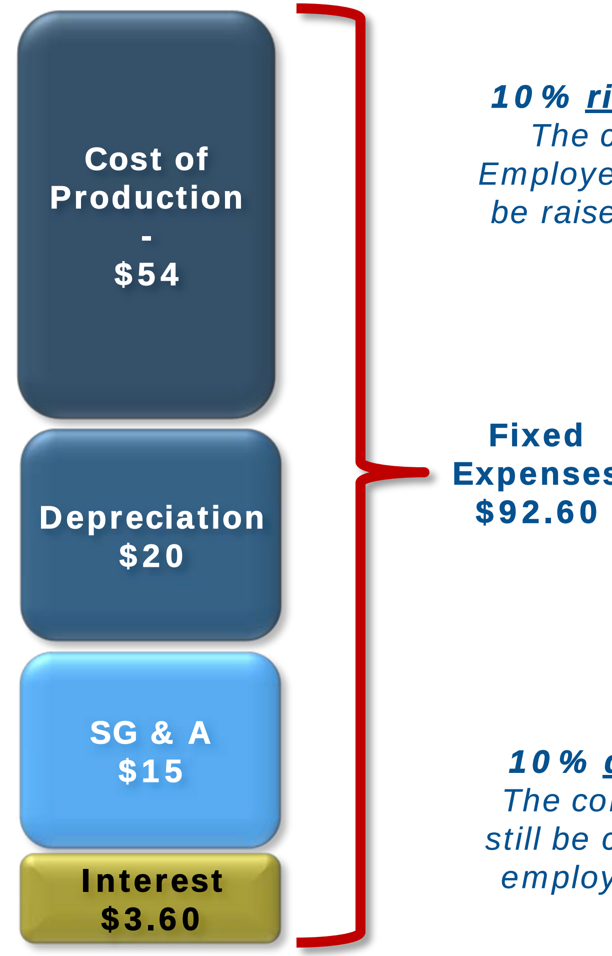
If a company can generate an 12% return on it's shareholders investment
it is likely a good company but as an investor you must always ask "What's the price?"

Basic Valuation of Company XYZ

- In a simplistic world, the $40 of Company XYZ stock (equity) is probably worth about $40 in the market.
  - If the company had 10 shares of stock, each share should be worth around $4. At $4, assuming the business is stable, the equity (stock) investor would make a ~12% return with a combination of growth (reinvestment) and/or dividends.
  - If the shares could be purchased for $3 or even $2 each, the return the investor would expect to get would increase because the profits of $4.81 ($0.48 / share) would provide a bigger bang for cheaper purchases.
  - The return on the ***original*** inventors equity would still be 12%, but the new investor (assuming they only pay $2 each) would see a return of $0.48 / $2, or nearly 24%.
- But it's not that easy…
  - An important thing to realize is that real businesses have competitive markets, and lots of costs to pay to do business.
  - It's important to understand how sensitive the business is to the economy.

Sensitivity to the Economy

- Imagine the prices for Company XYZ's product may rise or fall 10% in different situations:
  - Prices ***rise 10% in a booming economy*** (but volume of product is unchanged)
  - Prices ***fall 10% in a steep recession*** (but volume of product is unchanged)
- There are $92.60 worth of fixed expenses for Company XYZ
  - SG&A is mostly salaries which can be cut a little, but not too much
  - Depreciation is a non-cash expense but it assumes that the factory must be maintained; any cuts to capital expenditures can have big impacts on future profitability.



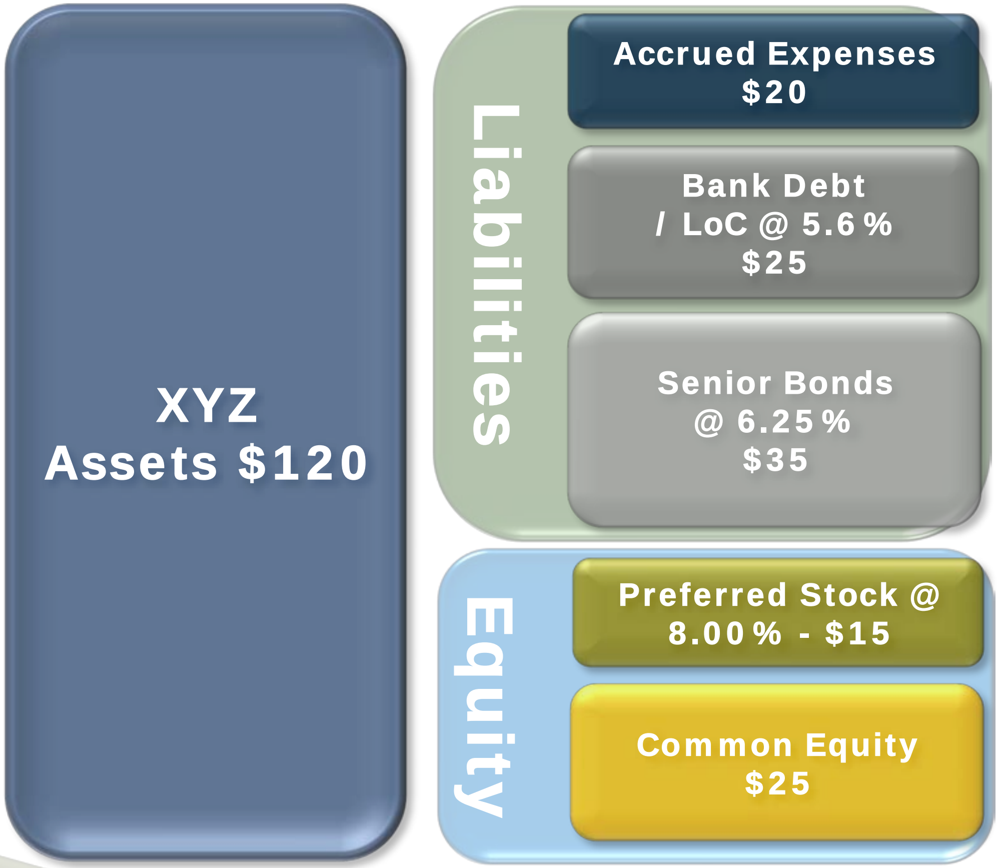
10% rise in Revenue (to $110)
*The company **earns $11.30**. Employee salaries will likely need to be raised but business will be very good for everyone.*

10% drop in Revenue (to $90)
*The company **loses $2.60** but will still be cash flow positive by starving employees and/or reducing factory upgrades.*

Investors and business owners must understand how bad it can get and be able to survive economic downturns. Many businesses can lose money for a few quarters survive, but for longer periods it does not usually end well.

Putting it All Together Visually

- A similar company with a slightly more detailed structure of financing
- The sample *capital structure* is as follows:



Accounts Payable, Salary/Benefits unpaid, etc. No cost.

Lots of companies don't have much bank debt.

Most companies have at least a little debt

Most companies don't have preferred stock. Usually all common

Equity takes first loss but maintains all excess profits

- 'Capital Structure' is just a fancy way to say "How a company is financed".
- Businesses usually start with some bank funding, and a founding person's equity funding. Later on a company can raise money via bonds, preferred, selling more stock, etc.

Investing – Where and How?

- For any given investment in a companies stock or debt, you get some sort of return and some kind of risk. Regardless of whether you buy stock or debt, the companies' business is of utmost importance.
  - ***For Debt:*** Understanding the companies cash flows and liquidation values in bankruptcy are the most important things to know to determine what is backing the debt.
  - ***For Stock:*** The ability of the company to pay their debt, and ***then*** the ongoing profitability are key areas of focus. Ongoing profitability above debt payments is what accrues to stockholders, so that is where the focus should be.
- As with all investing, a key focus must always be put on the price paid. Bonds are usually lower risk and lower return than stocks, but paying too much for bonds or stocks will always end badly in the long run.