Review and Notes - Board Of Books

boardofbookseditor

Summary

Scott has studied and profited from business failure through his career managing Crown Capital. The book shares entertaining stories of his discussions with management at these companies over the years and provides a helpful list of failure categories to be mindful of in investing and operating decisions.

Key Takeaways

- Failure is more common than people realize, but it often takes a long time for a company's stock to go to zero due to optimistic mindset of management and investors
- Management can be completely out of touch with the reality of their business (do not rely on insider buying)
- Avoid elite infallibility when evaluating management teams
- Companies can deteriorate due to frauds, fads or failures, but the most common are pure failures
- When shorting a stock, Scott waits until it has lost at least ½ of its value – when stock is at 52 week high it attracts a lot of attention from analysts and this can push the price up
- Management matters – Scott has switched to a long position from short on companies in which there was a management/strategy change

Detailed Notes

- **Businesses failed because their leaders made one of the following mistakes:**
  - They learned only from the recent past
  - They relied too heavily on a formula for success
  - They misread or alienated their customers
  - They fell victim to a mania
  - They failed to adapt to a tectonic shift in their industry
  - They were physically or emotionally removed from their company's operations

- **Learned only from the recent past**
    - Assuming that the recent past is the most accurate predictor of the future and that the more distant past is less relevant
    - Global Marine – Oil services business in the mid-1980s – CFO pointed to the last 20 years in which rig utilization never dropped below 70%, but if you were to look at a longer period of time, there were catastrophic meltdowns in the oil industry – utilization went to 25% and the company filed for bankruptcy
    - TXU – $45bn buyout (Warren Buffett bought the bonds) in 2007 – seemed like a safe bet with a regulated utility and rising electricity demand. Huge natural gas deposits were discovered shortly after the deal and prices dropped
    - TGI Friday's – taught Scott the importance of growth over value. The company had gone public in 1983 and experienced strong growth and was trading at a value multiple, but the company could not adjust to consumer tastes and growth slowed
    - California Coastal Communities – Developer in California with $200mm of debt and revenue in 2007 declined by 50%. Trading near book value and everyone was predicting a recovery. A visit to one of their communities ($800K for small units with a glimpse of the ocean) revealed how distressed the company was
- **Relied too heavily on a formula for success**
    - Do not confuse formulas with good decision making – if you get fixated on a set of numbers, you can miss other critical information
    - Costco and Starbucks
        - Met with both companies in 1999 and decided not to invest because their growth was less than their earnings multiple and also avoided recent IPOs – missed out on once in a lifetime opportunity (Starbucks was at a 30x multiple)
        - Starbucks – had concerns about commodity exposure and ability to pass on price increases – but the company had done studies that showed people were not price sensitive – they wanted an affordable luxury and consistency
        - Costco – thin margins and were generating most of their profits from their membership fees
    - Value Merchants – Ran Everything is a Dollar Store and had been doubling their store count. Scott went on a store visit – they were mainly selling junk and the manager told him whatever didn't sell was put on a truck and taken to another store. They could not properly manage inventory and merchandising with rapid growth
    - Krispe Kreme – Rather than slowly roll out their franchises like McDonalds and require that operators prove themselves before getting more locations, Krispe Kreme granted block/regional rights – this resulted in regional closings and operational issues
    - Advanced Marketing Services – Sold books to Costco with a 15% markup and also handled all distribution and returns. Profit margins started to decline even while revenue was growing. A top money manager and cousin to the CFO even recommended to Scott not to invest in the company, but he continued to do so. Profits never recovered and there was a case of gross financial fraud at the company
    - Yellow Pages – 2008, declining revenues, run by smart CEO who was cutting costs to increase EBITDA and it was a Wall Street hot stock for a while because of low EBITDA multiple – filed for bankruptcy and emerged as Super Media and filed again in 2013 and re-emerged, each time rallying

- **Misread or alienated their customers**
    - Personal experience – tried to open a Cajun restaurant in Mill Valley and nobody was interested (older, retirees)….a few years later he reopened the restaurant in Berkeley and it did extremely well
    - JC Penney – Eliminated coupons and started to stock more expensive brand name merchandise. Ron Johnson held the job for 18 months and wanted to make it a place where he and his friends (coastal elites) would shop. Curtailed advertising in Spanish ad reduced big and tall selections. Johnson had an absentee management style. Gave sales people ipads for credit card processing, but cash checkout was near the back of the store – 30% of transactions were still cash and many of consumers were unbanked
    - First Team Sports – Analysts thought rollerblading was going to replace bikes because all of their friends enjoyed it. Trading at a 30x multiple and went from $6 to $2…very similar story as Nordic Track, which was bought by a few Harvard MBAs – it was a huge piece of equipment
    - Chemtrack – OTC blood test for cholesterol levels and company based projections on the same level of pregnancy tests sold (5mm a year) and completely misunderstood that people that buy a pregnancy test absolutely need to know the results of the test. Shorted stock – it dropped, but took 5 years to go to zero
    - PlanetRX – 1999 – were trying to make pharmaceutical business like Amazon, but it took 24-48 hours for people to receive drugs, when a senior could drive 15 minutes to local drug store. Also very different than books – people can wait 14 days for a book, but need RX
- **Fell victim to a mania**
    - com – sold banner adds – content only. Scott met with CEO and asked if there was anything that could go wrong with the company – she said absolutely nothing with a unbridled enthusiasm – within 10 months the stock went from $15 to $0.70
    - From Credit Suisse report on Commerce One – Conventional valuation measures don't capture a revenue stream where the real value is hidden in services yet to be introduced
    - Quckka Sports – CEO was a young energetic Aussie named Alan. They were live streaming yacht racing – called it immersive viewing and they were expecting 2mm viewers in the U.S. for the Americas Cup, but there was nowhere near that level of interest in the U.S. for sailing. Similar to Larry Ellison's planning for America's Cup in SF – company filed for bankruptcy in one year
    - Fresh Choice – extremely enthusiastic CEO/CFO. They had very clean cafeteria style restaurants that served healthy food – most of the company was Mormon and they have very large families. The problem was that they opened locations in wealthier cities and those people with average sized families are willing to pay up for a regular set up – a cafeteria style dining is not upscale. Company filed for bankruptcy a few years later
    - Cygnus Therapeautics – Non-invasive way to monitor glucose levels with a wristband. Continued to visit with them from 1994-2002 and they were always delayed. Had an enthusiastic team led by Stanford MBA. Finally got FDA approval, but was not very effective
    - Shaman Pharmaceuticals – Tried to bring compounds from Amazon rainforest to pharma. Started in 1989, but only released one antidiarrheal medication and filed for bankruptcy. Investors were so captivated by the story – the CEO was able to raise millions and lose 2x

- **They failed to adapt to a tectonic shift in their industry**
    - Blockbuster – Visited in 2007 and at the time had 9,000 stores and Netflix was rapidly stealing share. Were still focused on their stores and shifted to a retail strategy in which they would add products (selling movies, concessions, etc.). Icahn had taken over Blockbuster in 2005 while the current CEO was pushing to focus more on the internet – declared bankruptcy in 2010. Considered merging with Hollywood video and Circuit City, but that fell through (be cautious of "synergies"). People were not trying to get into cars to drive 5 miles to a store so they could overpay for movies
    - Pagenet – 1999 and still convinced that pagers were a viable business model because they were lighter than phones, allowed people to return calls on their own time, believed people would continue to carry both, opportunity in developing markets, had better reception – in 2 years the company was bankrupt
    - Ultimate Electronics – Retail store for audio equipment enthusiasts – high end and knowledgeable staff. Large electronics stores started selling the same brands at a loss to bring customers in the door, but company through service would prevail – bottom line was that even affluent people like a bargain (Costco understood this)
    - Yellow Pages – In 2008, CEO expected 10% adoption online – thought books would be bread and butter and that people in middle America would still use the books due to habit
- **They were physically or emotionally removed from their company's operations**
    - Building Materials Holding Corp – $435mm of long-term debt through acquisitions in a commodity driven business – compete on price and low margin. In 2007 permits for new houses were down 30% and the CEO was convinced it was cyclical and that the housing market would bounce back. The company was originally based in Boise, but CEO had built an elaborate headquarters in SF (embarcadero building) – company filed for bankruptcy in 2009
    - JC Penney – Ron Johnson flew private every week and stayed at the Ritz Carlton in Dallas. Held companywide conferences from his house in Silicon Valley
    - Miniscribe – disk dive company that had lost IBM as a customer in the late 1980s. SF-based investment firm had "Dr. Fix-It" to manage the company, but the CEO refused to move from LA to CO HQ. The executives at the company ended up falsifying shipments and there was huge litigation as a result
    - Consilium – software product for automated factory operation – revenue was falling flat and the CFO blamed it on M1 monetary supply and not the quality of their product or competitors
    - 50-Off Stores – blamed weather in public filings using the same exact wording for two years
    - The best CEOs are focused on driving financial performance and not the stock price – quote from Bill Gates – "To have a stock trader call up the chief executive and ask him a question is uneconomical – the ball bearings shouldn't be asking the driver about the grease." In contrast to Enron, which had its stock price displayed in its elevators
    - SilkGreenhouse – company that leased out bankrupt grocery stores and stocked with 1,000s of fake flowers. Company filed for bankruptcy in two years and could not manage growth – CEO discussed at length the impacts on the stock price of certain growth initiatives

- **Short to Long**
  - People are extremely important and with several companies, Scott has gone from short to long due to smart manages being put in place
  - Acquisitions have a huge impact on morale – people are always a business's most valuable assets and can kill value by disrupting their lives
  - Andrew Carnegie – the only irreplaceable capital an organization possesses is the knowledge and ability of its people (this is why professional service mergers rarely work)
  - Cost Plus World Markets – Started in the 1950s with first location in Fishermans Warf and carried a unique variety of merchandise from around the world (bottles for wine from Argentina), but by 2003 they had ridden the housing boom and were at 175 stores with plans to expand to 600. They had also completely changed the format and started stocking higher end furniture and common wine brands. Comps started to slow and the CFO blamed the slowdown on the Walmart effect and various other issues. By 2009, the stock was at $0.50 and they had hired a new CEO and CFO – brought the company back to basics and executives were very transparent about the past mistakes and future plans – bought out by Bed Bath and Beyond in 2012
  - Zale Corporation – Middle class jewelry store. In mid 2000s shifted inventory to a broader assortment of inexpensive items and lost brand appeal – performance tanked. In 2000, they hired a new CEO and they turned the company around – drove innovation through higher end product offerings (Vera Wang). Zales was acquired by Signet in 2014
  - IGT – Slot machine manufacturer. Indian Casinos were opening up around the country and Scott thought this was driving all of the company's growth. In reality, the company has spent 5x more on research and development and made a vastly superior slot machine that pooled jackpots across the machines. Also got a percentage cut of the slot machine revenue

- **Misc Notes**
  - In the midst of lean times, most businesses assume the corporate equivalent of the fetal position
  - Elitism never sits well with workers, middle management or even executives and always leads to internal problems
  - When shorting a stock, Scott waits until it has lost at least ½ of its value – when stock is at 52 week high it attracts a lot of attention from analysts and this can push the price up
  - Longevity is actual quite common in a distressed company – Advanced Marketing Services took 4 years to file for bankruptcy – this is likely due to excessively positive outlook that people will prevail
  - People in management positions can be completely wrong about the fortunes of their company
  - Be careful of elite infallibility – "But the CEO is a Harvard MBA"
    - Robert Jaedike – accounting professor at Stanford and also the chairman of the audit committee at Enron!
    - Bernie Madoff – Donated millions to charities, friends with Senators and Chairman of Nasdaq
    - Country Club effect – people will perform less due diligence when dealing with someone with whom they have an affinity
  - Index can conceal the level of failure – Apple at one point was 12% of the Nasdaq and accounted for most of its gains
  - Competitiveness – makes managers and investors less likely to recognize their mistakes and change course
- **Issues with financial industry**
  - Be wary of self-promoters that say they have an easy path to riches in the stock market. There is a long history of them – Elaine Garzerelli, a Lehman analyst who predicted Black Monday, but in the next decade had only predicted stock market direction correctly 38% of the time
  - Jack Grubman – telecom banker for Solomon who had recommended Worldcom
  - Bogle – the total fees and commissions from financial industry – $500bn a year
  - Typical financial industry professional – Joinerism, power worship, hyper-competitiveness, intellectual torpor – lead to common mistakes such as averaging down and trusting so called experts
  - Asset expansion leads to diminished returns – good example is Julian Robertsons Tiger fund – had 31% average returns, but may have lost more money than they made because the losses were when the fund had expanded
  - Front running – buying stock in personal account before fund
  - Through 2009, Scott's fund averaged a 13% CAGR