# Evaluating Management
# Compiled by Kevin Gillogly, DC Chapter

"Too many beginning users ignore Section 2…Don't overlook this area…If you are investing for the long term, try to name one thing that is more important than increasing management efficiency." (Understanding The SSG Or You Will Buy Turkeys When It's Not Thanksgiving, Ed Chiampi, Co-Founder NAIC Computer Group, BI April 1998)

## The three tests of management

"If your candidate meets your growth requirements, the next step is to look at its efficiency (profit margins) and effectiveness." (Take Stock, pg. 119)

"Question 2 (of the SSG Report) covers the three most important tests of management: Is it producing the desired rate of sales growth (1-1)? Does it meet our standards for earnings growth (1-3)? If so, is it earning a good rate on equity (2B)?" (Official Guide, pg. 102)

"The drive of a corporation's management is the single most influential element of growth." (Official Guide, pg. 21)

"Pre-tax profit margin and return on equity are two of the best statistical measures of managerial efficiency." (Official Guide, pg. 48)

"High and consistent numbers in Part 2 of the SSG tend to identify quality companies that are industry leaders." (Classic Plus Manual, pg. 94)

## Comments on management

"… strong growth companies tend to gain market share in depressions or recessions as competitors contract their businesses… Start with understanding the drivers behind the pre-tax profits (SSG Section2A) and return on equity (SSG Section 2B)… Be HIGHLY skeptical of management reports that downplay challenges or suggest under-estimation of competition." (George Nicholson, NAIC Co-founder as quoted in Mark Robertson's article in BI July 1999)

"Lest we ever forget, investing is quite simply, all about people… Curiosity is the mark of good investing. With patience and commitment, and a little practice, one of the gifts that NAIC practitioners experience is that SSGs become easier to complete, and the discoveries easier to identify… Growth and strength of management should always be a key strategy in the selection of investments… we first evaluate the driving force and competence of management." (BI, Mark Robertson, Hints on Recognizing Memorable Management, July 1999

## Where is the Growth Coming From?

"One of the primary factors to take into consideration when you look at a company's EPS is the company's *profit margin*. Profit margin is the relationship between a company's profit and its sales, or how much a company earns on every dollar of sales… The relationship between a company's EPS and its profit margin is a very significant one as a company's profit margin typically drives its earnings per share… You take these figures and compare them against other companies. Comparing the pre-tax section on the back of the SSG is one easy way of doing this… You can also compare a company's profit margin against itself over the past few years." (BI, Amy Rauch-Bank, Beginners Corner, September 1994)

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## Determining the Quality of Management

"… management actually encompasses all of the people that run the business of a daily basis… Effective management is successful at maximizing sales while controlling costs… Based on the relationship between sales and pre-tax profits, we derive the ratio known as pre-tax profit margin (2A)… Increased sales are impressive, but only when management can demonstrate its ability to achieve the same percentage of profit as it was getting from existing sales... It's not necessary for us to micromanage by following the nuances of each management decision. We're really interested in the results as displayed in Section 2A of the SSG… An acquisition could explain a recent dip in a company's pre-tax margin… Profitability attracts competition, which in turn drives prices down, thereby limiting revenue growth… Whereas… consolidation among a company's customers can affect costs. Fewer and larger customers can demand better pricing… This is where a comparison with other companies in the same industry can become an essential part of our analysis… If a company's margins are slowing, but remain comfortably in line with or even above those of its competitors, a slightly declining trend might be forgiven. It's hoped our research will confirm the company is maintaining market share in the faced of increased competition… We need to do the necessary research to understand what is going on beyond the numbers… Declining profit margins can serve as an early warning of potential problems before they show up as a decline in earnings… Maintaining a balance between sales and expenses can be particularly crucial during an economic slowdown… Profit performance almost always suffers in a decline. It's very difficult for a business to respond to a sharp falloff in sales by cutting its expenses immediately… Learning to scrutinize the equilibrium or disequilibrium between sales and costs by viewing the trend in pre-tax profit margins, supported by research and peer comparison, will go a long way toward improving our stock analysis skills." (BI, Nancy Isaacs, Simply Put, Evaluating Growth Companies: Determining the Quality of Management, Jan. 2002)

## Identifying Good Management

"Good management achieves long term growth by balancing sales initiatives and cost controls." (Stock Selection Handbook, pg. 93)

"Companies must develop products of extraordinary quality to increase prices without losing market share to competition." (Handbook, pg. 94)

"Be skeptical of above-average profit margins that make a big jump. The company might have taken actions that provide short-term improvements at the expense of long-term performance... Number that stay the same over the years might mean that a company has cost control down to an art with little room for improvement. However, don't rush to applaud management. Flat numbers can easily represent stagnation." (Handbook, pg. 95)

"Percent earned on equity is an indicator of how well management is utilizing the company's resources contributed by shareholders' money and reinvested earnings." (Handbook, pg. 96)

## Using Preferred Procedure to cross check your estimates

"After you calculate the pre-tax profit margin in Section 2, you can corroborate your estimate of EPS five years out using NAIC Preferred Procedure." (Handbook, pg.  98)

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## The mechanics of Section 2 of the SSG

## Section 2A:

"Management has only two resources with which to generate earnings: *revenue* … and the *equity* of the company… As a beginning investor, you will be interested only in revenue." (Take Stock, pg. 119)

"To analyze the efficiency with which management uses the money it receives from the sale of goods or services, you will look at the return it earns on sales – the company's *profit margins*… look at the profit margin before taxes because management has no control over taxes." (Take Stock, pg. 120)

"The profit margin … is calculated simply by dividing pretax profit by sales… The higher that percentage figure, the more efficiently management has utilized the company's income… the percentages are only important when you compare (it) with its peers in the same or similar industries. They are not nearly so important as the trend." (Take Stock, pg. 120)

**Step 1 –**
**Determine Consistency and Trends:** Make sure the trend for the past 5 years is fairly consistent or tending up… Numbers within a variation of + or – 5% from the 5-yr. average are considered consistent." (Classic Plus Manual, pg. 92)

"A flat trend is as good as an uptrend… there will be times when a little research will lead you to excuse a minor or temporary downtrend. But as a new investor you should never consider investing in a company whose profit margins are declining." (Take Stock, pg. 123)

**Step 2 –**
**Industry Comparison:** Confirm that the company has high profitability and high return on equity numbers in relation to other companies in its industry. (Classic Plus Manual, pg. 93)

**Interpretation**
"%Pre-tax Profit on Sales (also called Pre-tax Profit Margin) measures how well management converts sales dollars into profits…Look for profitability of 12% to 15% or better." (Classic Plus Manual, pg. 93)

## Section 2B:

"The second item on management's report card is return on equity – the return management is able to produce with the equity of the company – the investors' ownership… At its simplest, the ROE is suppose to answer the question, 'Given the amount of money this company is worth after paying off its debt, how much profit does management bring in for every dollar of that value?' … ROE just addresses how efficiently management is making use of *your* share of the company." (Take Stock, pgs. 192-193)

"The investor usually finds the greatest opportunity in companies where the percent earned on equity is above 20 percent. That is a very significant indicator of the rate at which shareholder value is increasing." (Official Guide, pg. 96)

**Interpretation**
%ROE measures the amount of money (the return) made by the company in relation to the amount invested (the equity)… Higher %ROE numbers usually indicate superior management. However, balance sheet leverage (debt) and buyback of stock can skew these numbers. Numbers of 10% to 12% or higher are good results for %ROE." (Classic Plus Manual, pg. 94)