Good companies do not always make good investments

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A good company has to be a good investment, doesn't it? After all, Warren Buffett focuses on good companies and he's a billionaire. So it follows that good companies have to be good investments.

Or do they?

Mr. Buffett has become a billionaire not because he is just buying good companies, but because he is buying good companies at a discount to their intrinsic value. That is, it all depends on what price one pays. There is valuation risk no matter what kind of investment one makes.

For example, Intel is a good company, but had you bought it in 2000, you would have overpaid terribly. In fact, you wouldn't have made any capital gain for the next 23 years.

But let's not get ahead of ourselves. A good investment is easy to understand, but what is a good company? Let me define it. A good company is one that not only has a competitive advantage (i.e., a moat, in Mr. Buffett's words), but also one that has a sustainable competitive advantage.

BlackBerry was a company with a competitive advantage. It had good and innovative management, push e-mail, and a highly secured network of servers. But management lost focus, others replicated its push e-mail without infringing on its patents and countries around the world started to demand access to its customers' communications. In addition, BlackBerry was in a highly competitive industry with many barbarians at the gate waiting to take advantage of its missteps. BlackBerry's key product became less sexy to own over the years. Other competitors, like Apple, came up with sexier products that consumers, particularly young people, wanted to own. Consumer tastes are fickle. In this industry, consumers will gravitate to the best product, regardless of brand. So sustainability eluded BlackBerry.

To find out what really makes a good company – and whether or not it's a good investment, let's look at one company that has a lot going for it.

Stella-Jones is a Canadian company that isn't competing in the same sexy industry as Apple and BlackBerry, but it is a good company in my view. Stella-Jones manufactures pressure-treated industrial lumber products, such as railway ties and utility poles. The company focuses on products that are tied to infrastructure and this insulates it from extreme volatility over the business cycle. Maintenance requirements, a necessity, drive demand for Stella-Jones's products and its customer base, which consists of utility and railway companies, is reliable, stable and low-risk. Big telecommunications companies purchase Stella-Jones's utility poles to maintain their networks. Bell Canada is unlikely to go out of business and leave SJ with unpaid receivables. The same is true for Canadian National Railway or Canadian Pacific, both of which use Stella-Jones's railway ties.

Stella-Jones is by far the largest company of its type in Canada and expanded aggressively into the United States with a consistently high return on invested capital. This affords Stella-Jones economies of scale advantage, which enables the company to produce its products at a lower cost than its competitors. Additionally, Stella-Jones sells large volumes to a relatively small customer base, mostly large companies. It is the only national player supplying railway timber in large quantities. Customers rely on Stella-Jones because no other company in the industry would be able to meet Stella-Jones's ability to promptly respond to a large demand for railway timber – so switching costs may be in place as well as search costs affording Stella-Jones a demand advantage.

The company's demand advantage, in conjunction with its economies of scale advantage, produces not only a formidable competitive advantage, but also sets in place the necessary conditions for sustainability. Sustainability requires competitive advantage in recruiting new customers as well as retaining existing ones. And Stella-Jones meets this challenge.

How about management? Stella-Jones's management, aided by an outstanding board of directors, has done an excellent job in executing the company's business model.

So, Stella-Jones is a good company with a competitive advantage and sustainability.

But would I buy it today? Probably not, as there is valuation risk in the company – the company is no bargain at this point and offers no margin of safety. Let me explain. We estimated Stella-Jones's intrinsic value to be about $75, a bit lower than its current price of about $77. (Intrinsic value was calculated using the present value of the after-tax normalized free cash flows discounted by the appropriate risk-adjusted cost of capital.)

So buying Stella-Jones at its current price affords not much margin of safety, which is like having insurance for possible mistakes we make and for things we do not know that we do not know. A better price at which to enter the stock would be around $60, which does afford a margin of safety and takes away any valuation risk. As Ben Graham used to say, “The function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future.”

So, do good companies always make good investments? It all depends.

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