

BEING THERE

Are Company Site Visits a Delusion?

BY CHRISTOPHER WRIGHT



IT WAS A TALE OF TWO HEADQUARTERS: the best of times for management versus the best of management for shareholders. The time was the early 1990s.

A site visit to the first company, a large conglomerate in Mexico, revealed a “huge modern headquarters with priceless art on the walls.” Dinner provided another revelation. “I had dinner with management in a private dining room in the penthouse—four-course meal, white-gloved waiters,” recalls Cindy Sweeting, CFA, executive vice president and director of research of the global equity group at Templeton Investment Counsel in Ft. Lauderdale, FL. As she was leaving, Sweeting concluded that these managers were primarily interested in their own enrichment and this big building was nothing more than a monument to their colossal egos.

Her next stop was another Mexican conglomerate—this one housed in rented space in a modest bank building. “At 7 o’clock at night,” she recalls, “there were still people at their desks working.” The board room had recently been expanded. Sweeting could still see a line running down the middle of the floor where the old carpet met the new. The managers owned a stake in the company and were very focused on shareholder value. The second company, clearly the better steward of shareholder funds, was the one Sweeting recommended for investment when she returned home.

Skeptics contend that company site visits are useless or even counterproductive. Some analysts argue that the financials are enough to tell the company’s story and nothing worthwhile can be learned where rules are in place against selective disclosure (See sidebar, page 42). Worse, they believe, is that a visit gives corporate managers the opportunity to pull the wool over the eyes of analysts, who are either naive or emotionally overcommitted to the company. But Sweeting and other analysts tell a different story.

Sometimes, “it’s hard to tell who’s being up-front and who’s just trying to feed you a story,” admits Michael Cumming, CFA, energy equity analyst at research provider Morningstar in Chicago. But he remains convinced that company site visits add value: “It really helped me, especially early in my career, gain a better feel for how the industry worked and how all the assets fit together.”

Cumming visits oil and gas properties as well as company headquarters. He goes “to get an idea of whether I think management is competent or not.” More importantly, he visits to get a sense of whether the company has the best possible long-term strategy in light of industry trends. When the

subject is what is happening in the industry, Cumming has found that managers will go well beyond what they have said in regulatory filings and earnings calls. With enough visits, he believes an analyst can spot management teams that are unaware of their own best opportunities or that play up areas that (according to the analyst’s other research) augur poorly for the company’s future success.

NOT IN THE PRESS RELEASE

A visit to a watch and jewelry company in Shanghai was an epiphany for Francisco Alzuru, CFA, managing director for emerging market research at Hansberger Global Investors in Ft. Lauderdale. He thought the company was just a manufacturer, but the visit revealed that the company’s best growth opportunities were in its new distribution and retail initiatives. The company was blanketing retail outlets throughout China with fashionable middle-market goods and, in addition, selling high-end luxury items through its own outlets. Although the company had issued press releases announcing the opening of new stores, the genius of the strategy was not apparent until he was on site and could see how situating stores in low-cost, high-traffic locations in affluent areas in Shanghai and other major Chinese cities allowed the company to avoid the steep rents other luxury outlets were paying in high-end malls nearby.

Alzuru went to one of the stores and witnessed for himself the ambience the company successfully created to pamper its well-to-do customers—wine cellar, walk-in humidior with Cuban cigars, etc. It may sound a bit much, but these are customers who think nothing of spending US\$100,000 on a wristwatch.

“You can’t see that in a press release,” says Alzuru.

Another discovery came in Latin America. He went to see an upstart telecom operator that was competing against the incumbent carrier with a unique low-cost solution for the “last mile” (from network node to individual house). He saw the technology—how fast it could be deployed to new customers and how little it cost to implement. Although not apparent from its website, the company was getting ready to roll out several new value-added services. In other words, it was offering new and improved services at a lower cost than the incumbent. Not until he saw the installation first-hand did the case for potential investment in the company click in his mind.

Site visits also made something click for Templeton’s steel analyst in the early 1990s, according to Sweeting. The analyst

was able to contrast traditional behemoths to the mini-mills, which were new at the time. He visited US Steel, which, Sweeting says, “had a steel mill the size of a city—the beginnings of it were decades old, it was union-run, with old technology, really poor logistics.” On the same trip, he saw the mini-mills of Nucor Corporation, where most of the employees seemed to be in a computer room; everything was mechanized. In short, Sweeting says, site visits can “really bring home the cost advantages of new technology versus old technology.”

VALUES AND CULTURE

For Chad Kilmer, CFA, it's not about visiting hard assets but trying to get a read on the company culture. Kilmer co-manages a small-cap value mutual fund at William Blair & Company in Chicago. Kilmer has had good luck making long-term investments in companies located in the U.S. heartland. He tunes in to the company's value-set and is more receptive when his gut tells him he has found honest, hard-working, frugal, unpretentious people. “We're active managers,” he says. “The site visit allows us to have more conviction. That

confidence lets us take bigger positions.”

In 2004, Kilmer visited a consumer health care products company in Minnesota with good numbers. The company was located in a nondescript warehouse-type building. Staffing was lean. He was struck by how polite and friendly the employees were and how genuine and intelligent the leaders seemed. “Culture is very important when we're investing in companies long term,” he explains. “You want to make sure that you're investing in companies that have healthy cultures and foster employee development and that it's a place where people want to come to work.” In this case, “you could tell they were very excited by what they did every day. Earning a paycheck wasn't their primary motivator; they had fun doing what they did.” He went away feeling extremely confident about the long-term outlook for the company. It was a US\$10 stock at the time and was recently acquired for US\$37.50 a share.

In 2001, he visited a high-end commercial office furniture maker in Iowa with strong return on invested capital and a very conservative balance sheet. Despite the company's positioning at the high end of the market, it was very Spartan—

HOW TO MAKE THE MOST OF SITE VISITS

Know Your Objectives

Cindy Sweeting, CFA, isn't looking for short-term guidance. Her focus is on “the strategic positioning of companies over a five-year time frame.” Will the company stick to what it does best? Does it allocate capital judiciously? She uses the visit to assess these and other points that will make a difference in the long-term value of the company.

Francisco Alzuru, CFA, also has a strategic focus. “Tell me why your company is going to be better five years from now than it is today,” he says. To sharpen his forecasting, he also wants to know how sustainable the company thinks its pricing is. The company managers are the ones who know how much competitors are investing in new productive capacity and what effect that will have on prices.

Go Prepared

Before visiting, Chad Kilmer, CFA, reads up on a company—analyst reports, proxy material, earnings call transcripts, and so on. He also talks to sell-side analysts and the company's competitors. “Show the management team that you're knowledgeable about their business,” he says.

“They're going to respect you more and talk to you longer.”

Take a checklist of topics you want to cover, advises Michael Cumming, CFA. You'll be skipping around during the meeting. Checking items off a list helps you get to all the points you meant to cover. Sweeting starts with a generic list of key questions that typically apply.

Cumming confirms arrangements over the phone shortly before the visit to ensure that his plant tours and appointments with field managers are all lined up. Kilmer recommends bringing good maps when you're new in town.

Get Beyond Investor Relations

“It's definitely far more valuable to have a chance to talk to the CEO or the CFO,” Cumming says, “because they're the people who are making the decisions. Investor relations can tell you what they've been told to tell you or what they understand to be the direction of the company, but to get it from the people at the top is really vital.” He also likes to talk to hands-on people out in the field; they give better tours, he believes, than investor relations people. “Talking to the

people who manage the assets gives you a different perspective from the traditional company line,” he says.

Kilmer tries to talk to as many people as he can, including workers on the shop floor and the sales force. They can give you a read on whether the company is excited about what it's doing. He tries to see whether their body language matches what they're saying. “Reading peoples' body language is an art,” he says. “The people who are good at picking up non-verbal cues tend to have pretty good investment track records.”

Sweeting is also a strong proponent of talking with field personnel. She was covering a U.K. pharmaceutical company that derived half its revenue and most of its profits from the U.S. and that had been pummeled by sell-side analysts (because they thought that its top-selling pharmaceutical product would be negatively impacted by generic substitution upon patent expiration and because of the company's announcement of higher marketing costs to roll out its own replacement product). Instead of dealing with investor relations in London, she went to Cleveland, in March 2002 to meet with

the furnishings hadn't changed in their humble downtown building in 40 years. The visit allowed him to invest with high conviction at a stock price of US\$20 a share. Its share price exceeds US\$50 today.



BE A DETECTIVE

Another reason to visit is to test the credibility of the company's assertions about itself. Templeton's Sweeting visited a generic drug manufacturer that was told by the U.S. Food and Drug Administration to stop selling a certain product until safety concerns were met. The managers were upbeat in their public pronouncements, saying the situation would soon be corrected. But when she toured the manufacturing facility, Sweeting saw a distinct lack of activity in the production area for the drug in question. It was quiet. She could see that quite a bit of staff had been laid off. "It made me very skeptical about the contention that this issue was going to be resolved soon," she says. If management really believed its own words, manufacturing would have been ramping up and test batches would have been rolling off the assembly line. Instead, inventory canisters date-stamped two years earlier sat gathering dust in a corner. From all these signs, she concluded that management was not sanguine about getting a green light on this drug; they weren't making the necessary preparations to restart manufacturing. Sweeting's instincts turned out to be right, but it was the site visit that gave her the critical information.

the U.S. heads of sales, marketing, and R&D, the people in charge of the company's key product. She found out that no U.K.-based analyst had ever visited these people before and concluded that the negative conclusions in the sell-side reports were unfounded. She recommended buying the company, and it turned out to be a strong investment, tripling in share price over the past four years.

Stay Detached

Some analysts believe the best practice is never to interact with corporate managers because analysts who establish relationships are too easily swayed by management. Kilmer disagrees: "If these are going to be the people that you're putting your shareholders' capital to work with, wouldn't you want to get to know them and see what makes them tick?" As a long-term investor, he definitely is trying to establish a relationship. This way, he gets his phone calls returned and an early heads-up when their tone or demeanor changes.

He acknowledges, however, that "all management teams to some extent are trying to promote their company, so

they're usually going to paint a rosy picture." The antidote? "Walk in there, take off your rose-colored glasses, and be a healthy skeptic." Or as Sweeting puts it, "Don't drink the Kool-Aid."

Kilmer also maintains objectivity by setting price targets. When the company reaches its target price, he trims or sells his position. The practice of selling or trimming stocks that have reached estimated fair value is an everyday occurrence "whether we love the management team or not," he says. Alzuru takes the same approach and has no problem telling managers that he will sell a position when a target or stop has been reached.

Understand the Cultural Context

When visiting companies in foreign countries, Cumming recommends that analysts who don't speak the local language have their own translator accompany them. He recalls a meeting in China conducted in Chinese. The company made a translator available, but for Cumming, having his own Asian colleagues with him "helped ensure that my questions were asked the way that I wanted them and my

analyst could help me get any language cues or other sort of hidden information beyond what was said."

If you don't have the context, you can easily misinterpret the information you are receiving. Alzuru had a meeting at 1 p.m. at a petrochemical/plastics manufacturer in Taiwan. Arriving 15 minutes early, he went to the second floor where the meeting was to take place. "As we walk in the door, the entire floor is dark and every single employee is with his or her feet on the desk, sleeping," he remembers. "At 1, somebody turned the lights on and everybody went to work." This was not at all strange to the Venezuelan-born Alzuru, who watched his father take a 10-minute siesta every afternoon before going back to work. Nor were the bottles of wine he saw on every table in a steel mill cafeteria in Italy any cause for concern. In other cultures, he explains, "you can have a beer or a shot of whiskey at lunch and nobody would even think of questioning it."

“Be a detective” is her advice. Before every visit, she asks herself, “How can I uncover things that management really doesn’t want me to know?”

Alzuru finds site visits helpful also in assessing whether management statements are credible. Before asking clients to invest in emerging market companies, he goes to “kick the tires—see if the headquarters are where they say they are, if the stores exist, if the plant exists,” he says.

Credibility problems are not confined to emerging markets. Alzuru began visiting a large retail bank in the United Kingdom in 1998 where the managers always had an excuse for low earnings and dwindling market share. The investor relations representative “was very skillful at presenting the story in a way that made me give them the benefit of the doubt,” Alzuru says. But after three years of hearing lame

excuses, he figured there must be better investments elsewhere. He would not have picked up on the company’s fancy dancing and dissembling had he not consistently visited the company once a year, he says.

GREAT EXPECTATIONS

The experiences of these and other analysts cannot be denied. There are times when company site visits provide valuable information. “If done thoughtfully and well, when you’ve already identified the key issues,” says Sweeting, “you can uncover some interesting conclusions and observations.” But, she cautions, “site visits are just one piece of the puzzle. They’ll never solve the investment case for you.”

Christopher Wright is a freelance writer and the author of an investment newsletter in Arlington, Virginia.

SITE VISITS AND STANDARDS OF PRACTICE

Wined, Dined, and Brought Inside

Suppose you’re an analyst in Country A and you are invited to visit a company listed in Country A but located in Country B. They’ll fly you overseas at their expense, put you up at a hotel, and treat you to world-class golf while you’re there. You know that refusing the invitation would be tantamount to accusing them of bribery in their culture, so you accept. At dinner overlooking the golf course, they tell you they want you to be the first to know that they have completely straightened out their plant operations and they expect efficiency gains to hit the bottom line in the future. When you get back, you discuss the operational gains in a note to clients and trade in the stock. Are you on ethical *terra firma*, or is the ground shifting beneath your feet?

Even if the countries involved do not have insider-trading rules, CFA charterholders are still bound by Standard of Practice II(A) regarding material nonpublic information. “If analysts come into possession of some inside information, they’re basically locked down—they can’t act on that or cause others to act on it,” says Jonathan Boersma, CFA, standards of practice director at the CFA Institute Centre for Financial Market Integrity

There are rules in some countries against the selective disclosure of material nonpublic information to analysts (e.g., SEC Regulation FD [Fair Disclosure] in the U.S.; FSA Conduct of Business Sourcebook at MAR 1.4 in the U.K.). Analysts must first decide whether information gained in a site visit is “material.” In other words, explains Boersma, “Would it likely have an impact on the valuation or stock price or cause somebody to trade?” If so, the question becomes whether the information is currently “nonpublic.” If the answer to both questions is yes, the CFA Institute Centre advises analysts to alert the company that a selective disclosure issue exists and encourage the company to disclose the information to the public in a simultaneous press release or some other way.

Are operational improvements “material”? Beyond earnings guidance, profit margins, and acquisitions, the question of materiality gets murky. “If you have any doubt in your mind whether it’s material,” says Chad Kilmer, CFA, “talk to your compliance department and don’t act on it until they say you can.”

Gifts and Other Perks

Gifts, accommodations, meals, and entertainment are judgment calls, according to Boersma. Under CFA Institute Standards of Professional Conduct I(B), charterholders must use reasonable care and judgment in maintaining their independence and objectivity.

Generally, accepting air fare from a company would be unethical. An exception would be a chartered flight that is the only way to get to, say, a remote mining operation. With regard to gifts, the CFA Institute rule limiting gifts to US\$100 has been eliminated; charterholders must now consider whether a reasonable person would conclude that a proposed gift compromises the analyst’s independence and objectivity. Boersma points out that a particular sum of money, such as the old standard of US\$100, means more in some countries than in others.

Analysts and their firms that want to avoid even the appearance of impropriety will reimburse the company for meals and pay for that round of golf. If refusing hospitality is not practical for cultural or other reasons, gifts, meals, and the like should be disclosed so that employers and investors can judge the analyst’s objectivity for themselves. For further guidance, see Example 1 on page 20 in the current Standards of Practice Handbook (ninth edition, 2005).