Ideas @ Edelweiss Multi Strategy Funds – Quality Traps

Recently, the Indian financial media has had a lot of debate whether there is a bubble in quality stocks - equity of businesses with high return on equity and return on invested capital and whether there is a limit on the price markets are willing to pay for greatness. The concept of a value trap has been widely studied over the years, in this month's Ideas @ Edelweiss Multi Strategy Funds we discuss how to think about a related situation - the Quality Trap.

A quality trap is a business with a high return on equity or return on invested capital but one which lacks growth. These businesses generate steady free cash flow but do not scale because of a limited size of opportunity, lack of entrepreneurial ambition or business constraints. Contrary, to the value trap which is a worthless investment, a quality trap can still be a good investment because of its positive economic value added (ROIC>WACC). In fact, if you survey the universe of all private and public investments you will find the landscape littered with quality traps: firms that are highly dependent on a few skilled individuals (e.g. law firms, super-specialty medical practices), family enterprises that are involved in trade related arbitrage like import-export of commodity goods or small and medium businesses that dominate geographical or product niches like your local grocer.

Quality traps are wonderful businesses to run as a promoter but are usually terrible for minority shareholders. The best example of how a quality trap can be a great investment is Warren Buffett's purchase of See's Candy in 1972 for $25MM when its net profit was $4.2MM. Four decades on, See's only earns $82MM of net profit - pedestrian growth by any measure but has generated a cumulative net profit of $1.65BN which Berkshire Hathaway has been critically been able to use to fund other ventures in its empire. It has only been able to harness See's incredible earning power because it owned the company outright and prevented it from accumulating cash on its balance sheet. The main risks in a quality trap are the death/exit of a talented founder, family disputes or disruption from the organized sector (e.g. from e-commerce aggregators that eliminate the problem of long-tail distribution).

Since quality traps have the characteristic of a bond, the right valuation metric to use is P/B not P/E because a discounted cash-flow analysis reduces to fixed income analysis. Another way to phrase this is that bonds are valued on a premium/discount to par value (P/B) not as a ratio of the coupon (P/E). This allows an investor to frame an appropriate margin of safety on an interesting investment class.