The Importance of Quality

At Pacific Ridge Capital Partners (PRCP), *we invest at the intersection of Valuation and Quality*. This is a fundamental part of the value/contrarian investment philosophy that guides the management of our Small Cap Value and Micro Cap Value strategies.

For many years, we have used a scatterplot diagram in our presentation materials depicting the broad Russell 2000 universe (see Figure A). On the vertical axis, we use total enterprise value (TEV) to sales as a measurement of Valuation, demonstrating what the market is willing to pay for each dollar of sales a company generates. The horizontal axis charts operating margin, as a measure of Quality. Operating margin is also known as EBIT%, or the earnings of a company before interest and taxes, divided by sales.

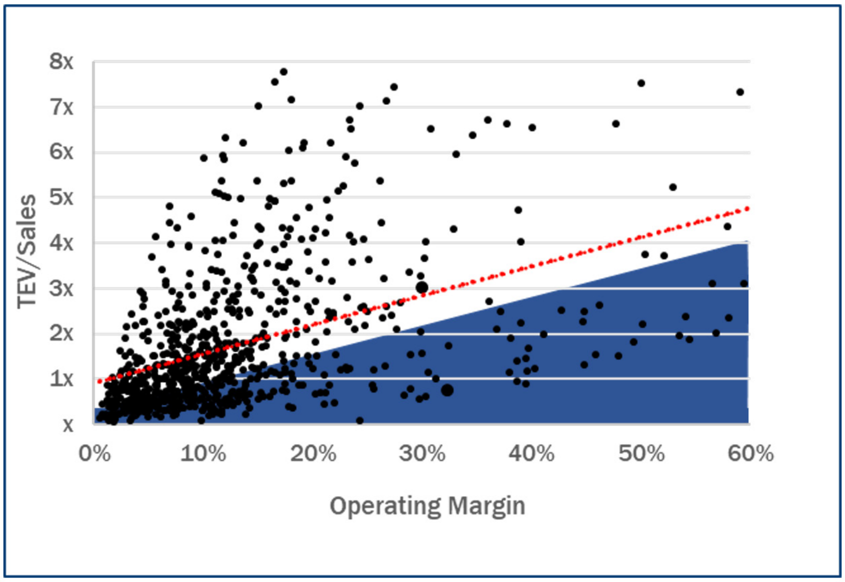

Figure A

Over the years, we have shared the importance and methodology of our Valuation work. (See our previous commentary letters [Defining Value]() and [Investment Philosophy]()). In this commentary, we want to focus on Quality and how it factors into our investment decisions.

While profitability is the simplest *measure* of Quality, we have spent considerable time over the years thinking about the *elements* of Quality. Though we have a long list of items that make up the "Quality Checklist" that we utilize during our due diligence process, we can reduce them down to four key elements.

Element 1: Cash Flow Generating Ability

Any asset is worth the cash flow it will generate over time, discounted appropriately back to today's value. Cash flow can be variable over time, based on factors like changes in working capital or investment in capital expenditures. We focus on return on invested capital (ROIC) and favor companies that generate returns in excess of their cost of capital. Companies that do this create positive economic value and generate cash flow. Although we use other measures of profitability in our modeling, differences in accounting treatment across companies and over time can diminish the objectivity of the analysis. To us, what ultimately matters is cash flow.

Element 2: Balance Sheet

A company's balance sheet is a key determinant of risk and has a direct impact on Quality. As equity investors, we know that we are subordinate to debtholders' claims on the value of a company. Having little or no debt and excess cash minimizes risk, while providing flexibility. For companies with debt balances, we study the following key factors in our evaluation.

- Interest Coverage. Reducing net income available to equity holders.
- Debt Coverage. The amount of debt relative to expected cash flow. This helps us judge a company's ability to pay down the debt over time.
- Maturity. The timing and flexibility a company has to pay off debt, or its ability to refinance the debt if the need arises.

Element 3: Competitive Position

Monopolies or broad market dominance are rare. Almost all companies operate in a competitive environment, so understanding their competitive position is key. Factors we focus on include:

- Absolute level and trends in market share.
- Consistency, stability and predictability of sales and expenses.
- Differentiation or uniqueness of products or services.
- Ability to identify and compete in a specific niche.
- Strength of brands or franchises, either broadly or regionally (if applicable).
- Threats from potential new competitors, product obsolescence or key input disruptions.

Element 4: Management

Good management teams have a clear strategic vision that they can articulate and execute. We look for substance and details, versus a glitzy presentation. In assessing the ability to execute, we consider the following:

- A track record of success, either at previous companies or in pre-CEO/CFO roles.
- Demonstrated leadership strength, including potency at key roles below the CEO/CFO level.
- Ability to meet quantitative or qualitative milestones.
- An aptitude to understand and articulate ROIC and balance sheet.
- Communicate and discuss risk factors beyond boilerplate language from filings.
- Appropriate governance factors, such as a strong board, insider ownership and capital allocation decision making.

As is the case with Valuation, our assessment of Quality is multifaceted and relies on our judgement, informed by our decades of experience. While cash flow and balance sheet elements skew towards the quantitative side, competitive and management factors are more qualitative in nature. Having a clear understanding of the factors that make up Quality is of the utmost importance, given that we *invest at the intersection of Valuation and Quality*.

Opportunities Arise From Different Views on Quality

We often hear about "quality stocks" (as opposed to quality companies) or a "quality-driven market" (that is, a rally or a sell-off). First, we suspect that there are many different definitions used by market participants to define the term "quality." Second, the focus of these "quality" conversations is often on the stock or the market.

This creates a lot of noise among the thousands of companies in the small- and micro-cap US equity universe—and a significant opportunity for us. At PRCP, we have a very clear definition of Quality, as outlined in this document. Our focus is not on the stock or the market, but on the company itself. This allows us to find companies at attractive valuations that the market often misses. Whether or not the stock proves to be a good investment over time is a function of the price we pay and the accuracy of our assessment of Quality. However, having a strong definition of Quality and clarity of how we apply its measurement gives us a distinctive advantage when making an investment decision.

In Summary

At PRCP, we spend our time looking for a disconnect between how the market views a company on a Quality and Valuation basis, versus how we view them. When we say that we invest at the intersection of Valuation and Quality, the key word is *invest*. Because we are long-term minded, patient and disciplined investors, we are doing far more than simply buying shares of a public company. We invest the time and resources necessary as if we are buying the entire company, with the intention of holding it indefinitely until presented with an attractive valuation exit point. That is why we put such a strong emphasis on Quality. In concert with Value, Quality helps us determine which companies conform to our investment philosophy, and ultimately which investments are best for our strategies.

Sincerely,

Pacific Ridge Capital Partners