



WHAT WE LOOK FOR WHEN VISITING A COMPANY

If you have read any of our past letters, then you know how much we emphasize the criteria we use to select businesses for investment. We are constantly looking for leadership teams and cultures that exhibit:

1. Humility, Integrity, Trust
2. Long-Term Focus
3. Purpose and Passion
4. Teamwork – Cooperation, Not Competition
5. Employee Empowerment – Driving Fear Out of the Organization
6. Disciplined Capital Allocation

And you probably know that we spend a lot of time traveling to our companies (and a variety of other companies as well) learning about how these cultural principles show up in the operations of these businesses. One question we get a lot is: “What exactly are you looking for when you visit a company?” We’ll try to answer that question in this letter.

Running (and growing) a business is an endless series of problem-solving. Our criteria are designed to help us identify tools/skills/techniques/assets that companies are using to solve problems continuously in an innovative and evolutionary way. Here is a more detailed list of some of those assets (from our criteria):

- Humility
- Integrity
- Trust
- Long-term focus
- Purpose
- Passion
- Teamwork: Cooperation, not competition
- Teamwork: Information flow and removal of barriers
- Employee empowerment: Push decision making authority to value-added workers
- Employee empowerment: Culture of impunity
- Safety (physical and psychological)

For example, if a company’s leaders exhibit and help spread humility, then the company is much more likely to (i) embrace mistakes as learning opportunities, (ii) actively try to find and overcome problems, (iii) listen to customers in order to provide more customer value, (iv) create more functional work environments and project teams, and (v) innovate more rapidly and creatively. All of these outcomes are positive markers for sustained compounding over the long term.

To take the second bullet point (Integrity) as another example, if a company demonstrates high integrity, then its leaders and employees will exhibit the company values and principles in their day-to-day activities. This results in (i) higher customer and employee satisfaction and confidence, (ii) better adherence to the company’s principles, (iii) strategic initiatives that drive long-term success, and a corporate structure and systems designed to achieve that success, (iv) better leadership development, and (v) more consistent and teachable problem-solving. Again, we believe all of these outcomes are markers for future compounding.

And we could give many examples for every bullet point on the list above. Call us or drop by our office if you want to hear more, as we love to chat about this stuff!

When you are a “buy side analyst”¹ visiting one of our publicly traded companies, you are typically greeted by one or more C-level managers (CEO, CFO, or maybe the Chief Operations Officer, COO) as well as a representative from the “investor relations” team. They sit down with you at a conference room table and hand you a glossy binder with a slick presentation about current profitability, their newest products, and strategic initiatives to gain market share. We experience this all the time and we appreciate the information. But, often to their surprise, we explain that we are really there to discuss their culture.

“We invest in purpose-driven companies,” we say, “that empower all of their employees to solve problems and make decisions and give them all of the tools and information they need to continually create more and more value for customers in furtherance of that purpose.” We go on to say that if the culture is right, we believe that this employee-led progress toward value-driven purpose can help the company continually increase customer loyalty, increase market share, and enjoy greater pricing power. So, if we recognize a great culture, we feel that we can predict years of compounding cash flows. We describe what we are looking for when we analyze management and culture. We talk about our interest in servant leadership, the native genius in every employee, cultivating trust, emphasizing workers’ fulfillment, and fostering the next generation of leadership.

When they hear us emphasize these ideas, the company’s leaders often light up and we typically end up having a dynamic, earnest conversation about the topics that they really WANT to discuss. Often, our 30-minute meeting time extends for a couple hours, as these busy executives get the rare opportunity to explain to an interested outsider their leadership and cultural philosophy, highlight successes and gratifying moments, and discuss failures and difficulties. By the way, if they don’t light up, if they are not excited about these principles, then we have a good idea that they aren’t a good match.

¹ This can be an investor, which may already own or be considering buying shares of the company, or it might be an analyst working for a financial institution that gets paid to analyze and write reports for investors and advisors in that institution so that they can make decisions about whether and how this company may fit into their investment portfolio.

Usually, we will tour the factory floor after our meeting with leadership. It is not uncommon for the company leaders to clear their schedule and join us on the tour, beaming like proud parents as their floor-level employees repeatedly demonstrate their teamwork, initiative and accountability, and problem-solving skills. What specifically are we looking for on these visits? Here are some examples:

Integrity – Are the company’s values prominently displayed? Do the front-line workers know these values? Is it clear that they and their managers act in accordance with these values?

Trust – Are there security measures in place that indicate management doesn’t trust employees? For example, is inventory locked up? Do workers need to ask for permission to use the restroom? Do managers trust employees to lead our plant tour? Or to talk with us about problem-solving processes?

Purpose – Can we identify the company’s purpose? Are the company’s strategies linked to the purpose? Can management articulate the purpose? Is it visible in the facility? Is it clearly linked to the tasks being performed on the floor? When we talk to employees, are all levels excited about or engaged with the purpose?

Passion – Do the front-line employees talk about the purpose? If we ask an operator how her task fits into the company’s business, does she relate her task to the value provided to customers? Or does she not know how her contribution fits into the bigger picture? Is there a sense of pride in her workmanship or her problem-solving processes?

Employee empowerment – Are there clear mechanisms for employees to solve problems as they arise? Are there visual management systems that allow employees to see whether they are “winning” or “losing” in real time? Are managers exhibiting servant leadership by supporting employees in adding value or in problem-solving? Or is problem-solving only done at the direction of the “boss”?

Cooperation – What mechanisms for communication exist amongst team members and between different teams or departments? How often do folks participate in “cross-functional” teams? How do managers and their employees talk to each other? How much do front-line workers participate/speak in standup meetings, huddles, or pre-shift meetings? Are bonuses or other compensation or privileges provided based on individual performance or team performance?

Humility – Is there evidence of CEO and management humility? Do managers listen to line-workers? Are there systems in place to try to identify problems? Or are the systems designed to cover up problems or provide “work-arounds” that make the task easier to accomplish in the event of a problem (thus avoiding having to face and solve the problem)? Are there diversity and inclusivity initiatives?

These meetings and tours are really fun for us, but they require high levels of concentration throughout. We spend a lot of mental energy trying to learn as much as we can about how the organization approaches communication, training (and cross-training), team formation, research and development, communication, visual management, compensation and incentives, strategy creation and deployment, and development and promotion. We are constantly trying to determine the company’s levels of trust, humility, integrity, purpose, passion, teamwork, empowerment, and safety. These qualitative markers are often difficult to determine with confidence and accuracy. There are countless examples of ambiguous (or even counterintuitive) features of a company’s culture. For instance, one of our CFOs told us during a recent factory tour that the company wants to add another hundred middle managers in their production team. In theory, this might be concerning for us, because more middle managers could mean (i) more bureaucracy, or (ii) less authority and empowerment for front-line decisionmakers, or (iii) more difficulty creating efficient information flow. But in this case, the company wants to add middle managers in order to add mentors to provide MORE authority and empowerment for front-line workers, while at the same time developing more problem-solving skills and providing MORE information for front-line workers. In this case, our take-away was that this move could help foster the employee-led improvement that we are looking for. We’ve been visiting this company since 1997, and we have seen their philosophy produce huge gains in this area.

Most investors are looking for some advantage that will help them predict next quarter’s numbers or some other short-term insight or shortcut. But we are looking for long-term insights; information that we think will help us predict whether a culture will create compounding for decades to come. We visit many companies that are on our radar or in our portfolio, and we also visit many companies that are not in order to learn from as many companies as possible and to compare as many cultures as possible. We believe we can take the same publicly available information and interpret it differently than most other investors. By trying to determine whether and to what extent a company is using our criteria principles in a way that predicts long-term compounding, we make an otherwise routine factory tour and investor meeting into a highly informative learning opportunity. And it’s one that we happen to enjoy a whole lot as well!

As always, please call us at (406)541-0130 if you have any questions.

Thank you from Russ and the Front Street Capital Management Team!



Russ, Michele, Ginger, Jeremy, and Dominic

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