THE LEAN ADVANTAGE

Our criteria for selecting companies for long-term investment is based upon the work of W. Edwards Deming. Deming is one of the "fathers" of lean production, in both Japan and in the US. The Toyota Production System and the Total Quality Management (TQM) movement that gained traction in Japan after World War II and started working its way to the United States in the 1980's is based in no small part on Deming's work on quality by focusing on management. I was introduced to Deming's work in 1988, and I developed a criteria for investing in companies who can compound over the long-term using the components of his philosophy:

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

We have been committed to these criteria since then and have been consumed with, passionate about, and fascinated to learn about every aspect of creating great corporate cultures based on these criteria. The objective is to energize employees at every level to engage and continuously learn while simultaneously breaking down barriers across the organization. Then learning is shared and compounded exponentially and indefinitely into the future. This is what we call "the Deming philosophy." As our Deming-influenced principles have evolved over the past thirty-six years, we have tried to stay at the forefront of this movement while simultaneously staying true to the human element of its philosophy, which we believe is the core of its enduring success. We believe human nature is the one constant in an ever-changing world.

In the United States, the most successful practitioners of the Deming philosophy have perhaps been the brothers Mitch and Steven Rales. In the late 1980's they took a struggling supplier of brake systems for diesel trucks (nicknamed "Jake Brake") and through the adoption of TQM and the Toyota Business System transformed its culture. Then they leveraged that continual improvement culture through one acquisition after another into one of the leading companies in the world under the corporate name Danaher.

As time has gone by, TQM has morphed into what is now referred to as "Lean," although we still believe "TQM" is a better description of the process. There have been many companies over the years that have used the term "TQM" or "Lean" but have been more focused on short-term (often cost cutting) results than on the human motivation that creates the process that eventually leads to sustainable, long-term compounding improvement. Again, our criteria have helped keep us focused on the *human* journey that drives the Lean process, which we feel has served us well.

We believe our work has been improving at an accelerating pace during the past seven years with the addition of Jeremy Brown and Dominic Piazza to our team. Jeremy and Dominic have been traversing not only the United States but the globe during this period, walking manufacturing floors and meeting with both C-Suite and line-level employees to identify companies that are committed to Lean thinking. To truly achieve cultural change, it takes a full-on commitment starting at the top and driving all the way through the organization. The level of commitment is paramount, and Jeremy and Dominic have made significant strides in being able to identify that commitment and distinguish the wheat from the chaff. Recently, Dominic has decided to take his experience and expertise to spread his wings beyond Front Street Capital and Missoula, Montana. We are grateful for the work he has done during the past seven years which we believe has been instrumental in our recent improved performance and our improved capabilities. Because of his and Jeremy's work we believe we are working from a stronger foundation on which we can continue to build indefinitely into the future.

Although we will always be in the early innings of understanding corporate cultures and human motivation, we think our extensive background and ongoing research in this area is unique and works to our advantage as investors. We are constantly upgrading our portfolio to increase the proportion of our favorite Lean practitioners. As we speak, the overwhelming majority of the companies owned in our portfolios identify themselves as Lean. Because of our improving ability to recognize Lean thinking, we are confident that our long-term investment performance will be more than competitive versus the popular averages as our capital compounds at a similar rate that these outstanding underlying companies compound their own capital. In addition, maybe – just maybe – our efforts to upgrade might also smooth out some of the volatility in our portfolio. On top of compounding alongside these outstanding companies, meaningful additional value can be added by identifying attractive entry points to purchase our long-term ownership stakes. We use two primary methods to identify these opportunistic entry points:

First, even the best managed companies will from time to time run into an obstacle beyond their control that will interrupt their free cash flow compounding. Fortunately for us, short- to intermediate-term stock prices are almost exclusively determined by short-term (a) financial results, or (b) macroeconomic events. As a result, a temporary setback in a company's quarterly earnings (or a series of quarterly earnings) can have a significant negative impact on the price of a stock. Hence, an investor can acquire an ownership stake in the long-term free cash flow compounding of the underlying business at a discount. Our ongoing research work enables us not only to identify these opportunities, but also to give us the confidence to act quickly and boldly on your/our behalf when such a situation arises. Being correct on one's assessment of a situation is not enough; one must have the conviction to act aggressively. As Warren Buffett has said: "Predicting the flood doesn't do any good unless you build an arc."

Cognex is a real-time example of an outstanding company (according to our criteria) that we have owned and admired – and that has compounded our capital at meaningful rates – for decades. During the past few years, however, due to circumstances that were beyond their control, their earnings have disappointed investors. Again, we believe this pause in their long-term compounding presents us an opportunity to confidently add to our ownership stake at a compelling valuation.

Second, there are also some rare situations where our background and research work can add even more potential upside to the portfolio. These are situations where a struggling company's board of directors has the insight to make a bold management change in favor of a proven Lean transformation leader. These situations are rare because these transformations can take years to take hold and entail a massive, sweeping mindset that will disrupt every aspect of the company. Boards of directors are not known for accepting responsibility for a messy solution that will be disruptive in the short term, to fix a problem for the long term. Again, our research work is paramount in the process as we need to have the conviction to purchase a meaningful ownership stake in a situation that looks to the rest of the investment community like a disastrous lost cause. These opportunities are so unique that we believe they may only be available but a few times in one's entire investment career. We have been fortunate enough to have had a few. Our first was a TQM transformation in the late 1980's with heavy equipment manufacturer JLG Industries. This was early in my career and our success was more related to good fortune than skill. But it was a valuable learning experience, nonetheless.

More recently, we were able to clearly identify a Lean transformation opportunity when Larry Culp was appointed as General Electric's CEO when the company was thought by most to be on the brink of bankruptcy. Larry led Danaher from 1990- 2005 and in many respects was the architect of the Danaher Business system. Clearly, this was an opportunity that was in the center of our circle of competency (the bull's eye) and we were able to purchase a meaningful position at a compelling valuation. Again, with the work of Jeremy and Dominic, we were able to monitor Larry's cultural transformation, and at each step of the way his actions were nothing short of awe inspiring. Now that the stock has recovered, we just need to make sure the culture is being supported, which in turn should enable us to compound our capital indefinitely into the future alongside the company's ever-compounding free cash flow.

And such an opportunity arose two years ago with a transformational management change at Lumen Technologies, a company we had unfortunately already owned and was a major detractor of our portfolio's performance due to a variety of misfortunes, many of which were self-inflicted. Fortunately, our background and research enabled us to identify that their newly appointed CEO, Kate Johnson, had the background (and more importantly, the courage) to transform the culture of a company that had been written off by investors. Again, as she executed the transformation, we could see her actions fit our playbook to a tee. This enabled us to meaningfully add to our ownership at much lower prices than our previous purchase prices. Although Lumen's stock has recovered somewhat, it is at an earlier stage than General Electric, and hence we are working hard to monitor whether they are continuing to push their cultural transformation forward rather than slide backwards due to fatigue.

Lastly, we have one additional example of a Lean transformation in the portfolio that has yet to be recognized by other investors. The Manitowoc Company was a struggling crane manufacturer that brought in a team, which is now going on seven years, led by one of the original participants in the Jake Brake turnaround decades earlier at Danaher. Jeremy and Dominic have traversed the globe over the past six years, walking every inch of many of Manitowoc's manufacturing facilities, and they have witnessed first-hand that its transformation has been stunning. The Manitowoc Company, like our earlier experience with JLG Industries, serves the highly cyclical heavy equipment industry. Our experience with JLG taught us that, in the near term, regardless of operational improvements that are very visible (and regardless even of improving financials), analysts will not recommend a cyclical stock. That is, until they think they can predict the cycle is turning up. When that occurs, suddenly they all rush in at the same time. It's crazy. The last up cycle for the crane industry was an unprecedented seventeen years ago. In our experience, the longer a cyclical industry stays in a depressed state, the bigger the explosion comes out the other side. We have written before that with a lot of research work and a disciplined process we can be pretty accurate as to "if" something will happen, but we will never know "when." In this case, we have been happily accumulating an ownership stake in Manitowoc for over six years. In fact, this situation has taken so long that the original ex-Danaher transformational leader has since retired and has handed the reins to his young, brilliant protégé Aaron Ravenscroft. Although Aaron is only in his mid-forties, he has a long pedigree with Lean that dates to when he worked for Cliff Ransom (now widely recognized as a leading authority on Lean) as a research analyst covering – you guessed it – JLG Industries. We are excited to partner with young Aaron for decades to come as his Lean journey unfolds.

So, in a nutshell, we believe this is our "Lean Advantage" now and we will enjoy continually improving and learning well into the future. We are grateful you have chosen to join us on this unusual and exciting journey.

Best regards,

On December 31, 2024, the closing share prices of the companies noted in this newsletter were:
Lumen (LUMN) $5.31 / 13.07%, General Electric (GE) $166.79 / 11.21%, Danaher (DHR) $229.55 / 5.32%, Manitowoc (MTW) $9.13 / 7.45%. Oshkosh (OSK) purchased JLG in 2006.

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