

**This is a checklist to try and “kill” an investment before it is made.**

This checklist is based on mistakes great investors such as Warren Buffett, Seth Klarman, Peter Lynch, and many more have made. The checklist focuses on four key elements:

1. Industry and business 2. Management 3. Financials 4. Risk factors

You don't *need* to invest in any specific company. Your goal is to maximize the odds in your favor so that the potential upside is multiples bigger than the downside.

Always remember that if you lose 50% you will now need to earn 100% just to get back to what you already had.

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### **Industry Study 1/2**

- What are the key success factors to superior performance in this industry?
- What is the historic and current rate of success in this industry?
- Is this a growing or a declining industry?
- Define the market opportunity.
- What are the barriers to entry?
- Has there been any consolidation in the industry?
- Is the industry facing competition from other industries?
- How has this industry changed over time?
- What is the relative power of:
  - I. Customers
  - II. Suppliers
  - III. Competitors
  - IV. Regulators

### **Industry Study 2/2**

- Who controls industry pricing? Does the company/sector have any pricing power?
- How (and by how much) can a good company differentiate itself from a bad one in this industry?
- What market share can the company achieve in the long run from the entire market?
- Is the company #1 or #2 in its market? If not, who are? Can the company compete with them?
- Does the company have pricing power over its customers or is its product a commodity?
- What are the industry trends?
- What is the industry's exposure to cyclical markets?
- Does the industry have the ability to pass on price increases?
- What is the volatility of demand from customers?
- Why have competitors failed in this industry?
- What's the market potential size? How much can the company grow in its market?

### **Business Model**

- Do you understand the business? Describe it to a ten-year-old.
- Does the company enjoy economies of scale? Why?
- What is the selling model? Razor/Blades? Services? One-off contracts?
- What are the economics of the base unit? How does it stack up against competitors?
- What is the companies' moat? How sustainable is it? Is it shrinking?
- Why is the company good (or bad) at what it does? How sustainable is it?
- How is the company growing (acquisitions, organic)?
- Analyze the latest acquisitions.
- Did any competitors close and thus help the revenue increase?
- What other macro factors could have contributed to revenue growth?
- Are any of the company's competitors restructuring?
- Will high unemployment or a recession hurt the business?

### **Management & Board of Directors 1/2**

- What was their background before joining the company? Write a detailed chronology.
- Was someone from management or the board ever charged with or convicted of fraud?
- Have they been successful in their past businesses?
- Do they have a longer-term vision for the business?
- Have they shown positive business acumen in operating the business?
- How many years are they with the company?
- How does the management treat its employees?
- Are their interests aligned with shareholders? How?
- Is management actively buying shares?
- How is management compensated? How much of their compensation is tied to performance?

### **Management & Board of Directors 2/2**

- Do they have any family relationships with other key personnel in the company?
- Have they changed how they measure performance in the past?
- Does the CEO make a significant amount more than the rest of the management?
- Does management prediction work? Check if what management said did happen in the following years.
- Is management consistently beating guidance? If so, are they more worried about the stock price than the business?
- How is the corporate governance structured, i.e., do they have measures that help to entrench management to the potential detriment of shareholders (e.g., staggered board, poison pill, golden parachutes, blank check preferred, etc.)?

### **Products**

- Describe the economics of each product the company is selling.
- What are its margins?
- What's the product upgrade cycle?
- Is this product protected by a moat? (pricing, patent, etc.)
- Are the products leased or bought?

## @Shaulkoral Investment Checklist

- For the company to grow will its new products cannibalize its current products?
- Does the company have any new products in the pipeline? When will they start to sell them?
- How will these new products affect the company's numbers on the top and at the bottom?
- Where are we on the product's life cycle (Introduction → Growth → Maturity → Decline)?
- Do the consumers have any complaints about the products? What is the company doing to address them? What is the competition doing to address them?

### Customers

- Who are the company's customers?
- Is there a make-or-break customer?
- How many customers leave the company each year (churn rate)?
- How much does an average customer produce in revenue?
- Is the customer upgrading cycle beginning or ending?
- Do the company customers use their competitors as well?
- Are the company's customers financially strong?
- How much of the projected sales for the coming years are from existing customers and how much from new ones?

### Suppliers

- Who are their suppliers?
- Is there a make-or-break supplier?
- Are the company's suppliers financially strong?
- How long has the company been working with its suppliers?
- Do the company suppliers supply their competitors as well?

### Strategic Partnerships

- Does the company have any strategic partnerships?
- How dependent is the company on these partnerships?
- How dependent is the counterparty on these partnerships?
- Does the company own a minority or majority ownership in these partnerships?

### Capital Allocation

- Is the company's growth organic or M&A based?
- How is management allocating capital:
  - I. Reinvesting the capital back in the business into new projects.
  - II. Holding cash on the balance sheet.
  - III. Paying dividends.
  - IV. Buying back stock.
  - V. Making acquisitions.

### Competitors

- Who are the company's competitors?
- Is the number of competitors growing or shrinking?
- Are the company's competitors bigger or smaller than the company?
- How does the company compare to its competitors on financial and performance metrics?

- What is the biggest threat to the company from its competitors?
- If you were a competitor how would you attack the company? Write a plan of attack.

### Balance Sheet 1/2

- What is the company's capital structure and how does it compare with its peers?
- How much leverage does the company have?
- Are the loans recourse or non-recourse?
- What are the liens over the company's assets?
- How much of the company's debt is to bondholders and how much is to banks?
- What is the purpose of the debt?
- Is the company using rapid Depreciation/Amortization?
- Break down inventory by category.
- How is inventory handled? (FIFO or LIFO).
- What are the A/R and A/P turnover ratios?
- How much is the company keeping for receivable allowances?

### Balance Sheet 2/2

- Share structure and dilution:
  - I. How many stock options/restricted units/warrants does the company have?
  - II. How are they diluting the current shareholder base?
  - III. By how much?
  - IV. Are there different classes of shares? If yes, why?
  - V. What are the voting rights of the classes?

Check for off-balance sheet items ("*Commitment and Contingencies*"):

- I. Loans.
- II. Warranties.
- III. Purchase contracts.
- IV. Pensions. Are they fully funded or in a deficit?
- V. Operating Leases (usually are off-balance sheet debt, add back to balance sheet). As a rule of thumb multiply one year's rental expense by seven.

### Sales and Earnings

- What has been the growth for the last 3, 5, and 10 years?
  - I. Sales.
  - II. COGS.
  - III. SG&A.
  - IV. Depreciation.
  - V. Other operating costs.
- What are the current and historical gross, operating, and net margins?
- How volatile are gross, operating, and net margins?
- Have there been any extra items in the income statement?
- How frequent are these items?

### **Liquidity**

- What are the coverage ratios on interest payments?
- What is the current ratio?
- What is the quick ratio?
- What is the working capital ratio?

### **Cash Flow**

- How does operating cash flow compare to net income?
- How do capital expenditures compare to depreciation?
- Have there been any one-time items that had a big impact on operating cash flow?
- What are the company's capital requirements and cash flow characteristics?
- Are the sales and cash flow of the business sustainable or overstated/understated due to boom or bust conditions?
- Is free cash flow enhanced from temporary tailwinds?
- Is the business sustaining itself (through operating working capital) or does it need to raise cash (through issuing bonds or stock) to operate? How often?
- Is the company factoring its receivables?

### **Shareholders**

- Does the company have significant shareholders?
- How much of the company do insiders own?
- How much of the company do institutions own?
- Is there an activist involved?
- Do any shareholders have holdings in other parts of the capital structure (preferred stock etc.)?

### **Debt**

- Remember that debt holders are first in line to the assets of the company.
- How much of the company's debt is to banks and how much to bondholders?
- What are the covenants on its loans?
- At what price is the debt trading?
- Is the debt rated?

### **Shenanigans**

- How is the company recognizing sales (end customer or distributor)?
- Is the company under or over-stating operating expenses? Is it capitalizing expenses (and thus driving short-term earnings up) when it should be expensing them?
- Did the company extend the useful life of an asset to reduce depreciation expense?
- Did the company change its depreciation method?
- Are there any "*liability reserves*" in the footnotes?
- Is the company using "*cookie jar*" accounting?

### **Risks**

- What are the big unknowns? How much can the company control/influence these risks?
- What could cause this investment to be a total disaster? How bad could it get?
- Is the company currently involved in significant lawsuits?
- Does the company have these operational risks:
  - I. Overcapacity.
  - II. Commoditization.
  - III. Deregulation.
  - IV. Increased power among suppliers.
  - V. Shifts in technology.
  - VI. Changes in laws and regulations.
  - VII. Product obsolescence.
  - VIII. Patent expirations.
  - IX. Development of new product lines where the business has limited expertise.
  - X. The emergence of competitors.
  - XI. Brand erosion.
  - XII. Overreliance on too few customers.
  - XIII. Limited geographic distribution.
  - XIV. Research and development failure.
  - XV. Business- development failure.
  - XVI. Merger or acquisition failure.
  - XVII. A weak product pipeline.

### **Performance Metrics**

- What is their Return on Invested Capital?
- What is their Cash Conversion Cycle?

### **Valuation**

- There are three main valuation techniques:
  - I. DCF analysis
  - II. Comparable analysis
  - III. Historical transactions.
- Is this business priced at a discount to its fair value?
- If this was a private company would I be willing to buy it all?
- Are the earnings at a trough, mid-cycle, or peak?
- Can I buy a cheaper investment with comparable quality?
- Am I feeling greedy or fearful right now?
- If the market closes tomorrow for the next 5 years, will I be happy being invested?