

Management, Governance & Capital Allocation

BEN CLAREMON

PRINCIPAL & PORTFOLIO MANAGER

COVE STREET CAPITAL

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Cove Street Capital...at a glance

- Cove Street Capital ("CSC") is an LA-based, SEC-registered investment adviser founded in 2011
 - 100% employee owned
 - ~\$700 million under management
- Concentrated, Small/SMID Cap value focus
 - Business, Value, People
- Talent-dense analytical team
 - Jeff Bronchick, CFA
 - Eugene Robin, CFA
 - Ben Claremon
 - Principal and Portfolio Manager
 - Andrew Leaf
- <http://covestreetcapital.com/>



Presenter Biography

► Ben Claremon

Ben Claremon joined Cove Street in 2011 as a research analyst. He also serves as a Co-Portfolio Manager for our Classic Value | Small Cap Plus strategy. Previously he worked as an equity analyst on both the long and the short side for hedge funds Blue Ram Capital and Right Wall Capital in New York. Prior to that, he spent four years with a family commercial real estate finance and management business. Mr. Claremon was also the proprietor of the value investing blog, The Inoculated Investor. He is now the host of the Compounders podcast. His background includes an MBA from the UCLA Anderson School of Management and a BS in Economics from the University of Pennsylvania's Wharton School.



Investment Philosophy

- Classic fundamental, research-driven value investing
- Concentrate on best ideas
- Think and act long-term
 - Mathematics of compounding
 - Less is more
- Key investment questions:
 - Is this a high return company that is getting more valuable each day?
 - Is this company run by honest people who understand capital allocation?
 - Is the stock undervalued based on conservative assumptions about the future?

Poll #1

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- ▶ **Have you ever read a proxy statement (form DEF14A) before taking this class?**
 - ▶ A) Yes
 - ▶ B) No

Reading/Viewing Materials Provided

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- ▶ SNBR Proxy
- ▶ SKX Proxy
 - ▶ Anyone want to share what their first experience was like reading through a proxy statement?
- ▶ Interview with Ben Claremon:
<https://www.youtube.com/watch?v=lirBilAUyhU>

Topics to Cover

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- ▶ Who manages the company really matters
- ▶ Why capital allocation is so important
- ▶ Framework for assessing company management
- ▶ The purpose of the proxy statement
- ▶ Important proxy contents
- ▶ Company case studies (SKX and SNBR)
 - ▶ Student break out session
- ▶ Practical investment applications

Why this topic is important to YOU?

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- ▶ Every organization is made up of people—so what could possibly matter more than recognizing their importance?
- ▶ Understanding people, their incentives, and the reason for their actions will be very useful no matter your career choice
- ▶ If you do choose a career in investment management, your ability to pick good stocks or successful managers will be highly dependent on the integrity, acumen, and motivations of the people with whom you partner
- ▶ If you develop a framework for assessing company management teams and boards early in your career, you may be able to distinguish yourself from other job seekers and investors
- ▶ Don't take it from me: the best investors in the world are focused on people as well (see next slide)

2 quotes from Warren Buffett

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- ▶ "I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."
- ▶ "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."
- ▶ Does this mean management doesn't matter?
 - ▶ No! It is hard to find a true compounder that doesn't have really good management

Why capital allocation is important

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- ▶ What do we mean by capital allocation?
- ▶ Avenues for allocating capital
 - ▶ Organic growth
 - ▶ CAPEX
 - ▶ R&D
 - ▶ Dividends/buybacks
 - ▶ M&A
- ▶ How to assess capital allocation prowess
 - ▶ Not always easy: qualitative and quantitative
- ▶ First thing to know: very few things matter more than capital allocation



Who are some good capital allocators—and why?

Cove Street's "Proprietary" Management Assessment Framework

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- ▶ Compensation & proxy statement analysis
- ▶ Scrutinizing prior M&A
- ▶ Buyback and dividend policies
- ▶ Tracking management objectives (TMO)
- ▶ Does management talk the talk?
- ▶ Insider transactions
- ▶ What has the stock done?

Cove Street's Management Assessment Framework (cont.)

- ▶ Now, the hard aspects to assess:
 - ▶ Integrity of management
 - ▶ True motivations
 - ▶ Relationship with the Board
 - ▶ True skillset(s)
 - ▶ Willingness to stay in the role
- ▶ Feel free to use this presentation as a checklist when you first approach a potential investment
- ▶ **Just because it is hard doesn't mean you can ignore it!**

Don't be like this guy!

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Compensation & proxy statement analysis

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- ▶ We will get into this in much more detail, but:
 - ▶ Proxy helps you understand motivations & incentives
 - ▶ Compensation levels & targets can tell you a lot about the company & Board
 - ▶ Is management aligned with you as a shareholder?

Poll #2

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- ▶ A company makes the announcement that is it making a large, transformational acquisitions. What should your reaction be?
 - ▶ A) Great, now the company can grow more!
 - ▶ B) While I am not sure about the price and the strategic rationale, no need to worry because M&A is almost always a good thing
 - ▶ C) Uh-oh. This may not be good for existing shareholders.

Scrutinizing prior M&A

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- ▶ Look at all deals done during time the CEO was in that role & working for the company
 - ▶ What has happened to free cash flow (FCF)?
 - ▶ Trends in ROIC
 - ▶ Margin changes
 - ▶ Revenue diversification
 - ▶ Synergy capture results
 - ▶ Size and type of deals: bolt-ons, tuck-ins, “transformational” deals
 - ▶ Organic growth as well?
 - ▶ Stated multiples paid
 - ▶ Divestitures are important as well
- ▶ Remember: empirical data says most M&A = value destroying for buyers

Mike Mauboussin on M&A

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- ▶ “Alfred Rappaport, a professor emeritus at the Kellogg School of Management, and Mark Sirower, a principal with Deloitte Consulting, explain why creating value through M&A is so challenging for a buyer. First, if the premium is too large the buyer cannot recoup its investment even if the deal makes strategic sense. Second, often competitors can replicate the benefits of a deal or take advantage of the buyer’s lack of focus as it goes through an integration process. Third, M&A requires payment up front for benefits down the road. This makes investors legitimately skeptical. Finally, M&A deals are generally costly to reverse.”
- ▶ <https://www.valuwalk.com/2017/03/mauboussin-buy-not-buy-checklist-assessing-mergers-acquisitions/>

Buyback and dividend policies

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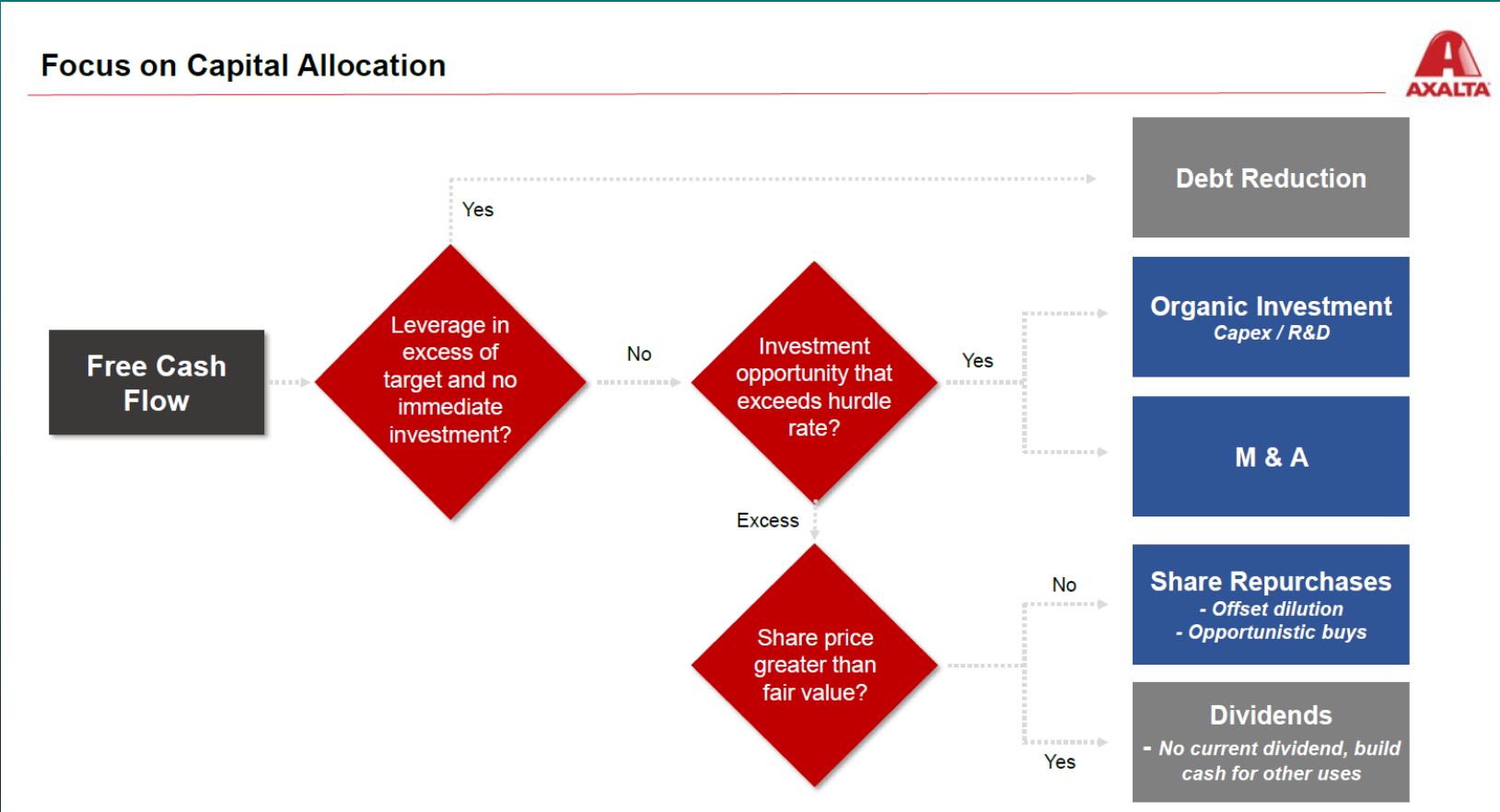
- ▶ Buybacks
 - ▶ Size of authorization
 - ▶ Policy/strategy
 - ▶ Mechanical or opportunistic?
 - ▶ Used to offset option dilution
 - ▶ Use of a grid
 - ▶ Does management buy more on the way down (or up)?
 - ▶ Execution of buyback: value additive or destroying?
 - ▶ The tyranny of the share buyback

Buyback and dividend policies (cont.)

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- ▶ Dividends
 - ▶ Policy
 - ▶ History
 - ▶ Articulation of why dividend versus buyback
 - ▶ Cut the dividend in times of stress?
 - ▶ Dividend in relation to strength of balance sheet

Example of a good capital allocation framework: AXTA



Source: AXTA filings and presentations

Does management talk the talk?

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- ▶ A lot of times CEOs don't even know what is important to shareholders
- ▶ Do they even use the buzzwords?
 - ▶ Return on invested capital
 - ▶ Creating shareholder value
 - ▶ Hurdle rate for investment
 - ▶ M&A discipline
 - ▶ Long-term
 - ▶ Divesting non-core businesses
- ▶ Is compensation tied to any of the above?
- ▶ Do their actions match what they say?
 - ▶ Gets back to TMO

Tracking Management Objectives

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▶ What you want:

- ▶ Clearly defined objectives with some time horizon provided
- ▶ Management teams and Boards who do not move the goalposts when objectives are not met
- ▶ Compensation tied specifically to the stated goals

▶ What you don't want:

- ▶ Easy to achieve goals that require little improvement
- ▶ Management constantly changing what the company is targeting to achieve
- ▶ No accountability when goals are not met
- ▶ Management teams that receive full bonuses despite missing targets

Recent quote from JPM CEO Jamie Dimon

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“We don't know what's going to happen next quarter, and I don't care.”

Insider Ownership/Transactions

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- ▶ Have insiders been buying or selling?
 - ▶ Is there cluster buying or selling?
- ▶ Do execs always sell when the price hits a specific level?
- ▶ Size of the buy relative to net worth of person
- ▶ 10b-5 plans
- ▶ Is buying/selling a relevant signal at all these days?
- ▶ How much stock does management own?
 - ▶ Did they buy in the open market?
 - ▶ Did they get it all through stock/option grants?
 - ▶ Do they consistently exercise and sell?
 - ▶ Has the % ownership gone or down up over time?
 - ▶ How meaningful is the dollar amount to management?

Example of someone who really cares what the stock does

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▶ CLH CEO Alan McKim

▶ What does it mean that he has sold shares over time?

Top Holders View All ¹					
Holder	Common Stock Equivalent Held	% of Total Shares Outstanding	Market Value (USD in mm) ²	Position Date	
Wellington Management Group LLP	6,496,316	11.60	372.5	Sep-30-2018	
BlackRock, Inc.	5,071,096	9.05	290.8	Sep-30-2018	
The Vanguard Group, Inc.	4,495,357	8.03	257.8	Sep-30-2018	
McKim, Alan S.	4,086,722	7.30	234.3	Nov-06-2018	
ArrowMark Colorado Holdings, LLC	3,022,871	5.40	173.3	Sep-30-2018	

Holder	Dec-31-2004	Dec-31-2005	Dec-31-2006	Dec-31-2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014	Dec-31-2015	Dec-31-2016	Dec-31-2017	Latest
Wellington Management Group LLP	-	-	-	190	185,022	-	-	189,200	-	3,449,791	4,604,053	6,072,906	6,140,425	6,064,866	6,496,316
BlackRock, Inc. (NYSE:BLK)	4,800	449,198	109,136	993,720	1,413,066	3,813,148	3,751,380	3,163,228	2,799,444	3,234,237	3,298,576	3,557,611	4,089,106	4,205,918	5,071,096
The Vanguard Group, Inc.	441,362	456,780	580,282	857,228	1,447,500	1,897,890	2,107,116	2,362,467	2,997,773	3,066,686	3,139,134	3,338,229	3,877,418	4,177,183	4,495,357
McKim, Alan S.	-	8,331,524	7,290,382	6,070,382	5,620,382	5,441,182	5,095,182	4,891,516	4,773,736	4,602,506	4,599,806	4,619,296	4,545,015	4,400,681	4,086,722

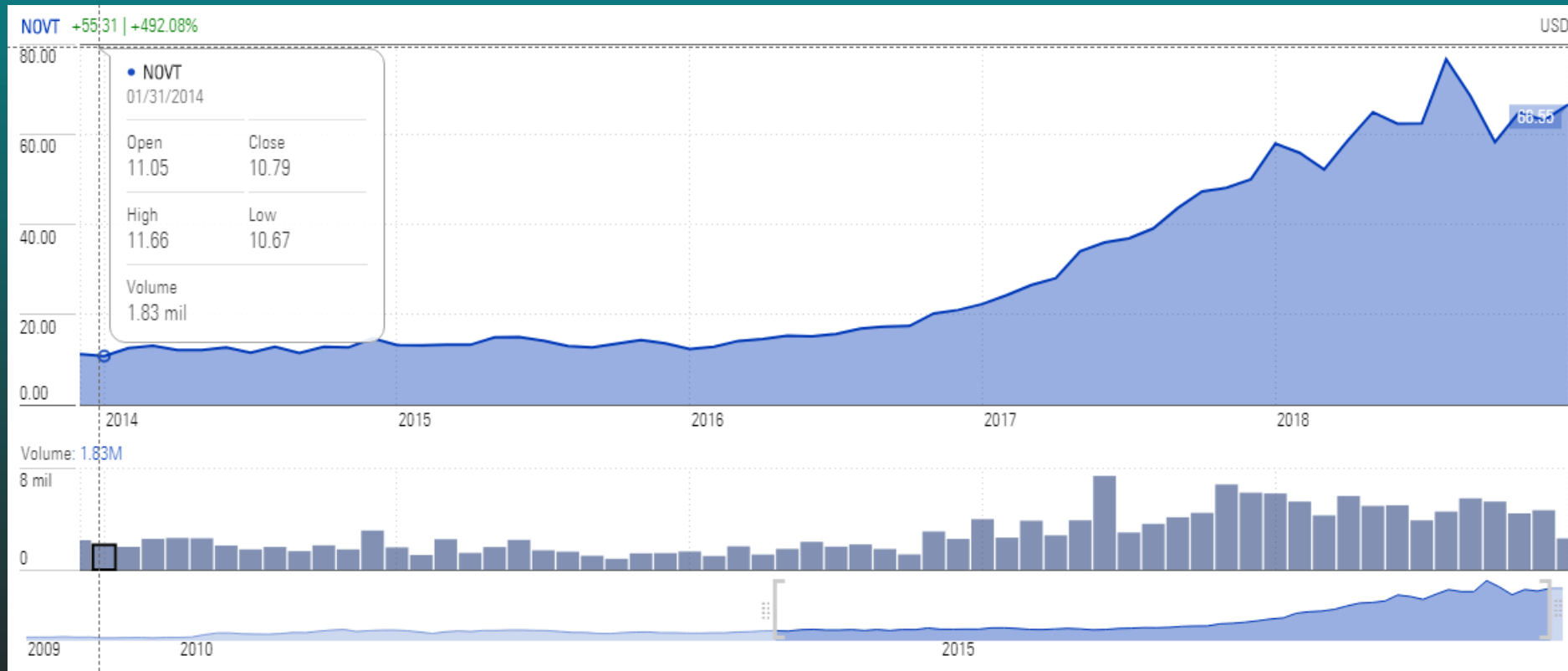
What has the stock done?

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- ▶ Some return assessment is necessary
- ▶ But, this is somewhat of a crude metric
 - ▶ Cyclical companies
 - ▶ CEO coming in at wrong/right time
 - ▶ Movements in valuation multiples
 - ▶ Industry tailwinds/headwinds
- ▶ But, if someone has been there for years and has overseen a multi-bagger...

...are they smart or lucky? Or both? (NOVT)

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How do you assess the “softer” stuff?

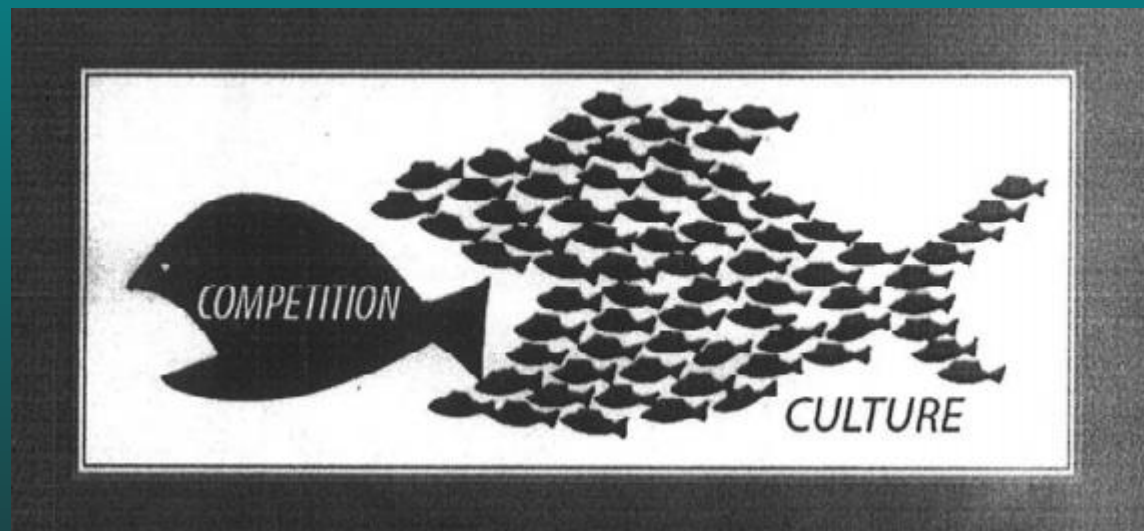
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- ▶ Talk to former employees or colleagues
- ▶ Ask for personal references
- ▶ Look at Glassdoor and Indeed
 - ▶ Track these scores over time
- ▶ Meet them in person—but beware of the professional salesperson
- ▶ Read 10 years’ worth of 10-Ks, proxies, etc
- ▶ Use expert networks to source industry specialists
- ▶ Talk to other investors who own the stock (sparingly)

How do you assess the “softer” stuff?

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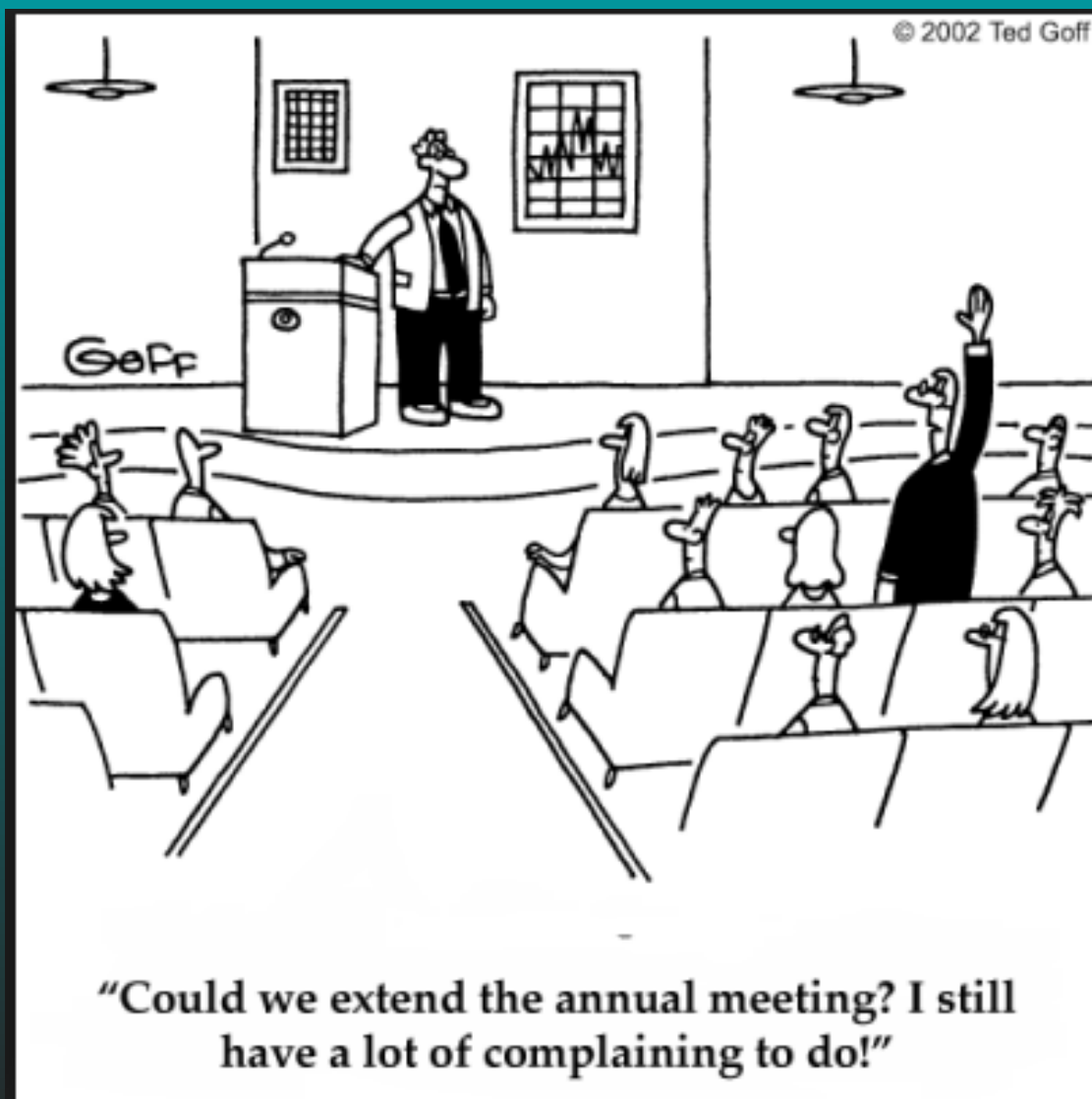
- ▶ What do the headquarters look like?
- ▶ Does the CEO commute from another city?
- ▶ Recently divorced?
- ▶ Brand new fancy car? Boat? Plane?
- ▶ First CEO job or is the 5th time?
- ▶ Would \$10mm make a difference to you?
- ▶ In the role for the status? The money? Or love of the company/business?
- ▶ Succession planning? Is there a deep bench?



Last, but never least: culture

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- ▶ Peter Drucker: “Culture eats strategy for lunch.”
- ▶ Peter Kaufman: “The secret to leadership is to see through the eyes of all six important counterparty groups and make sure that everything you do is structured in such a way to be win-win with them. So here are the six. Your customers, your suppliers, your employees, your owners, your regulators, and the communities you operate in.”
- ▶ What kind of company culture is the management team building?
- ▶ Recommended reading:
 - ▶ Simon Sinek: *Leaders Eat Last*
 - ▶ Anything by Peter Kaufman of Glenair, including: <http://latticeworkinvesting.com/2018/04/06/peter-kaufman-on-the-multidisciplinary-approach-to-thinking/>



One More Quote from Warren Buffett

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- ▶ "You want to figure out ... how well that they treat their owners," he said. "Read the proxy statements, see what they think of — see how they treat themselves versus how they treat the shareholders. ... The poor managers also turn out to be the ones that really don't think that much about the shareholders, too." – Buffett on CNBC

The Proxy Statement

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(AKA: SEC Form DEF 14A)

- ▶ What is the purpose of the proxy statement from the company's perspective?
 - ▶ Lay out compensation practices
 - ▶ Discuss governance policies
 - ▶ Showcase the Board Members and their various committee roles
 - ▶ Explain everything to be voted on at the Annual Meeting
 - ▶ Present material that shareholders use to vote their shares

The Proxy Statement

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(An underappreciated gold mine of information)

- ▶ What is the purpose of the proxy statement from investors' perspective?
 - ▶ Figure out how to vote their shares
 - ▶ Understand what drives management's behavior
 - ▶ Decipher the company's goals and focus
 - ▶ Determine the role of the Board vs. named execs
 - ▶ Make qualitative assessments about whether management is stealing for you or from you
 - ▶ Remember: ISS and Glass Lewis essentially determine what constitutes good corporate governance

Key Elements of the Proxy

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- ▶ Board Members and Board structure
 - ▶ Election of directors
- ▶ Compensation policy (long term & short term)
- ▶ Insider & outside shareholder ownership structure
 - ▶ Management/director share ownership requirements
- ▶ Employee agreements and severance policies
 - ▶ Golden parachutes
- ▶ Comparative set for benchmarking
 - ▶ Role of compensation consultant
- ▶ Annual say on pay
- ▶ Perks, related party transactions
- ▶ Certification of auditor
- ▶ Common and uncommon proposals

Evaluating Board Members

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- ▶ Biographies and backgrounds
- ▶ Diversity of experience, race and gender
- ▶ Independent or not?
- ▶ Tenure
- ▶ Average age
- ▶ Level of engagement
- ▶ Committee involvement
- ▶ How has the company performed during tenure?



Evaluating Board Members (cont.)

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- ▶ What you don't want are people who:
 - ▶ Are there just to cash a check
 - ▶ Are golfing buddies with the CEO
 - ▶ Have no relevant experience whatsoever
 - ▶ Are on the Board just because of "star" power
 - ▶ Will not question management's goals, projections or strategies
 - ▶ Only read the Board memo on the plane ride over
 - ▶ Take advantage of company perks

Evaluating Board Members (cont.)

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- ▶ What you do want are people who:
 - ▶ Are not afraid to be contrarians
 - ▶ Think of the shareholders as the true owners
 - ▶ Hold execs' feet to the fire
 - ▶ Own a lot of stock in the company
 - ▶ Can use their network to help the company
 - ▶ Don't need the Board fees to put food on the table
 - ▶ Understand that the Board role is not forever
 - ▶ Are willing to engage with outside shareholders

Board Structure

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- ▶ Split Chairman and CEO?
- ▶ Size of Board
- ▶ Number of independents
- ▶ Staggered or elected annually?
- ▶ Committee makeup
- ▶ Age limits
- ▶ Stock ownership requirements
- ▶ Lead Director?

Board Structure (cont.)

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- ▶ You will never understand the internal dynamics unless you are on the Board
 - ▶ **But, in general, remember these (anecdotal) lessons:**
 - ▶ Chairman holds a lot of power
 - ▶ Boards move VERY slowly
 - ▶ Few people want to be the jerk in the boardroom
 - ▶ You need a second for any motion
 - ▶ Committees are mini-silos
 - ▶ Board meetings serve as reasons for people to get together
 - ▶ Powerful CEOs can dominate a Board
 - ▶ Most people are not paying attention if things are going well
 - ▶ These people have other jobs and lives

Poll #3

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- ▶ **Which of the above represents excessive compensation?**
 - ▶ **A) Jamie Dimon of JPM receiving \$34.5M in total comp in 2021**
 - ▶ **B) The CEO of a \$250mm market cap company receiving a \$10mm salary**
 - ▶ **C) A management team issuing 5% of total shares outstanding to the executive team each year**
 - ▶ **D) All of the above**

Compensation

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- ▶ What % of compensation is at risk vs. fixed?
- ▶ Executive salaries
 - ▶ Rate of yearly increases
 - ▶ Excessive for the role or company size?
- ▶ Short-term comp (bonus)
 - ▶ Metrics
 - ▶ Targets
- ▶ Long-term comp (equity)
 - ▶ Options, PRSUs, RSUs
 - ▶ Vesting periods
 - ▶ Metrics
 - ▶ TSR
 - ▶ Multi-year period?

Compensation (cont.)

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► Reasonable salary, but...

Name and Principal Position	Year	Salary (\$) ⁽¹⁾	Bonus (\$)	Stock Awards (\$) ⁽²⁾	Option Awards (\$) ⁽²⁾	Non-Equity Incentive Plan Compensation (\$) ⁽³⁾	All Other Compensation (\$) ⁽⁴⁾	Total (\$)
Michael Rapino President, Chief Executive Officer and Director	2017	2,416,667	1,000,000	58,631,538	1,720,677	6,766,667	80,211	70,615,760
	2016	2,300,000	—	574,992	1,959,351	5,520,000	83,898	10,438,241
	2015	2,300,000	—	1,266,500	1,250,555	5,060,000	83,324	9,960,379

► What do you consider excessive?

► What if the stock has done REALLY well?

Compensation (cont.)

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- ▶ The metrics and targets are REALLY important
 - ▶ Aggressive or easy to reach?
 - ▶ Targets: EPS and sales growth or ROIC and Free Cash Flow?
 - ▶ Does management get a bonus or share grants even if targets are missed?
 - ▶ Metrics measured over multi-year period?
 - ▶ Equity comp tied to targets or annual “gifts?”
- ▶ Overall question: does the compensation appear reasonable and is it contingent on company’s success?

Other Key Proxy Components

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- ▶ Employee agreements and severance
 - ▶ Does the company offer employee agreements?
 - ▶ Severance:
 - ▶ Change in control
 - ▶ Without cause
 - ▶ With good reason
 - ▶ Death/disability/retirement
 - ▶ Is the amount egregious?

Severance/Change in Control

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▶ Back to our friend from Live Nation:

Name	Benefit ⁽¹⁾	Termination w/o Cause (\$)	Termination w/Good Reason (\$)	Death (\$)	Disability (\$) ⁽²⁾	Change in Control (\$)
Michael Rapino	Severance ⁽³⁾	22,560,000	22,560,000	14,040,000	14,040,000	—
	Equity Awards ⁽³⁾⁽⁴⁾	94,221,028	94,221,028	94,221,028	94,221,028	94,221,028
	Medical Benefits ⁽³⁾	180,000	180,000	—	—	—
Total		116,961,028	116,961,028	108,261,028	108,261,028	94,221,028

▶ Is this egregious?

▶ Is this a great incentive to sell the company?

▶ Or would it dissuade a potential buyer?

Other Key Proxy Components

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- ▶ Insider ownership
 - ▶ How much does management own?
 - ▶ How long do directors/execs have to reach ownership requirements?
 - ▶ Do directors own material amounts of stock?
- ▶ List of major outside shareholders
 - ▶ Passives (ETFs) or active managers?
 - ▶ Presence of activists?
- ▶ Presence of dual class shares
 - ▶ Owner-operator or someone who can't be thrown out?

Other Key Proxy Components

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- ▶ Peer set
 - ▶ What purpose does the comp consultant provide?
 - ▶ Is the company comparing itself to good or mediocre companies?
 - ▶ How has the company performed relative to the peer set?
- ▶ Say on pay
 - ▶ Annual or every 3 years?
 - ▶ How did shareholders vote last year?

Other Key Proxy Components

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- ▶ Certification of auditor
 - ▶ Have you heard of the auditor?
 - ▶ Does it change frequently?
- ▶ Perks and related party transactions
 - ▶ Perks: plane use, company apartment, company car, etc.
 - ▶ Related party transactions: family members working for company, commercial relationships with execs or Directors
 - ▶ See slide on red flags
- ▶ Burn rate
 - ▶ High burn rate= excessive share compensation?

Other Key Proxy Components

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- ▶ Common Proposals
 - ▶ Election of direction
 - ▶ Certification of auditor
 - ▶ New compensation plan/ability to issue new shares
 - ▶ Say on pay
 - ▶ By-law changes
- ▶ Less common Proposals
 - ▶ Board de-staggering
 - ▶ Shareholder nominations for Directors

Breakout Session

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- ▶ Break up into groups of 4-5 people
- ▶ Odd numbered rooms to focus on SNBR
 - ▶ Even numbered rooms to focus on SKX
- ▶ Take about 8 minutes to talk about the companies
- ▶ We will ask for one group to volunteer to talk about SNBR
 - ▶ And one group to talk about SKX
- ▶ Topics to consider:
 - ▶ Should shareholders be happy with the proxy contents? Why or why not?
 - ▶ What elements stand out to you—good or bad?
 - ▶ Does reading through the proxy make you want to trust management and the Board more—or less?

Case Study: SNBR

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- ▶ 2017 proxy statement
 - ▶ **Good:** ROIC over 3 years, 75% performance stock, reasonable salaries given the market cap, aggressive targets for metrics (\$2.75 in EPS), 3 year compensation plans, diversity of Board
 - ▶ By the way, they hit this number (amazing)
 - ▶ 2020 EPS of \$4.90 and 2021 EPS of \$6.16
 - ▶ **Bad:** Half year results and semi-annual targets, staggered Board
 - ▶ Recall that this company was “activisted”

Case Study: SKX

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- ▶ 2017 proxy statement
 - ▶ **Good:** directors not compensated excessively, 4 year vesting of restricted shares, no employment contracts
 - ▶ **Bad:** Staggered board, A/B (dual class) stock, related party transactions, only 5 independent Directors, multiple family members on the board
 - ▶ **More Bad:** same Chairman/CEO, no diversity on Board, net sales growth (quarterly!) is the only annual metric, no RSUs aside from the ones for the new CFO, total comp is pretty substantial—as is the CIC, 1500:1 CEO pay ratio

Proxy Red Flags

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- ▶ Dual class share structure (not many Berkshire Hathaways out there)
- ▶ Staggered board (sadly this is somewhat commonplace)
- ▶ Board members who have been there for decades
- ▶ Management and board members who own no stock
- ▶ More than one paragraph of related party transactions
- ▶ Constant auditor changes
- ▶ Peer set changes every year
- ▶ Different compensation metrics each year
- ▶ Very easy to reach profitability or growth targets
- ▶ Compensation consistently looks egregious
- ▶ Management gets equity simply for showing up (time vesting)
- ▶ Excessive list of management perks
- ▶ Tax gross ups (company basically pays execs' taxes)

Practical Implications/Takeaways

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- ▶ In general, making decisions under uncertainty is really hard
 - ▶ You can never know 100% of what you would like to know
- ▶ Understanding management is tough and it is time consuming
 - ▶ But not many things are more important
- ▶ So much of assessing management is subjective and is tied to a “smell test”
- ▶ Best predictor of the future is what happened in the past
- ▶ True integrity is hard to fake
- ▶ Incentives guide you to what someone is likely to do
- ▶ You must develop a level of skepticism—assume people are lying to you
 - ▶ Or maybe better: trust but verify
- ▶ Key questions to ask yourself:
 - ▶ Do you trust these people?
 - ▶ Would you want your kids to work at the company?
 - ▶ Do you feel like the execs truly understand the business?
- ▶ You will make mistakes over time **BUT LEARN FROM THEM!**

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 - ▶ <https://compounders.podbean.com/>