Capital Allocation

Notes From Michael Mauboussin PDF here.

Things bolded or highlighted are my emphasis. Things in brackets are things I've added.

Capital allocation is a senior management team's most fundamental responsibility. The problem is that many CEOs don't know how to allocate capital effectively. The objective of capital allocation is to build long-term value per share.

Capital allocation is the most fundamental responsibility of a senior management team of a public corporation. Successful capital allocation means converting inputs, including money, things, ideas, and people, into something more valuable than they would be otherwise.

Why should value determine whether a management team is living up to its responsibility? There are two reasons. The first is that companies must compete. A company that is allocating its resources wisely will ultimately prevail over a competitor that is allocating its resources foolishly. The second is that inputs have an opportunity cost, or the value of the next best alternative. Unless an input is going to its best and highest use, it is underperforming relative to its opportunity cost.

Warren Buffett, chairman and CEO of Berkshire Hathaway, describes this reality in his 1987 letter to shareholders. He discusses the point of why it is beneficial for Berkshire Hathaway's corporate office to allocate the capital of the companies it controls. Buffett is worth quoting at length:2

"This point can be important because the heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising. Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics.

Once they become CEOs, they face new responsibilities. They now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly-talented musician was not to perform at Carnegie Hall but, instead, to be named Chairman of the Federal Reserve.

The lack of skill that many CEOs have at capital allocation is no small matter: After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business. CEOs who recognize their lack of capital-allocation skills (which not all do) will often try to compensate by turning to their staffs, management consultants, or investment bankers. Charlie [Munger] and I have frequently observed the consequences of such "help." On balance, we feel it is more likely to accentuate the capital-allocation problem than to solve it.

In the end, plenty of unintelligent capital allocation takes place in corporate America. (That's why you hear so much about "restructuring.")

As Buffett says, *"The first law of capital allocation—whether the money is slated for acquisitions or share repurchases—is that what is smart at one price is dumb at another."*

Proper capital allocation requires a sharp analytical framework and independence of mind.

In assessing management, ask a fundamental question: If there is a conflict between maximizing a reward based on the incentive plan and creating long-term value per share, which route will the executive select?

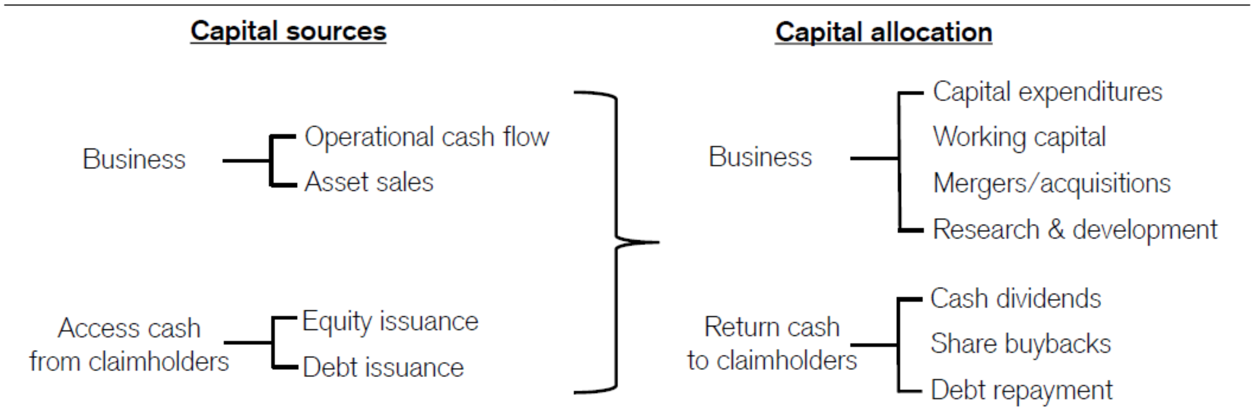
The rate of return on incremental capital is the maximum growth rate in operating profit a business can reach without external financing. By extension, a company with a return on invested capital (ROIC) greater than its growth rate will generate surplus capital.6

Companies that cannot fund their growth internally must access cash externally, either by borrowing or selling equity.

In a buyback, selling shareholders benefit at the expense of ongoing shareholders if the stock is overvalued, and ongoing shareholders benefit at the expense of selling shareholders if the stock is undervalued. All shareholders are treated uniformly only if the stock price is at fair value.8

Exhibit 1 summarizes the sources and uses of financial capital. These follow closely the alternatives and choices that Thorndike specifies in *The Outsiders*.

Exhibit 1: Sources and Uses of Financial Capital



Source: Credit Suisse.

A country **{COMPANY}**with a high ROIC can fund a greater percentage of its investments with internally generated cash than a country with a low ROIC.

There are pros and cons to having internal financing represent a high percentage of investment funding. The pro is that companies are earning high returns on capital in general and need not rely on capital markets to fund their growth. The con is that companies can deploy internally generated funds into value-destroying investments **{If management is bad at allocating capital}.** The need to raise money from the capital markets creates a check on management's spending plans.

The issue of judicious capital allocation is certainly nothing new. Henry Singleton, the CEO whom William Thorndike holds up as the standard for excellence, started his company, Teledyne, more than 50 years ago. And Buffett's quote about capital allocation is more than a quarter century old. Still, the issue feels particularly pressing today. **{Link to Teledyne case study and presentation info below.}**

Before delving into each of the specific uses of capital, it is worth considering what the academic research says about capital allocation. The findings are easy to condense: "Asset growth rates are strong predictors of future abnormal returns." This is true in both U.S. and international markets.

More specifically, firms with low asset growth rates earn substantially higher shareholder returns, after adjusting for risk, than firms with high asset growth rates. Further, companies that contract their assets tend to generate higher shareholder returns than companies that expand their assets.

High returns to shareholders tend to follow events such as spin-offs, dividend initiations, share buybacks, and debt prepayments, whereas low returns to shareholders generally follow events such as acquisitions and stock and debt issuance.

Exhibit 18: Probability of M&A Success Based on Type of Deal

Success Rate	Category	Type	Description	Example(s)	Success Threats (Ex-Pricing, Phase)
87-92	Opportunistic	Bottom-trawlers	Dying competitor signals exit, advantage to fast, cash bidders	Marconi, Palm	Obsolescence, incompatible technologies
80-85	Operational	Bolt-ons	Fills void in acquirer's existing product/service offer, quickly	P&G/Pantene	Hidden integration difficulties cancel timing advantage
65-70	Operational	Line extension equivalents	Next generation/different variant of existing product/service	Volkswagen/Skoda	Actual synergies limited to scale, insufficient to cover APP
55-60	Transitional	Consolidation -- mature	Same industry contraction: scale, overhead synergies	Pharma, telecoms	Overestimation of market share gain importance
40-45	Operational	Multiple core-related complementary	Logical complements to present offer: products/channels/areas Two or more related elements	Disney/ABC; P&G/Gillette; Coty/Avon	Mistaken judgment of development potential (r-synergies)
37-42	Transitional	Consolidation -- emerging	Same industry contraction: Picking winners	ABC Capital Cities/Dumont	Overstated premiums (APP) based on target's prior performance
30-35	Operational	Single core-related complementary	Similar to complementary but one or less related elements	Daimler Chrysler	Exaggerated benefits attributed to target in 'marriage made in heaven'
20-25	Transformational	Lynchpin strategic	Major change in emphasis in acquiring company's business mix and forward strategy	IBM/PwC Consulting	Dependent on extraordinary acquiring company
15-20	Transformational	Speculative strategic	Radical, high-risk experimentation with company's business mix and model	AOL/TW; Vivendi (Messier)	CEO's imagined vision inconsistent with market realities

Based on Peter J. Clark and Roger W. Mills, Masterminding the Deal: Breakthroughs in M&A Strategy and Analysis *(London: Kogan Page, 2013), 148-149.*

Another factor that can work in favor of acquirers is the source of deal financing. The research suggests the market greets cash deals much more kindly than stock deals. **{Confirms what Buffett has said for years.}**

Some firms, including Apple, have a negative CCC, **which means that the company receives cash on the sale of inventory before it pays its suppliers. This effectively makes the company's suppliers a source of financing and can be relevant in competitive interactions.**

For instance, Walmart Stores Inc.'s CCC was 12 days in 2014 while Amazon.com's CCC was -23 days. With a CCC for each company in hand, you can compare the efficiency of working capital use from one company to the next.

Academic research shows **a strong relationship between a lower CCC and a higher return on capital within, and across, industries.[50] In other words, good working capital management is associated with high returns on invested capital**.

When assessing a repurchase program, investors and executives should consider the golden rule of share buybacks, which states: A company should repurchase its shares only when its stock is trading below its expected value and when no better investment opportunities are available.

Exhibit 37: The Value Conservation Principle

Assumptions	Base	Scenario A Assume buyback @ $200	Scenario B Assume buyback @ $50	Assumptions	Scenario C Assume dividend of $20
Buyback amount		$20,000	$20,000	Dividend amount	$20,000
Firm Value	$100,000	$80,000	$80,000	Firm Value	$80,000
Shares outstanding	1,000	1,000	1,000	Shares outstanding	1,000
Current price	$100	$200	$50	Current price	$10
Shares post buyback		900	600		
Value/share	$100	$88.89	$133.33	Value/share	$80.00
				Dividend/share	$20.00
Selling shareholders		100	400		
		$200	$50		
Value to sellers		$20,000	$20,000		
Ongoing shareholders		900	600	Ongoing shareholders	$80,000
		$88.89	$133.33	Dividends	$20,000
		$80,000	$80,000		
Total value		$100,000	$100,000	Total value	$100,000
Per share +/- sellers		$100.00	($50.00)		
Per share +/- holders		($11.11)	$33.33		

In Scenario A, we assume the stock price is $200, double the fair value of $100 ($100,000/1,000). The company can buy 100 shares, leaving $80,000 of value and 900 shares outstanding. In this case, the selling shareholders gain $100 per share ($200 proceeds - $100 value = $100) and the continuing shareholders lose $11.11 per share ($88.89 continuing value - $100 initial value = -$11.11). Buying back overvalued stock benefits sellers at the expense of buyers.

In Scenario B, we assume the stock trades at one-half of fair value, or $50 per share. The company can buy 400 shares, with $80,000 of remaining value and 600 shares outstanding. Now we see that the selling shareholders lose $50 per share ($50 proceeds - $100 value = -$50) and continuing shareholders gain $33.33 per share ($133.33 continuing value - $100 initial value = $33.33).

In Scenario C, the company pays a $20 dividend to all shareholders. Just as in the prior scenarios, the firm value drops to $80,000, but each shareholder receives identical treatment, leaving aside tax considerations.

So what elements should you look for in an effective incentive program? The key is to look for a company that seeks to build long-term value per share with the belief that the stock market will ultimately follow that value. If the market fails to reflect that value, management can take action by sharpening communication or buying back stock.

Warren Buffett explains that a good plan "should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of the plan participants." **{Buffett explaining the importance of incentives.}**

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Charlie Munger on the Power of Incentives in his speech **The Psychology Of Human Misjudgment PDF**… Or Video Below.

https://www.youtube.com/watch?v=pqzcCfUglws

This is one of the most important things I've ever read. And watching or reading the above speech multiple times will help you become a better investor and thinker than most other content will.

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Know the value of assets, and be ready to take action to create value. Intelligent capital allocation is similar to managing a portfolio of stocks in that it is very useful to have a sense of the difference, if any, between the value and price of each asset. This includes the value of the company and its stock price. Naturally, such analysis must include considerations such as taxes.

Capital Allocation Checklist at the end of the research report.

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A Case Study Of Financial Brilliance

Presentation by Leon Cooperman About Henry Singleton and Teledyne

37 Page PDF File **here** via Valuewalk.

Or Video Link of presentation **here**.

My notes below.

Exhibit 3

Buffett considers that Henry Singleton of Teledyne has the best operating and capital deployment record in American Business. When I asked if he did not consider Tom Murphy of Capital Cities to be equally outstanding, Buffett smiled and said, “Well, Murph plays a simpler game,” but added that part of the great business ability is to get into simple games. Singleton’s return on assets, calculated in the way that Buffett likes to do it (Inventory *plus* fixed assets), is unique. All four major industry groups in Teledyne are in fully competitive areas; none has a special protected niche; and yet all four earn 50 percent on assets. The company earns $250 million after tax, with very conservative accounting.

Singleton bought 130 businesses for “Chinese paper,” as it used to be called, when his stock was riding high. Then when the market, and his stock, fell he reversed field and the last eight years hasn’t acquired a single company; on the contrary, by buying his stock back he has shrunk his capital from 40 million shares to 12 million.

According to Buffett, if one took the top 100 business school graduates and made a composite of their triumphs, their record would not be as good as that of Singleton, who incidentally was trained as a scientist, not an MBA. The failure of business schools to study men like Singleton is a crime, he says. Instead, they insist on holding up as models executives cut from a McKinsey & Company cookie cutter.

Excerpt from Pages 24 & 25 of The Money Masters

Author: John Train, Publisher: Harper & Row, Published: 1980

One usage of retained earnings we often greet with special enthusiasm when practiced by companies in which we have an investment interest is repurchase of their own shares. The reasoning is simple: **if a fine business is selling in the marketplace for far less than intrinsic value, what more certain or more profitable utilization of capital can there be than significant enlargement of the interests of all owners at that bargain price?** Source: 1980 Berkshire Hathaway Annual Report

By making repurchases when a company’s market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management’s domain but that do nothing for (or even harm) shareholders.

A manager who consistently turns his back on repurchases, when these clearly are in the interests of owners, reveals more than he knows of his motivations. No matter how often or how eloquently he mouths some public relations-inspired phrase such as "maximizing shareholder wealth" (this season's favorite), the market correctly discounts assets lodged with him. His heart is not listening to his mouth—and, after a while, neither will the market.

This entire presentation is filled with gold… But most of it is charts and other graphics illustrating the power of buy backs. And proper capital allocation.

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Capital Structure and Stock Repurchases – A Case Study On Capital Allocation via John Chew from CSInvesting 58 Page doc filled with gold.

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For even more reading on capital allocation read all of the Berkshire Hathaway Shareholder Letters. You can download them all **here** for only $2.99.

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Reading all the information in this doc will not only help you become a better investor. But also a better thinker. Decision maker. And entrepreneur than most other content and college education.

All for only $2.99. A fraction of the cost of a college education.