QUALITATIVE METRICS OF A SUPER COMPOUNDER
Characteristics of Quality Management

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> ***"We intend to continue our practice of working only with people whom we like and admire."***
>
> *- Warren Buffett*
> *(1986 Letter to Berkshire Hathaway Shareholders)*

One of the most successful companies in the last century was Tom Murphy and Dan Burke's Capital Cities Broadcasting. Between 1967 and 1995, Murphy grew Capital Cities through a series of large and intelligent acquisitions. These included several acquisitions which set industry and market records at the time, including:

- KTRK for $22 million
- Fairchild Communications for $42 million
- Triangle Communications for $120 million
- The Fort Worth Telegram for $75 million
- The Kansas City Star for $95 million
- Cable Com for $139 million
- The milestone 1986 acquisition of ABC for $3.5 billion

A lot can be learned from Capital Cities in finding 100X returning stocks by evaluating their process in acquisitions. First, we can look at how Murphy funded his acquisitions; Murphy skillfully employed leverage to grow his company saying "always, we've . . . taken assets once we've paid them off and leveraged them again to buy other assets." Murphy then used the improved gross margins from the business and the free cash flow generated by his COO, Dan Burke, to immediately start paying down the debt incurred from the acquisition. Burke described this process by saying that his "job was to create the free cash flow and Murphy's was to spend it."

Not all acquisitions are created equal, in fact 2/3 of all acquisitions are said to erode shareholder value. Capital Cities ensured valuable acquisitions through a confidence in their operational efficiency by only acquiring companies in which they could improve gross margins through their unique management style. This style was defined by decentralization, even characterized as anarchy. This involved a relentless slashing of non-essential costs, like the sale of opulent ABC real estate holdings in New York City, the elimination of superfluous headquarters staff, and the discontinuance of executive benefits like limos. These cost improvements increased gross margins and optimized free cash flow for reinvestment and capital allocation. Once these cost improvements were implemented, it was common for the executives of Capital Cities' subsidiaries to not hear from Murphy or Burke for months if operations were progressing in a satisfactory manner. Murphy and Burke's low cost and high ROIC management style was the essential ingredient to their success in acquisitions, with Warren Buffett calling them "The greatest two-person combination in management that the world has ever seen."

As we evaluate current companies it may be valuable to apply the Capital Cities lens to their acquisitions and operations. Did they fund their purchase responsibly with strong free cash flows and intelligent debt? Can they improve the operational efficiency and add value to the companies they acquire? Are they waiting patiently for the proper acquisition opportunities and careful not to overpay? If a managerial team can consistently fill these requirements investors may be in store for outsized and compounding returns. If not, investors may be in the bottom 2/3 of value erosion.

Capital Allocation and "The Outsiders"

The primary sign of a strong management team is its ability as allocators of capital. In short, how well do they reinvest cash flow? This skill is an essential function of a company's executives. The ability of a business leader to effectively carry out this function can supercharge a firm's ability to compound. The ultimate guide on this topic of capital allocation is William Thorndike's book The Outsiders. Thorndike emphasizes the value of intelligent capital employment, conservative balance sheets, and patient leverage when acquiring fairly-valued businesses.

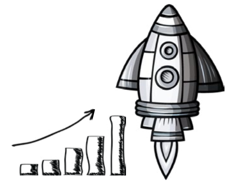
The essence of creating a multi-bagger lies in the committed creation of shareholder value. This trait exhibited by a management team can be hyper-valuable if identified properly. It can be seen in the communication management maintains with shareholders, in annual letters, and at annual meetings, which are vital the process of understanding management intentions and ability. If investors analyze the language and earnestness exhibited in these regular communications, investors can glean the values of management and its commitment to shareholder value creation. Two brilliant resources on this topic are The Essays of Warren Buffett and Dear Shareholder, both assembled by Lawrence Cunningham. Two specific management practices can work to increase shareholder value. The first is a disinterest in the dilution of shareholders through stock issuances to raise capital. The second is a commitment to intelligent and well-timed buybacks to decrease the number of shares outstanding and increase per share value.

Buybacks

A buyback is when a company purchases its own shares from the marketplace to boost per share market value. Well timed and effectively funded buybacks can be a fruitful way for a company to systematically increase shareholder value over the long term. The purchase of shares, if it does indeed shrink the number of shares outstanding, has the effect of concentrating the ownership of the company into fewer and fewer positions, therefore increasing the value of each individual share. For a buyback to be effective it must first meet a few criteria; first the company must resist buying overvalued shares, as is most often the case in ineffective buybacks. Second, buybacks are optimally bought with cash holdings on its balance sheet, not through borrowed money. Finally, the buybacks must decrease the number of shares outstanding. If the company is using cash assets to buy shares to then turn around and issue them as compensation to executives, this functions to diminish shareholder value. (For more on buybacks and how best to use them, see the Appendix to this paper.)

Time Horizons

The managerial teams of the highest returning stocks consistently demonstrate a focus on the long term. They show this in how they communicate and their resistance to quarterly forecasts or guidance. This consistent attitude of looking into the future for the long-term health of the company dissuades management from making suboptimal accounting or capital allocation decisions to hit quarterly numbers, freeing them to make the best decisions overall. Another hallmark of a strong managerial team is patience. The best opportunities for acquisitions, capital allocation, or any investment tends to be when others are emotionally heightened and making poor decisions. If an investor can find a managerial team that is patient with their capital and only acts when pricing is favorable, as Buffett did in 2001 and 2008, or John Malone of TCI did in the intermittent market downturns of the 80's, they likely have found a manager who can super-compound stock returns.



Insider Ownership/Executive Incentive Structure

Insider ownership can function as either a powerful force of incentive or a weight of entrenchment on management. Depending on several factors, insider ownership can be a powerful predictor of performance, but Qualitative due diligence is necessary to decide its efficacy. Historically, owner-operators with high equity stakes in a business are often a catalyst to outperformance. Famous examples of this include Sam Walton, Warren Buffett, Bill Gates, Jeff Bezos, Katherine Graham, and, recently, XPEL's Ryan Pape. These owner-operators epitomize aligned incentives. With a large amount of their wealth tied up in the stock and their position as management disincentivizing any selling, they are highly encouraged to increase shareholder value over the long term through effective management.

Stock-based compensation plans are often used to motivate employees beyond regular cash-based salaries by offering shares at a discounted price. An advantage of using stock-based compensation is that it can motivate employees to stay with the company longer and it does not require additional cash payments unless the company is repurchasing shares to fulfill these plans. However, this method may dilute the ownership of existing shareholders, and the plans can often be too generous to employees. But many companies justly see stock-based compensation as a necessary tool to attract and keep the talent to create a competitive company. Jeff Bezos, in his 1997 Letter to Shareholders, emphasized the importance of equity compensation when he wrote: "We will continue to focus on hiring and retaining versatile and talented employees and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner." Stock option plans are standard in modern executive compensation packages, and companies often need them to compete in the high-level labor market.

Poorly structured plans do have some very notable critics. Publicly, Warren Buffett is outspoken against the idea of stock-based compensation, saying that his managers can buy into the company like any other shareholders, forcing them to assume the same downside risk. Further, incentivizing managers to hit specific numbers to bolster their own pay moves them away from the long-term orientation that is best to produce durable, long-term returns. In short, one of the most important things for an investor to understand about a company is their compensation structure and how well it aligns management incentives with shareholder interests.

Moats

The advantages which allow a company to keep a competitive edge are called "economic moats." In Pat Dorsey's book The Five Rules for Successful Stock Investing he explores four ways to analyze a company's economic moat, which are: evaluating a firm's historical profitability, evaluating returns on capital, analyzing a competitive advantage period, and analyzing an industry's competitive structure. Moats are rare and finding them is an arduous process. Moats can take many forms, such as: a supremely strong brand, patent protections, proprietary intellectual property protections, network effects, high switching costs, etc. Moats will often materialize in high gross profit margins compared to industry average. These high gross margins are less susceptible to mean reversion and tend to persist over extended periods of time. This is not the only way a moat materializes. There are many qualitative measures to find legitimate moats but be aware of their rarity and do not try to convince yourself of the moats that are not immediately identifiable.

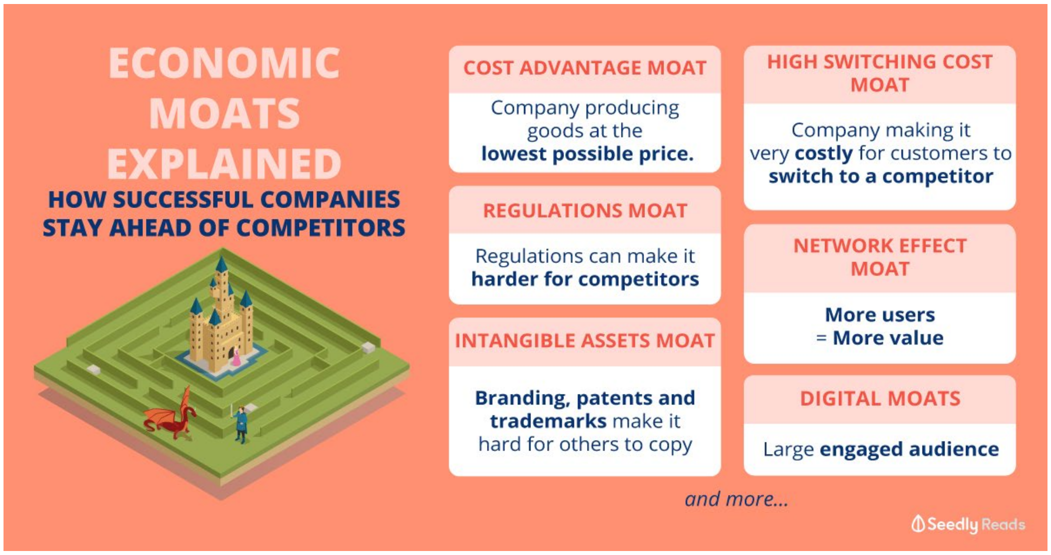


Figure 1: Economic Moats
https://blog.seedly.sg/economic-moats-investing

Industry

In recent years certain sectors have outperformed in producing multi-baggers. Unsurprisingly, the leading sector in the production of these compounders is technology, with a somewhat distant second being healthcare. We must keep in mind that while these industries have tended to recently produce the most big winners, investors can still find plenty of high-quality compounders in other industries.

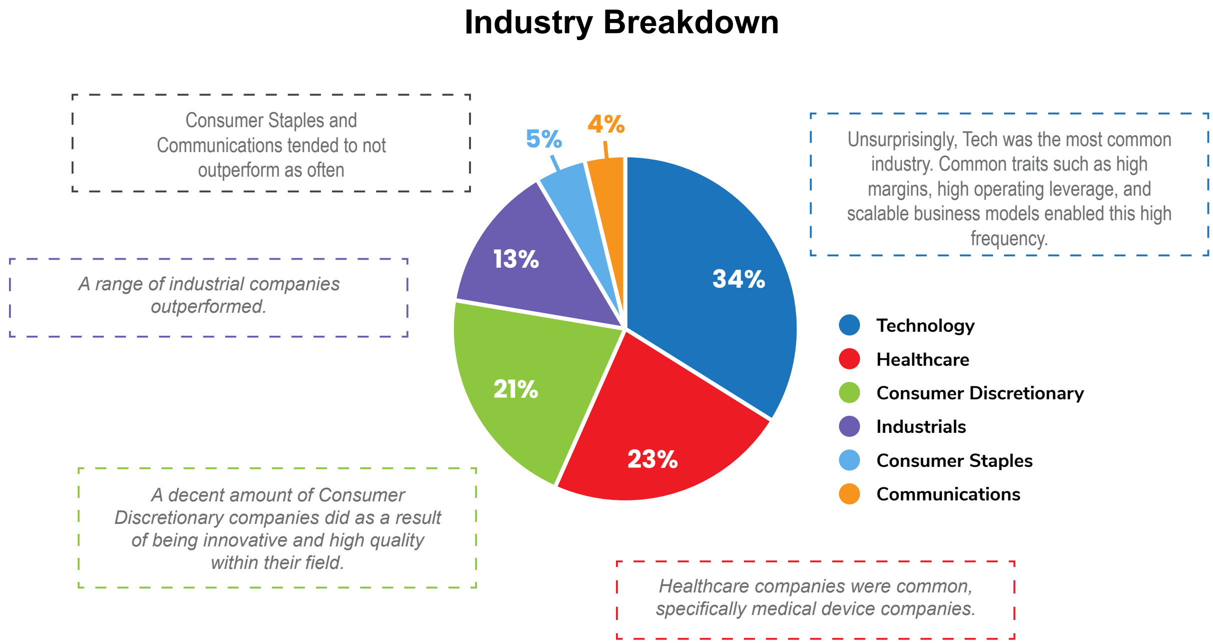


Figure 2: Industry Breakdown from Alta Fox's "The Makings of a Multibagger"

Final Thoughts

The qualitative factors laid out above are neither comprehensive nor exact measurements. An investor needs diligence and patience to accurately determine their effectiveness and evaluate quality on a company-by-company basis. These are the sort of factors that can deliver individual investors advantages over institutions and algorithms, as they may not have the patience to invest the resources in the research or cannot quantify the edge. Attention paid in these areas will pay dividends over the long term with the potential identification of companies that can grow at high rates for a long, long period of time—the super-compounders.

APPENDIX: WARREN BUFFETT ON SHARE BUYBACKS

As we mentioned in the paper, buybacks are a major tool in management's ability to produce long-term shareholder value. Warren Buffett has written extensively about when buybacks add value, and when they do not. Below are some excerpts from his shareholder letters on this topic.

1980 Letter to Shareholders

(We can't resist pausing here for a short commercial. 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 market place 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? The competitive nature of corporate acquisition activity almost guarantees the payment of a full—frequently more than full price when a company buys the entire ownership of another enterprise. But the auction nature of security markets often allows finely-run companies the opportunity to purchase portions of their own businesses at a price under 50% of that needed to acquire the same earning power through the negotiated acquisition of another enterprise.)

1994 Letter to Shareholders

Understanding intrinsic value is as important for managers as it is for investors. When managers are making capital allocation decisions—including decisions to repurchase shares—it's vital that they act in ways that increase per-share intrinsic value and avoid moves that decrease it. This principle may seem obvious but we constantly see it violated. And, when misallocations occur, shareholders are hurt.

For example, in contemplating business mergers and acquisitions, many managers tend to focus on whether the transaction is immediately dilutive or anti-dilutive to earnings per share (or, at financial institutions, to per-share book value). An emphasis of this sort carries great dangers. Going back to our college-education example, imagine that a 25-year-old first-year MBA student is considering merging his future economic interests with those of a 25-year-old day laborer. The MBA student, a non-earner, would find that a "share-for-share" merger of his equity interest in himself with that of the day laborer would enhance his near-term earnings (in a big way!). But what could be sillier for the student than a deal of this kind?

In corporate transactions, it's equally silly for the would-be purchaser to focus on current earnings when the prospective acquiree has either different prospects, different amounts of non-operating assets, or a different capital structure. At Berkshire, we have rejected many merger and purchase opportunities that would have boosted current and near-term earnings but that would have reduced per-share intrinsic value. Our approach, rather, has been to follow Wayne Gretzky's advice: "Go to where the puck is going to be, not to where it is." As a result, our shareholders are now many billions of dollars richer than they would have been if we had used the standard catechism.

The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent. That happens because the acquirer typically gives up more intrinsic value than it receives. Do that enough, says John Medlin, the retired head of Wachovia Corp., and "you are running a chain letter in reverse."

Over time, the skill with which a company's managers allocate capital has an enormous impact on the enterprise's value. Almost by definition, a really good business generates far more money (at least after its early years) than it can use internally. The company could, of course, distribute the money to shareholders by way of dividends or share repurchases. But often the CEO asks a strategic planning staff, consultants or investment bankers whether an acquisition or two might make sense. That's like asking your interior decorator whether you need a $50,000 rug.

The acquisition problem is often compounded by a biological bias: Many CEO's attain their positions in part because they possess an abundance of animal spirits and ego. If an executive is heavily endowed with these qualities—which, it should be acknowledged, sometimes have their advantages—they won't disappear when he reaches the top. When such a CEO is encouraged by his advisors to make deals, he responds much as would a teenage boy who is encouraged by his father to have a normal sex life. It's not a push he needs.

Some years back, a CEO friend of mine—in jest, it must be said—unintentionally described the pathology of many big deals. This friend, who ran a property-casualty insurer, was explaining to his directors why he wanted to acquire a certain life insurance company. After droning rather unpersuasively through the economics and strategic rationale for the acquisition, he abruptly abandoned the script. With an impish look, he simply said: "Aw, fellas, all the other kids have one."

At Berkshire, our managers will continue to earn extraordinary returns from what appear to be ordinary businesses. As a first step, these managers will look for ways to deploy their earnings advantageously in their businesses. What's left, they will send to Charlie and me. We then will try to use those funds in ways that build per-share intrinsic value. Our goal will be to acquire either part or all of businesses that we believe we understand, that have good, sustainable underlying economics, and that are run by managers whom we like, admire and trust.

1999 Letter to Shareholders

Recently, a number of shareholders have suggested to us that Berkshire repurchase its shares. Usually the requests were rationally based, but a few leaned on spurious logic.

There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds — cash plus sensible borrowing capacity — beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively-calculated. To this we add a caveat: Shareholders should have been supplied all the information they need for estimating that value. Otherwise, insiders could take advantage of their uninformed partners and buy out their interests at a fraction of true worth. We have, on rare occasions, seen that happen. Usually, of course, chicanery is employed to drive stock prices up, not down.

The business “needs” that I speak of are of two kinds: First, expenditures that a company must make to maintain its competitive position (e.g., the remodeling of stores at Helzberg’s) and, second, optional outlays, aimed at business growth, that management expects will produce more than a dollar of value for each dollar spent (R. C. Willey’s expansion into Idaho).

When available funds exceed needs of those kinds, a company with a growth-oriented shareholder population can buy new businesses or repurchase shares. If a company’s stock is selling well below intrinsic value, repurchases usually make the most sense. In the mid-1970s, the wisdom of making these was virtually screaming at managements, but few responded. In most cases, those that did made their owners much wealthier than if alternative courses of action had been pursued. Indeed, during the 1970s (and, spasmodically, for some years thereafter) we searched for companies that were large repurchasers of their shares. This often was a tipoff that the company was both undervalued and run by a shareholder-oriented management.

That day is past. Now, repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price. The shareholder who chooses to sell today, of course, is benefited by any buyer, whatever his origin or motives. But the continuing shareholder is penalized by repurchases above intrinsic value. Buying dollar bills for $1.10 is not good business for those who stick around.

Charlie and I admit that we feel confident in estimating intrinsic value for only a portion of traded equities and then only when we employ a range of values, rather than some pseudo-precise figure. Nevertheless, it appears to us that many companies now making repurchases are overpaying departing shareholders at the expense of those who stay.
In defense of those companies, I would say that it is natural for CEOs to be optimistic about their own businesses. They also know a whole lot more about them than I do. However, I can’t help but feel that too often today’s repurchases are dictated by management’s desire to “show confidence” or be in fashion rather than by a desire to enhance per-share value.

Sometimes, too, companies say they are repurchasing shares to offset the shares issued when stock options granted at much lower prices are exercised. This “buy high, sell low” strategy is one many unfortunate investors have employed — but never intentionally! Managements, however, seem to follow this perverse activity very cheerfully.

Of course, both option grants and repurchases may make sense — but if that’s the case, it’s not because the two activities are logically related. Rationally, a company’s decision to repurchase shares or to issue them should stand on its own feet. Just because stock has been issued to satisfy options — or for any other reason — does not mean that stock should be repurchased at a price above intrinsic value. Correspondingly, a stock that sells well below intrinsic value should be repurchased whether or not stock has previously been issued (or may be because of outstanding options).

You should be aware that, at certain times in the past, I have erred in not making repurchases. My appraisal of Berkshire’s value was then too conservative or I was too enthused about some alternative use of funds. We have therefore missed some opportunities — though Berkshire’s trading volume at these points was too light for us to have done much buying, which means that the gain in our per-share value would have been minimal. (A repurchase of, say, 2% of a company’s shares at a 25% discount from per-share intrinsic value produces only a ½% gain in that value at most — and even less if the funds could alternatively have been deployed in value-building moves.)

Some of the letters we’ve received clearly imply that the writer is unconcerned about intrinsic value considerations but instead wants us to trumpet an intention to repurchase so that the stock will rise (or quit going down). If the writer wants to sell tomorrow, his thinking makes sense — for him! — but if he intends to hold, he should instead hope the stock falls and trades in enough volume for us to buy a lot of it. That’s the only way a repurchase program can have any real benefit for a continuing shareholder.

We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated. Nor will we attempt to talk the stock up or down. (Neither publicly or privately have I ever told anyone to buy or sell Berkshire shares.) Instead we will give all shareholders — and potential shareholders — the same valuation-related information we would wish to have if our positions were reversed.

2016 Letter to Shareholders

In the investment world, discussions about share repurchases often become heated. But I'd suggest that participants in this debate take a deep breath: Assessing the desirability of repurchases isn't that complicated.

From the standpoint of exiting shareholders, repurchases are always a plus. Though the day-to-day impact of these purchases is usually minuscule, it's always better for a seller to have an additional buyer in the market.

For continuing shareholders, however, repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value. Consider a simple analogy: If there are three equal partners in a business worth $3,000 and one is bought out by the partnership for $900, each of the remaining partners realizes an immediate gain of $50. If the exiting partner is paid $1,100, however, the continuing partners each suffer a loss of $50. The same math applies with corporations and their shareholders. Ergo, the question of whether a repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent.

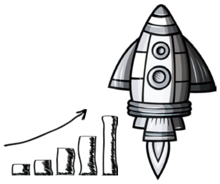
It is puzzling, therefore, that corporate repurchase announcements almost never refer to a price above which repurchases will be eschewed. That certainly wouldn't be the case if a management was buying an outside business. There, price would always factor into a buy-or-pass decision.

When CEOs or boards are buying a small part of their own company, though, they all too often seem oblivious to price. Would they behave similarly if they were managing a private company with just a few owners and were evaluating the wisdom of buying out one of them? Of course not.

It is important to remember that there are two occasions in which repurchases should not take place, even if the company's shares are underpriced. One is when a business both needs all its available money to protect or expand its own operations and is also uncomfortable adding further debt. Here, the internal need for funds should take priority. This exception assumes, of course, that the business has a decent future awaiting it after the needed expenditures are made.

The second exception, less common, materializes when a business acquisition (or some other investment opportunity) offers far greater value than do the undervalued shares of the potential repurchaser. Long ago, Berkshire itself often had to choose between these alternatives. At our present size, the issue is far less likely to arise.

My suggestion: Before even discussing repurchases, a CEO and his or her Board should stand, join hands and in unison declare, "What is smart at one price is stupid at another."



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