DORSEY ASSET MANAGEMENT

Competitive Advantage & Capital Allocation

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Introduction

Pat Dorsey, CFA

- Founder, Dorsey Asset Management
- Former Director of Equity Research at Morningstar

Dorsey Asset Management

- Launched in 2014
- ~$250m AUM, four research professionals + CFO
- Concentrated (10-15 positions) global equity strategy
- Focused on owning competitively-advantaged businesses with reinvestment potential, managed by strong capital allocators

ECONOMIC MOATS

RUNWAYS FOR REINVESTMENT

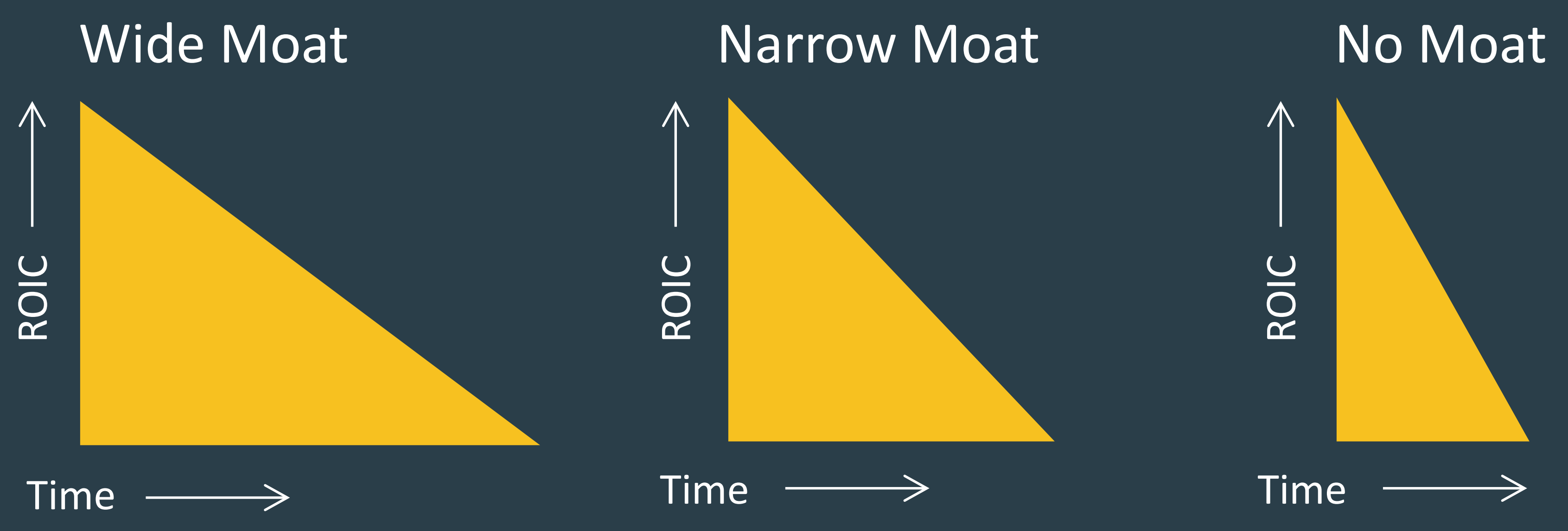
SUPERIOR CAPITAL ALLOCATION

Beating the Odds

- Capitalism works: High profits attract competition.
- But, a small minority of companies enjoy many years of high returns on capital.
- How? By creating structural competitive advantages, or economic moats.

Why Moats Matter

- An extended period of excess ROIC increases business value by lengthening the period during which capital can be reinvested at a high NPV.



Types of Competitive Advantage

- Intangible Assets (Brands, Patents, Licenses)
- Switching Costs
- Network Effects
- Cost Advantages

Intangible Assets

Brands

- Lower search costs (Budweiser, Tide, Maggi)
- Create positional value (Rolex, Cartier)
- Confer legitimacy (Moody’s, Nielsen, Gartner)

Patents

- Legal monopolies (ARM Holdings, pharma)

Licenses / Approvals

- Legal oligopoly vs. regulatory fiat

Note on Brand Vulnerability

Positional and legitimacy brands are based on strong social consensus. (Cartier, MCO, Nielsen)

Low-search-cost brands are more vulnerable.

- Fragmentation of mass media has dramatically lowered the cost of reaching a mass market.
- Challenger brands do not require a change in social consensus to deliver full value to new users.
- Dollar Shave vs Gillette / Chobani vs Danone
- How inevitable are the inevitables?

Switching Costs

Costs more for user to switch to competitor than it does to remain with incumbent.

- Costs come in many forms — money, time, risk — and may be explicit or implicit. More prevalent in B2B.

Examples:

- Products that are tightly integrated with customer business processes (Oracle, SimCorp, Autodesk)
- Products with high benefit/cost ratios (Chr. Hansen, Amazon, Moody’s, Abcam)

Network Effects

Provide a product or service that increases in value as number of users expands.

- Visa, Rightmove, Priceline

Network effects are maintained by:

- Subsidizing one side of the network (Adobe, Uber)
- Driving engagement (Facebook)

Network effects are at risk if:

- Pricing power is abused (Bloomberg)
- The user experience degrades (MySpace, Orkut)

Cost Advantages

Process: Create a cheaper way to deliver a product that can't be replicated easily.

- Inditex, GEICO, Dell, Southwest, Admiral PLC

Scale: Spread fixed costs over a large base. *Relative size matters more than absolute size*.

- RyanAir, Amazon, Cimpress

Niche: Dominate industries with high minimum efficient scale relative to TAM.

- Constellation Software, Wabtec, Spirax-Sarco

Moats & Management

Management is not a moat – rather, its actions create, preserve, widen, and destroy moats.

Moats should drive strategy.

- Amazon: Improve the customer experience.
- Bloomberg: Increase user switching costs.
- Uber: Increase vehicle liquidity.
- Howdens Joinery: Solve a builder's problems.
- Facebook: Drive user engagement.

Capital Allocation

- Capital allocation is the link between business value and shareholder value.
- If capital is deployed destructively, shareholders do not fully benefit from increased business value.
  - *Value is vaporized.*
- If capital is deployed intelligently, shareholders benefit from both increased organic business value and from value-accretive allocation decisions.
  - *Value compounds.*

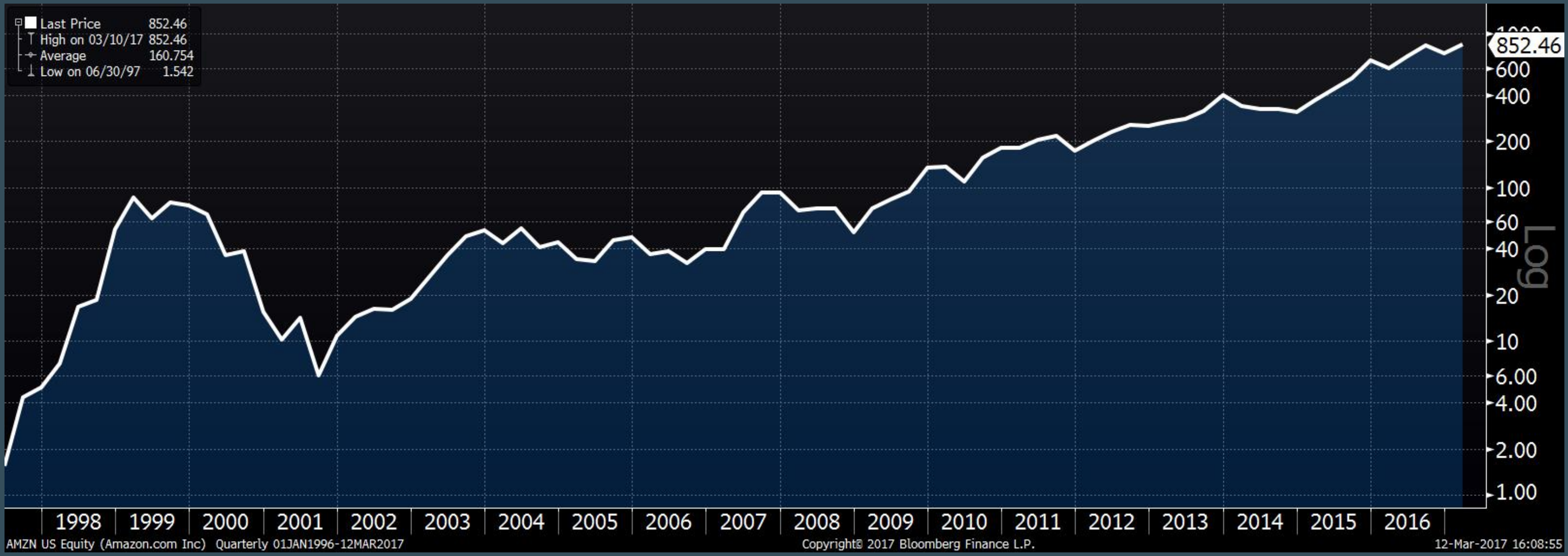
Capital Allocation: Basics

- Internal growth, dividends, and buybacks are often viewed as normatively good.
  - **Wrong. All three actions can destroy value.**
- M&A is a usually a destructive use of capital.
  - **BUT, there's a right tail of companies that have built huge value via intelligent M&A.**
- Accretive capital allocation requires discipline and focus. It must be proved, rather than assumed.

Growth: Invest if you can

If a company has high-ROIC internal opportunities, it should reinvest heavily.

- "When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the latter." (Jeff Bezos, 1997)



Growth: If you can't...don't try

Maturing companies usually continue to invest despite declining returns on capital.

- Aging is tough for companies as well as people.
- Cisco, MCD, Home Depot, Starbucks…

Phebe Novakovic's first earnings call at GD:

- Q: *"…I guess the question is about the parts of the business where you don't have growth? What do you do with those?"*
- A: *"Well, then you're going to drive earnings and cash, aren't you? There is no point in chasing revenue or pretending that you are in a growth market when you are not."*

Returning Capital

<u>Dividends</u> are not an admission of defeat…they are a declaration of victory!

- *"We're a growth company."*

Hoarding cash is pilloried in the U.S., but it has an evil twin in Europe & Oz: The Dividend Fetish

- Dividends are not normatively good if funded poorly or if they represent a large opportunity cost
- *"Because shareholders expect it."*

Returning Capital

Buybacks are an active use of valuable capital, not a passive tool for mollifying shareholders.

- Buybacks should always be driven by an objective assessment of intrinsic value.
  - *CFO: "We have no opinion about our shares' value."*
  - *PD: "Excuse me?"*
  - *CFO: "That's the job of our shareholders."*
  - *PD: "At 30x EV/EBIT, you have no opinion? Really?"*
  - *CFO: "No."*
  - *PD: "Wow. I sure do."*

What About M&A?

M&A should serve strategic goals, not paper over strategic failures.

- Microsoft/aQuantive: $7b set on fire
- Microsoft/Nokia: $8b flushed down the toilet
- Chrysler/Daimler: $30b destroyed
- RBS/ABN Amro: $60b kaput
- H-P/Autonomy: $18b kissed goodbye

High ROI M&A

If M&A is to have even a faint hope of creating value, it <u>must</u> be a a central part of strategy.

- Successful M&A requires a *disciplined process that is iterated and measured.*
  - Constellation Software
  - Lifco AB
  - Roper
  - Assa Abloy AB
  - DCC PLC
  - Danaher
  - Diploma PLC
  - Halma PLC

Assessing Capital Allocation

- Has the share count increased or decreased? When did large changes happen? Why?
- Look at the CF statement for evidence of M&A.
  - *How much was paid?*
  - *What was the result?*
- Did the company ever pay a dividend <u>and</u> raise equity?
- If ROIC has declined, is capital being returned?
- Are share repurchases opportunistic or regular?

Assessing Capital Allocation

- Is capital allocation discussed explicitly & rationally?
- Are words consistent with actions?
- Are actions & words consistent over time?
- What are the CEO's incentives? How does she get paid? Is there any ROI component?
- *Is M&A included in compensation targets?*
  - Managers who are paid handsomely to mis-allocate capital will gladly do so. *Incentives matter.*

A Chat About Capital Allocation

Do you have high-ROI internal investment opportunities?

Yes, of course!

Are you sure…or is it just hard to admit you can’t grow @ 10% any more?

I’m sure. Really.

But demand is growing 4%... How will you grow 10%?

If I changed our guidance to 4%, our stock would get killed. Now stop asking stupid questions.

Do you have high-ROI internal investment opportunities?

Well, maybe not anymore.

Thanks for being honest! Do you have a coherent M&A strategy to deploy capital?

I have an investment banker.

That means “no.” What’s Plan B?

I’ll create an M&A team with lots of smart MBAs and tell them to only do deals that exceed our WACC. In year three.

Dude, your WACC is 8%. Is that the best you can do?

What’s wrong with an 8% hurdle rate?

Well, if you need to ask…

Discussing Capital Allocation

- What is your process? Who is responsible for capital allocation? What is the hurdle rate? How is success or failure gauged? What's been your biggest error?

- How is the process measured? ROCE? ROIC? If ROI, what is included in the denominator? What was the ROI on past deployments of capital?

- What have you learned over time? What did you think would happen? What did happen? What did you learn? Should the process change?

Summing Up

- Competitive advantage drives the duration of excess ROIC, which increases long-term business value.
- Capital allocation links shareholder value and business value, amplifying or reducing equity returns.

"Lollapaloozas" occur when competitive advantage & capital allocation work together to compound value.

Outputs and Inputs

The outputs of capital allocation & competitive advantage may be quantitative, but the inputs require qualitative evaluation.

- You can't screen for switching costs – you have to talk to customers and understand the value proposition.
- You can't assume high market share equates to a cost advantage – you have to unpack the unit economics.
- You can't trust that management will allocate capital rationally – you have to gather supporting evidence.

Turn Off Your Laptops

"All of the information is in the past, but all of the value is in the future."

Quantitative data is often priced efficiently

$$\overline{\int_a^b f(x)dx} = \lim_{n\to\infty} \overline{A}(f,n) = \lim_{n\to\infty} \frac{b-a}{n}\sum_{k=1}^{n}(\overline{f}_k) = \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n} x_{k+1}$$

$$= \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n}\left(1+\frac{k+1}{n}\right) = \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\sum_{k=1}^{n}(k+1)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\left(\sum_{k=1}^{n}k+\sum_{k=1}^{n}1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\frac{1}{n}\left(\frac{1}{2}n(n+1)+n\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{1}{2}(n+1)+1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{n+1+2}{2}\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\frac{2n}{2}+\left(\frac{n+1+2}{2}\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[\frac{3}{2}n\right] = \frac{3}{2}$$

Qualitative insight is less efficiently priced

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Thank You

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