On Management Incentives

This article excerpted from a letter by MOI Global instructor Peter Rabover, principal and portfolio manager of Artko Capital. Peter is an instructor at Best Ideas 2018, the fully online conference featuring more than one hundred expert instructors from the MOI Global membership community.

"I will tell you a secret: Dealmaking beats working. Dealmaking is exciting and fun, and working is grubby. Running anything is primarily an enormous amount of grubby detail work . . . dealmaking is romantic, sexy. That's why you have deals that make no sense." –Peter Drucker

This quarter can be described as one of tepid disappointment in management teams of some of our holdings. One of the hardest things in active—but not activist—investing is making sure the management incentives of portfolio companies are aligned with those of minority shareholders. It is even harder in the small capitalization space, where corporate governance is often less sophisticated and occasionally mismanaged. There is no precise science to quantify the benefits, but ensuring that the incentives of shareholders and management are aligned through direct ownership or compensation structures is a significant way to limit the investor downside risk. We tend to favor companies where the CEOs and board members either own a substantial amount of stock or can create a substantial financial windfall for themselves through successfully increasing the value of the companies they manage.

Unfortunately, throughout our career we've found that after a certain financial threshold of ownership, the psychological motivations of wealth creation can move up the Maslow Pyramid into those of ego boosting, which may not align with those of other shareholders. In other words, after a certain amount of money is made, there may be less worry about the money and more worry about legacy, reputation, and control. On the other side, an argument can be made that having substantial wealth and reputation tied to a company creates an additional margin of safety where management is also motivated by capital preservation and is unlikely to take on value-destroying initiatives. There is no perfect solution, and finding a way to thread the needle of aligning management incentives with those of shareholders is often a challenging task. This quarter, we faced various transactions by management teams of our holdings that show the difficulty of aligning shareholder incentives with those of management:

National Research Corp. B Shares (NRCIB)

Our original thesis for investing in the B shares of what is now called NRC Health was the attraction to the oligopolistic high margin, recurring revenue business model engaged in rating the quality and patient satisfaction of hospitals and doctors in the United States. Additionally, the benefit of the B shares was that they received six times the voting and economic power of the A shares, including regular and special dividends, while trading at less than three times the value of the A shares. Founder and CEO Michael Hays controlled 54% of the A shares and 60% of the B shares, effectively controlling 56% of the company and receiving 56% of the dividend cash flows. We felt that being invested alongside the CEO and the board of directors in the B shares at a 50% discount to economic parity of the A shares provided a significant margin of safety in this special situation. Since our initial purchases two years ago at $33 per share, the B shares have paid out $6.34 cents per share in dividends (or close to 20%) and have appreciated in value to $54 for another 60% return. However, by September 2017, the discount between the economic parity to A shares has widened to over 70%, and the CEO saw the opportunity to recapitalize the company by buying back the B shares he did not already own at the current stock price. While a shrewd and opportunistic move to increase control of the company through a partial leveraged buyout, an exit scenario we always felt was the most probabilistic, we were extremely disappointed in the no premium, tender offer price significantly below the economic value of the B shares. We sold our 10% position at ~$54 per share and while pleased with the total returns we were dissatisfied in the transaction over which we had little control.

State National Companies (SNC)

During the quarter, our 11% investment in SNC received a buyout offer from Markel Corp. at $21 per share—a 15% premium to the price at the end of the previous quarter and 110% above our initial purchase price 10 months earlier. There are few things as prestigious as and validating of your personal success than having an insurance company that you founded be bought out by a venerable insurance institution like Markel. It is no surprise that the managing Ledbetter family, which owns 54% of the outstanding shares and has always had an interest in keeping SNC private, readily accepted the offer and committed to voting its ownership stake in favor of the deal where they would continue to grow the company within Markel. The $919 million offer would net the family close to half a billion dollars and allow the opportunity to continue to grow their legacy at Markel. However, we felt the $21 per share offer price was too low and allowing competing, but not necessarily as favorable to the family interests, bidder into the process would have netted offers of $25 per share or above, closer to our estimate of the company's true value. This was another example of where we, as minority shareholders, had little recourse in addressing what we felt were decisions made not in the best interest of all shareholders. We have not yet sold our position given the high probability of the deal close in this current quarter, our partners are better served paying taxes on long-term gains rather than the higher taxes on short-term gains. We expect to convert this position to cash in the current quarter.

USA Technologies (USAT)

In our biggest disappointment this quarter, we sold our 11% position in USA Technologies at approximately $5.45 per share. USAT was one of our favorite stories of the last two years, with a significant runway to increase its leadership position in the six million vending machine payments market from its current base of over 500,000 connections. The market agreed with us, and the stock appreciated almost 100% from our initial purchase levels. However, the journey to this point has not been without its bumps. Four CFOs, internal control issues, continuous cost overruns, and an out-of-control CEO have contributed to the deterioration of our confidence of our original thesis. Unlike the prior two positions, where managers with substantial ownership created additional shareholder value, during the quarter the company announced an unexpected and highly dilutive equity raise, for no reason we could find other than to get favorable coverage from a sell side institution. The company refused to answer our communication with respect to the equity raise, despite knowing we've been long-term shareholders. CEO Stephen Herbert chased us in the hall at a recent conference in San Francisco to express his displeasure at us asking a question about the equity dilution at a Q&A event. While this isn't the first time a CEO of a public company got upset with our line of questioning with respect to our investment in their company, we decided to exit our investment as a result due to the heavy concerns about Herbert. We realized Herbert's attitude toward USAT shareholders changed from a willing seller of a company to one of a "trust me" empire builder. While owning less than 1% of the stock outstanding, or approximately $2.5 million in equity, Herbert's salary climbed to over $1 million a year from $500,000 a few years ago, a high number for a small, $100 million/year revenue, company. A highly accretive sale of the company to a strategic acquirer would net Herbert an additional $1 million-$2 million, while he would surely lose his job or lucrative salary in any potential acquisition. Instead, it appears Herbert is focused on deal making, which as Peter Drucker said earlier in this letter, beats working. There is a good chance that this company will capitalize on its opportunities and the stock price may yet double from here. However, as a concentrated portfolio investment strategy, we believe our partners are better served being invested in management teams whose interests are aligned with our own.

If it seems like we are disappointed in our investments that doubled in value over one or two years, it is because we are. We do not like to leave money on the table, and we will continue to refine our focus on management incentives as part of our research process.