

Case Studies of Companies That Do Capital Allocation Right

Phil Ordway of Anabatic Investment Partners discussed companies that “do capital allocation right” at Best Ideas 2019.

Here is Phil’s session preview:

Investors place a lot of emphasis on capital allocation when considering businesses as potential investments, and rightfully so — over multi-year periods there are few things more important to a company success. So why do companies pay so little attention to it?

Is it because of managerial inexperience? Most CEOs get the top job because of operational excellence or other skills that have nothing to do with allocating capital. At least in the first few years of such cases it’s not even fair to expect capital allocation success from new CEOs.

But what about the board? Isn’t the board supposed to choose and oversee the executives? Yes, but most boards are similarly inexperienced when it comes to capital allocation.

So what about shareholders? They supposedly own the company; can they do something constructive in this regard?

Whatever the reason, I will argue that there are mutually beneficial solutions.

- Company boards could create a standing capital allocation committee to make ongoing assessments of investment opportunities and the effectiveness of prior decisions.
- Company boards could incorporate shareholder representation in the form of one or more rational but patient, long-term shareholders.
- Management teams could be more intentional and thoughtful in their investor relations efforts. How, when, and why companies communicate with their shareholders is important, and a good base of aligned, like-minded shareholders can be a significant asset over time.

We’ll look at several examples of companies who “do it right” when allocating capital and interacting with their investors. A smart capital allocation framework, communicated through a thoughtful investor relations function, can attract patient, long-term, rational shareholders that will be an asset to the company. It is possible to create a positive feedback loop in this regard, but precious few companies even bother to try. Studying the companies who get it right should yield a fruitful list of potential investment ideas.

The following transcript has been edited for space and clarity.

I thought I’d do something a little different this year, which is pick a topic and a group of companies as opposed to one specific industry, as I’ve done in the past.

Today’s topic is one near and dear to my heart – capital allocation and the role it plays with investor relations and overall corporate governance. This came up recently when a company that’s one of our biggest holdings hosted a meeting for some of its investors. Later, I was having a nice conversation with the CEO, and he asked for my impressions about some things, so I gave him my usual sermon on the topic of capital allocation, investor relations, and overall governance in that regard. To my great surprise, he was so receptive to it that he asked me to come present to the board. I regard this as a great sign because most investors probably know from experience it’s not a topic that seems to get as

much attention as it should at the CEO and board level. That's often through no fault of theirs – it's simply not their background, interest, or area of expertise. Still, it is a mistake, in my opinion, and companies do need to pay attention to it.

When I make presentations, I always advise against people blindly taking the information and acting on it. I believe they should study it and learn on their own. The companies I've picked here are not businesses I have particularly deep knowledge about; they are just particularly good or vivid examples of certain ideas and practices relating to capital allocation, investor relations, or overall corporate governance. This is not investment advice by any stretch of the imagination.

The basic idea is that all would agree there are three things all companies need. Firstly, they need to take their capital and allocate it effectively. They also need to have good shareholders, meaning the right kind of shareholders who are aligned with what the company is trying to do so that there is a helpful, productive, symbiotic relationship. To get that, companies need meaningful communication with their shareholders and all of their stakeholders. These three things often seem to be viewed in isolation, but maybe they're all related. If we study companies which do it right, we should get potential investment ideas over time.

Anyone who's been in investing for some time has seen how important these topics are. I mean, the best use of cash is the number one thing any investor is doing, and it's the same with any corporation. The CEO and board will certainly have a massive influence on the company over any amount of time. If they stay for more than a few years, they will end up allocating a lot of the capital deployed in the company. No matter how cheap the security, a bad capital allocation decision or regime, a bad acquisition, buybacks at the wrong price, or just a poor overall governance environment can ruin any business, and I'm sure we have all seen examples of it.

When we talk about capital allocation, it boils down to how we use our cash. This is a fundamental question, whether you're an investor or a company executive. It's amazing to me how adept many businesses have become at using their cash intelligently. They're incredibly smart in how they allocate their cash when it comes to managing their suppliers and vendors, running their internal accounts receivable, overseeing the day-to-day operations, or investing in their PP&E. When it comes to the financial aspects of their business, their capital structure, it tends to be a totally different conversation. That seems very strange to me because we're all just talking about tradeoffs. If you go out and talk to companies about this, you have to be able to argue that this will define them over time, separate the good from the great, and take the good or the mediocre and potentially turn them into something much worse if it's not done well.

Secondarily, over time, companies will get the shareholders they deserve. If they're doing things wrong or right will eventually manifest itself in the shareholder list. This is a key topic for this era because there are some big things happening in the way corporate governance is executed, at least in the US. The index funds are here, and they're massive. They're often the biggest shareholders in any given company, and they have many benefits. I am by no means discouraging index funds as a concept for there are many benefits from the rise of Vanguard and others, but corporate governance is not one of them. In any company's life, if you're looking at a 5-, 10-, 20-year period, you're almost guaranteed to have at least one event where there will come a vote that's extremely close. If all of your shareholders are passive or checked out, you could lose your company to a somewhat arbitrary decision coming down essentially from ISS or Glass-Lewis or non-economic factors. This is something no one wants.

Additionally, the activists are coming, and this does have the attention of many boards and companies. They're scared and rightly so. By the time the activists arrive, it's generally too late, in my view. Therefore, the idea is to engage with your shareholders and have the right capital allocation

environment to generate the right kind of shareholders so that you don't get to the point where the activists come.

On top of that, long-term engaged shareholders are a vanishing breed. Whether they're big institutions or sizable blocks of retail shareholders, they're shrinking, dying out and being replaced largely by the index funds and some of the large pension funds. The holding period has declined rapidly, and it's devolved into this unhealthy, unproductive shareholder environment that companies need to pay attention to and try to fix.

Capital allocation is a fluid process. The number one rule is that it's an ongoing process. There is no finish line, conditions change, and your capital allocation decisions have to be adaptable. A thoughtful framework is all that's required. There are no hard-and-fast rules, and no one size fits all. This is what I would refer to as a decision tree, which is not as fancy as it sounds. It is essentially a common-sense list of priorities. If you see a company which doesn't publish this, you should ask. If it can't walk you through this, it's a problem, and it needs to be addressed.

There are some common traits I see at companies with good capital allocation regimes and good corporate governance. Number one is that they have an investing mindset, which doesn't mean you used to run a hedge fund though it can certainly be helpful. There are plenty of CEOs who had an investing background in some way, shape, or form. They were a venture capitalist, a real estate investor, or a fund manager of some type, and then they somehow ended up in the C-suite at a company. There are also plenty of CEOs with absolutely no background in investing, people who previously worked as lawyers, marketing executives, or operations managers. Still, when it's explained to them, they get it, and this investing mindset then permeates through the whole organization.

At least as important is what not to do, first and foremost pretend like it doesn't matter or deny there's a problem. You see lots of individual practices that are particularly dumb, and eliminating them would be a big step in the right direction.

What I like to see in terms of overall corporate governance is a dedicated, and better yet, interdisciplinary capital allocation team at some level of the senior management. I certainly do this with my own investments during what I call pre- and post-mortem - looking in advance at what could go wrong, what actually happened at some point down the road, what worked and what didn't. Companies that can establish such discipline internally are particularly effective. At the board level, I would advocate for a capital allocation committee. That's not to add one more layer of committee or bureaucracy but to highlight the fact that this is something really important. There are shockingly few companies doing this or even mentioning it anywhere in their corporate governance documents, charters, and by-laws. I found out by searching SEC files, EDGAR, and SEDAR, and doing simple Google searches. There were shockingly few that mentioned any sort of capital allocation committee as a function, even if it's just a sub-function of the finance committee. I also did a little survey among 50 of the Fortune 500 companies and found fewer than a third even had a finance committee. You don't know what's happening in all these board meetings. They're talking about finance issues and capital allocation, but I think it would send a powerful message and be effective if they made it much more of a priority.

The second thing is finding at least one or two people to serve on the board who actually have the capability and the background diversity to think like an investor, to bring an independent board level view of capital allocation, to act as a check on the CEO and the management team, and to make sure the board has its own opinion. They certainly have their own opinions on other topics. Why wouldn't they have an in-house expert to do this for capital allocation? It would make plenty of sense.

Investor relations (IR) gets back into how you tie this all together. In most cases, IR tends to be a

dedicated function of the company that exists on its own. It tends to be about how you interact with Wall Street (the sell-side analysts in particular) and keep them happy and how you get the stock price as high as possible. Neither of those is productive and could, in my opinion, be quite counterproductive. The IR function ought to be an in-house but cross-functional role, some role within the CFO or controller's organization, not a permanent thing one person does forever. Make clear that what you're trying to do is communicate as needed, not just because you feel like you have to because the calendar is on a certain day or because your peers are doing it. Provide the information you want if the roles were reversed and you were a significant shareholder. I always prefer written communication as I find it more effective.

There are a number of companies I consider particularly good in that regard. The point is not that any of them are perfect - they certainly aren't, nor are they perfect investments or even good ones. By no stretch of the imagination am I evaluating any of these on the basis of price and value and their investment merits. These are companies I found to be, at least in one or two or three notable ways, extremely well managed, thoughtful, and effective in what they're trying to do. There is no ideal, perfect company, with perhaps one possible exception, which is, of course, the company in Omaha. When I bring this thing up in talks with CEOs, management teams, or even other investors, I've noticed you either get a visceral reaction to Buffett the personality or the very reasonable response "I'm not Warren Buffett. I'm not running Berkshire Hathaway, and I don't have these circumstances, so this stuff doesn't apply to me." That's fine, but my point is there's only one Warren Buffett and one Berkshire Hathaway. You don't have to be that. What you should try to do is make incremental progress to a better company and a better you. If you take some of the best practices companies other than Berkshire Hathaway have figured out, you can make a huge difference and make your company far more valuable over time.

One of the best examples of what I'm talking about is Constellation Software. This is a Canadian-based company which has made dozens and dozens of acquisitions over the years in various vertically managed software companies. It's a pure software technology company, so about as far as you can possibly get from Berkshire Hathaway and Warren Buffett. However, the CEO, Mark Leonard, is enormously thoughtful in what he does, and his results speak for themselves. This company IPO-ed in 2006, not even that long ago. This is the kind of investment that if you can identify it and find it early - which, unfortunately, I did not - it could literally change your life and your career.

I don't think it's any coincidence that capital allocation is at the very heart of this company. Mark Leonard didn't have an investing background, more of a VC-type background, but he gets it. If you look at what he's done and where or how he's laid things out over the years, you'll see a highly consistent framework, which is the most important thing. This was obvious in the prospectus when they filed to go public in 2006, but there are also fantastic, thoughtful shareholder letters. The management provides written responses to investor questions. Instead of doing a lot of time-consuming sell-side conferences or one-on-one meetings, which are also quite inefficient, you submit questions. They take the meaningful and thoughtful ones, reply to them, and file their responses so that everyone can read them. If you ask me, that's the most obvious thing in the world to do. The IPO prospectus says, "At the heart of our business model is the effective allocation of our capital." If that's not a clear, impactful, and meaningful mission statement, I don't know what is. It ought to be the case for every company. Constellation Software publishes case studies of things it has done; it has a very effective board of directors; and it actually tries to develop capital allocators at each level of the company, which is something I consider particularly unique. I don't think I've ever seen it in another company beyond perhaps Berkshire, where they try to nurture the capital allocation function amongst their other executives.

The prospectus of 2006 details what Constellation does and why, along with providing the capital allocation framework. It is very specific to the software business, but all companies ought to have

something like this – not in terms of the details, but how they go about allocating their capital, what they do when cash is available, and, just as importantly, what they do when they don't have opportunities. Constellation Software also ties its compensation plan to it, which is absolutely crucial. It makes sure people are tied to a return on capital and not just blowing capital out the door with no concept of an opportunity cost.

As regards the board search criteria, there is a really interesting story here. Most will be familiar with Larry Cunningham, who is the author of several fantastic books and compiled the original magnum opus, *The Essays of Warren Buffett* with Buffett's cooperation and approval. Larry is an expert, but he's a law professor by background and training. Constellation tries to find board members who match specific criteria – it doesn't view the board of directors as a country club for friends and cronies. It wants the board to add to the company's success, which puts it in the top 1% of companies out there in my opinion. As part of this search process, Constellation's management looks forward and says, "We'd like to find more people who understand corporate structure, culture, conglomerates, acquisition-hungry companies, and capital allocators." Mark Leonard was familiar with Larry from his work and reached out to him directly as a part of the search. They started taking and did some work together on the side and some studies. Larry's now on the board, which is just a fantastic example as to how this should work. Listen to them talking and you'll hear how much value the company has derived from that relationship alone. In my opinion, this is what every CEO and every board should be doing.

Another good example is Texas Instruments. I think everyone should look through its IR materials, particularly those dedicated to capital allocation. This company is absolutely fantastic: it has presentations, and it puts videos on YouTube to make it clear this is important. "At Texas Instruments, we as managers think that allocation of capital is one of the most important jobs that we have" – this is as clear and important a statement as you'll ever see, and you almost never see it. These are not guys who think of themselves as Berkshire Hathaway or Warren Buffett knock-offs, but they get it.

What may be the most interesting thing is that when Texas Instruments had a regime change some years ago, it actively reached out to what it thought were the right kind of investors. I won't name names, but it went to some people I think we would all agree are fantastic, patient, long-term investors and said, "We think that you guys will be the right shareholders to own our stock. We'd like to sit down and talk with you." It worked because it was so intelligent and thoughtful. The logic was there, and the company ended up getting several 2%, 3%, 4%, 5% shareholders that stayed invested for years. Think about how much more intelligent that is than sitting there and doing conference calls and sell-side presentations where you might be yelling into the wind. You're certainly not targeting the right kinds of people in this way.

Going back to the capital management strategy, the business model is built around four things the company calls its sustainable competitive advantage, and it has the discipline to allocate the capital to the best opportunities, but not because it feels like it has to. There is a strict hierarchy for these opportunities, and it makes perfect sense where and how it measures outcomes. It has targets and publishes the results, which is fantastic. Over the preceding decade, Texas Instruments allocated \$72 billion of capital. If you had said in 2008, "Guys, we need to sit down and allocate \$72 billion of capital over the next decade," it probably would have been a pretty sobering thought at the time, but it's true and is important. Every company has some version of this to think about.

Another great example is Morningstar, where we actually have something of a Warren Buffett link – founder Joe Mansueto is a long-time admirer, friend, and confidant of Buffett's. When the company went public, it intentionally structured its business to be decentralized, have a long-term focus, and go out and seek the right kind of shareholders. It said, "We're not going to take analyst meetings. We're not going to issue any kind of financial guidance," the latter being a thing whose popularity I still can't

fathom because it doesn't benefit anyone. Morningstar has candidly written IR communications as well, including published answers to investor questions.

Another really interesting one is Graham Holdings, which probably has the most direct tie to Buffett because he was a long-time shareholder and became a personal friend, mentor, and tutor to the management team and the family. Over the years, this company has been willing to reinvent itself in a capital allocation framework by selling its crown jewels, spinning off what was its cash cow, building a really diverse and talented board, going much younger with its executive team, and branching out into new industries. I feel as if management teams get trapped into thinking they have to be on the sell-side conference treadmill, that if they don't have a presence there, they will lose out somehow. What if you just limited it to the ones which really make sense? Graham does exactly one sell-side conference a year – a UBS conference in December – and that's perfectly effective and legitimate. An executive's most precious asset is their time, and so why wouldn't you want to be more careful in allocating your time to the few things that matter? Doing this once or maybe twice a year seems like quite a reasonable compromise.

With Credit Acceptance Corp, the business model may put some people on edge, but the point here is how it goes about using its capital allocation practices to benefit the company and make it more valuable over time. It says, "We have used our excess capital to repurchase shares only when prices are at or below our estimate of intrinsic value." This should be obvious, but it's rarely said out loud. The company acknowledges the fact that its assessment of its own capital position and valuation is subjective – another thing that is obviously true but needs to be said out loud and be at the top of mind.

Here's another interesting part: it cites two board members with very deep investment experience, revealing they are the ones who steer capital allocation at the board level. It's awesome to have a CEO saying, "Look, I think I'm a great executive. I run this company, but these two guys on our board are better investors than I am, so I'm going to defer to them in decisions where we may disagree about what to do with some of our capital allocation decisions, like repurchasing stock." How many CEOs have the self-awareness or the security to say and do this? That is exceptional and highly admirable, in my opinion.

Cimpress is another good example and quite an interesting company. Its CEO did not have an investment background, but he had that "aha" moment. When someone explains to you how capital allocation should work, you really ought to be able to get it in the first two minutes because if you don't, you're probably never going to get it. Here, the light bulb went off, and the rest was history. Cimpress does some really intelligent things, such as track all of its investments and repurchase activity. It has a document which covers its long-term incentive compensation plan, and I think it's particularly clear and admirable. It writes an annual letter explicitly talking about capital allocation, which is fantastic as well.

Amazon is probably one of the best-known companies in the world, but I think its capital allocation, IR, and communications efforts are underappreciated aspects. With its size now, these matters far less but certainly mattered a lot back in the day, particularly after the dot-com implosion, when the company was in a bit of trouble and the stock was beaten up. The way it went about discussing its capital allocation framework and cultivating the relationships with its shareholders absolutely mattered and was hugely important. This is a classic tech and – for the moment – disruptive company, but the statements you can see in its shareholder letters ought to resonate with any of us, no matter how stodgy our views might be.

Phillips 66 is at the opposite end of the spectrum, a commodity energy company, but look at this: "We buy our shares when they trade below intrinsic value" or "We operate in a volatile industry, but we

ought to be resilient through industry cycles by strategically investing our capital in a way that adds value to our business and our shareholders.” As far as I can tell, that is unique among all energy companies and makes it stand out. It has done quite well because of it.

It has also published the way it goes about calculating its returns on capital, which is another thing I’ve never seen an energy company do before. I’ve looked at plenty of them, not so much recently, but in my prior life, and it’s amazing to me how much return on capital gets completely ignored in this industry, particularly by E&P companies. Phillips 66 isn’t an E&P company, but the way it does this is uniquely thoughtful in the industry.

Sherwin-Williams is another great example, with a very clear and consistent capital allocation philosophy. There are certain things I may not consider ideal, which applies to all of these companies. Sherwin-Williams has taken this attitude that it will never hold cash. It wouldn’t bother me if a good company with a thoughtful capital allocation framework allowed cash to pile up for a year or two. You don’t want to hold an undue amount of cash for a decade, but this company has a very strong view the other way. It’s fine because that’s its framework, its business, its culture, and its goals, and you can see here how it’s working.

One other thing that makes Sherwin-Williams stand out is that it was one of maybe a couple of dozen large public companies, at least in the US, which were actively buying back their shares in 2008-2009. Everybody was buying back their shares in 2005 and 2006. Pretty much every stock got hit hard during that period. When a lot of them became very cheap, the buyers all disappeared, even among the companies with the capital structure, the excess cash, and the cash flow to buy. However, most of them didn’t have the courage or the framework in place to execute on it while Sherwin-Williams did. That’s incredibly important and valuable, and it should be commended for it.

WABCO is another company which had the courage to do it in a contrarian way. An example I want to call out is Jacques Esculier, who is a great capital allocator and did this in September 2011. You may remember there was a scary period in that year. The euro crisis was beginning to flare with Greece and some other countries. There was this pervasive fear that we were going to have a double dip and go right back into a nasty recession, like the one we’d just come out of, and a lot of stocks, WABCO in particular, were being hit hard. The company had a dedicated special call, announcing it would go out and buy back a lot more stock, telling people about it to address fears, concerns, misconceptions, and just provide an update on how things were really going because it was a pivotal time. It bought back a lot of stock and did well on it. It was a very intelligent purchase at the time.

Netflix is probably among the most analyzed or overanalyzed companies in the world. I don’t have any strong opinions about the things that normally get debated about, but most interesting, in my opinion, is how the company used capital spending, not in the sense of debt and equity or other securities but as a weapon to swamp its competitors. That’s fascinating and worth studying and considering.

Another thing that jumped out was its board practices. Netflix doesn’t have a typical board by any stretch of the imagination. Rather than publishing some massive 100-page document for a board book for each meeting, it restricts communication to relatively short memos directors can access, edit, comment on, and amend over time. Thus, you get more of a living document to mark and track your progress, just as I keep a running notebook with everything I’m doing, looking at, and thinking about. I use it to track my thoughts and progress over time, and Netflix does the same thing with board-level communications. As far as I can tell, that is unique among all boards of directors.

Netflix also encourages its directors to get out and get involved with the company. Rather than go to some board retreat or to a meeting in a sterile conference room, directors are urged to get out at least several times a year and go as observers only. They’re not supposed to influence or interact with the

meeting itself but go to lower level staff and executive meetings and watch how the company operates in the wild. I find this an enormously intelligent practice. The company has got some great IR documents and practices as well – the effort and thoughtfulness it has put into its IR are impressive.

Henry Schein, a dental and healthcare products and distribution business, has had some fantastic results in using a value-based approach in repurchasing shares and making acquisitions. It has done over 200 acquisitions in the last couple of decades and invested massively in organic growth, new product lines, and new geographies. One thing I find extremely interesting and which ties into this whole concept of IR and corporate governance is that Henry Schein doesn't let the tail wag the dog. It clearly and explicitly states that the company does not exist for the investors. The investors are important, and it acknowledges it can't exist without them, but it's not going to let things get out of order. I've been thinking about this a lot lately. Herb Kelleher of Southwest, who recently passed away, was very clear about this as well. You must have the right order of priorities. For most companies, there's a reason why equity holders are the residual security in the capital structure. If a company is being run properly, they ought to often be the residual consideration in that process as well. If you're not putting your employees and your customers ahead of your shareholders, something's probably out of order and probably going to go wrong.

Daily Journal is an odd duck but a fantastic example of capital allocation. It built up a massive cash hoard over several years leading up to and including the financial crisis, when Charlie Munger was at the helm and had been for many years. Then, in one fell swoop, in March of 2009, it made a massive investment in a handful of high-quality financial assets at exceedingly low prices, and it has held them ever since. It's been almost a decade now, and we know how well that's done. It has also been extremely patient, willing to invest and take a lot of pain and suffering in its digital transformation into more of a software company. That's the right way to behave, in my opinion.

Post Holdings is another example. Bill Stirtz is still there and actively involved. The way the company goes about this is really intelligent. It had a call a couple of months ago where it said, "We want to reach out to our shareholders and have a conversation. We're doing this convertible preferred offering, and here's why." It makes all the sense in the world, but most often, you don't see it at all. You just see a press release or a filing. I think it helps to go through and explain why you're doing something in common sense terms and language to your investors, and you just don't see that enough.

Another excellent example is AutoNation, where Mike Jackson has been the CEO since 1999. He is about to retire, but he's overseen repurchases of 85% of the shares during his tenure, often at exceptional values because the industry is cyclical. As the company says, "We use the choppiness in the US vehicle market to our advantage. We, from strength, can repurchase our stock." It's been a huge homerun largely because of that.

Here's something interesting: for many years, the lead independent director was Mike Larson, who is a fantastic investor and runs Bill Gates' family office. Mike Jackson was literally a car guy. He understood cars and dealerships but not capital allocation necessarily. And say what you will about Sears, you'd probably still rather have Eddie Lampert on your board compared to a lot of other people. Mike Jackson commented in an interview that Mike Larson and Eddie Lampert tutored him and taught him how to think about capital allocation. As the CEO put it, he got a PhD in capital allocation from these investors, who owned 15% and 16%, respectively, of the stock. Almost 1/3 was in the hands of two individuals who had board seats and each stuck with the company for over a decade – this is enormously powerful on multiple levels.

Another fascinating example is BNSF. In a recent interview, outgoing CEO Matt Rose looks back on his career and how things are going, also touching on the way capital is spent. He points out that Wall Street and the sell-side analysts in particular are pressuring some railroads to spend as a percent of

revenue, which he thinks is nonsense. “We don’t spend capital as a percent of revenue. We spend it based on gross ton-miles we haul. Bridges don’t wear out with revenue; they wear out with units and gross ton-miles.” This makes all the sense in the world, but it’s somehow apparently being lost in the financial community right now. He also talks about how a lot of companies have adopted a capital-light model, which for many industries and businesses is the right thing and is enormously powerful. According to him, it doesn’t make sense here, and he thinks that every industry and every business can benefit from growth. I find this a really interesting framework and the right way to put it. He also talks about the unwritten commitment the company has to be a good steward of capital in its regulated environment – most companies are not regulated anywhere near the level that railroads are.

Allow me to sum it up by referring to a presentation General Electric gave in November 2017. John Flannery, the CEO at the time, made an explicit push to put a new emphasis on capital allocation principles and priorities. He added a finance and capital allocation committee to the board, which I think is enormously commendable. He cut the size of the board and introduced some more shareholder-friendly things. It’s not easy, and I think he did all the right things in this regard. GE had been going a certain way for years, and this wasn’t enough to save it, which demonstrates there is no one true path. You have to do a lot of things right. This was one way to make some incremental improvements and something they tried to do.

The following are excerpts of the Q&A session with Phil Ordway:

Q: Could you elaborate on Amazon as a case study? The company has been faulted by some investors for not focusing much on profits. How do you square that with its good capital allocation?

A: I wouldn’t want to position myself as an expert on Amazon, but one thing that jumps out to me is that the company always had a framework in place which made a lot of sense: “We’re investing in the customer first and investing in our company to serve the customer first.” Rather than take a dollar of margins today, it prefers to reinvest that dollar of margin, drive down prices, and reinforce the whole company instead of running it to maximize capital today. I think it worked marvelously for Amazon, but the dangerous thing about it is that you see other companies end up in a sort of “Waiting for Godot” situation – they all talk the right game of deferred gratification by saying, “We’re going to invest for today to make tomorrow stronger.” That’s fine, but there has to be a tomorrow.

What’s most interesting about Amazon is that value was always there, and it absolutely worked; the capital allocation internally was very intelligent, and the fact that there wasn’t profit should not come first. Costco could serve as a good comparison. It obviously shares a lot of commonalities with Amazon in ways people may or may not think about. Amazon Prime, for example, certainly mimics closely the Costco membership model for good reason, and that, in my opinion, allowed it to make a lot of the leaps it did.

If you look back at Costco, it IPO-ed in 1985, and its first annual report came out in early 1986. It’s an absolutely fantastic read from the days when you could get a 25-page annual report that told you everything you needed to know. Costco wasn’t profitable at the time, not even close to it, but it was growing like crazy, memberships were doubling and tripling over a year or two, and you could see the business model, the framework was there. The company was talking about what it was doing and why and executing on it, but the profits weren’t there. I was talking to somebody at the company not that long ago, and I found out Costco had been in the Midwest for over 20 years. It has been growing like crazy in this region – I think it is up to 85 or 100 stores or something like that in the area out of the 700 or so stores it has in total – but as a whole, the Midwest business went profitable for the first time ever only in 2018. You’d think this is a disaster and terrible capital allocation, but the company was just playing a much different longer game. I think what matters is that it never changed the framework and the goal post. It didn’t try to distract people and say, “We screwed up. Let’s focus on

something else.” It was always very consistent and logical, which is not to say it didn’t adapt and change courses. These are also the things I would highlight about Amazon.

Q: What KPIs or metrics do you track to help assess capital allocation outcomes? At some point, it may not be enough to simply rely on anecdotal qualitative information from proxies and investor presentations.

A: Absolutely. I will, at least at first pass, be willing to accept what management is putting out there as the KPIs. If they don’t publish any, that’s a concern, but I’ll always have my own. I usually do it in a couple of ways, but I always track return on invested capital, and then track return on invested capital that’s incremental if you can do it. It’s sometimes a little hard depending on the business, but I think that’s the single one to focus on. You’re taking the dollar. You’re putting it out. What are you getting back for that dollar? You can do that at a high level. It’s even better to do it at a micro or a segment level if you can. It can get a little tricky and varies a lot from industry to industry. If I were dealing with a bank, I’d want to look at how many deposits per branch you have, what’s your efficiency ratio across the whole company, how that has changed over time, and certainly look at return on assets and return on equity to see how it all rolls up together. The efficacy as a bank is determined by how it gathers deposits and then redeploys that capital into income and yield-generating assets. If you’re looking at an airline, you try to get down to the level of individual plane and aircraft investments. You can’t really do that hub by hub although it might be possible if it’s a legacy carrier. You can get down into some granular data, see the returns at various levels of the company, and try to take it from there.

Q: What premium would you be willing to pay for good capital allocation? Maybe using Constellation Software as an example, a lot of the current valuation seems to assume continued future acquisitions at high returns on capital.

A: It’s a great question I have no great answer to. All I would say is that I would certainly place a value on it, and my appreciation for it grows every single day. There is too high a premium to place on it for sure, so I can’t give any specific advice. It’s dependent on your own specific views. If you wanted to take Constellation as an example, you’d have to evaluate both the business and the people involved and say what you think they’re going to do. Simplistically put, I would try to learn as much as possible about the business at a micro and operating level and place it in the context of where I think this business is going to be 2, 3, 5, or 10 years from now because I have no idea where it’s going to be on a short-term basis. Over the long term, the range of error gets pretty wide, so you have to be quite comfortable that the odds are in your favor. You just have to say, “What are the odds something goes really wrong here? What are the odds that something could go right? What’s most likely in between? And what’s a common sense price to pay for this? If I put \$100 of my own capital into this company today, what are the odds that I ever get it back? What are the odds that it provides a reasonable return?”

One of my favorite things to do is look at two companies side by side. Start them at, let’s say, 2010, coming out of the financial crisis, but take their names off and make it a blind comparison. Then say, “Here are their financial characteristics.” You can ask people to value them then and what they would pay now. Alternatively, you can have the valuation as a starting point and then look at what has happened and how they’ve allocated capital because eight years is a meaningful amount of time. Say, “Here’s what they’ve done over these eight years,” and then “What’s it worth at the end?” When you do the big reveal and say, “Look at what’s actually happened here,” that’s where it becomes clear whether the business is worth some massive premium. You could have paid a much higher price back in 2010 for a good capital allocator versus an average one, let alone a poor one. That’s probably the number one thing. I wouldn’t be too worried about the premium. You don’t want to pay a crazy prize by any stretch of the imagination, but just avoiding the bad ones is a huge step in the right direction.

About the instructor:

Philip Ordway is Managing Principal and Portfolio Manager of Anabatic Fund, L.P. Previously, Philip was a partner at Chicago Fundamental Investment Partners (CFIP). At CFIP, which he joined in 2007, Philip was responsible for investments across the capital structure in various industries. Prior to joining CFIP, Philip was an analyst in structured corporate finance with Citigroup Global Markets, Inc. from 2002 to 2005. Philip earned his B.S. in Education & Social Policy and Economics from Northwestern University in 2002 and his M.B.A. from the Kellogg School of Management at Northwestern University in 2007, where he now serves as an Adjunct Professor in the Finance Department.