

The Two Things We Look for in a Management Team

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Imagine you went back to 2007 and told investors that within the next ten years, General Electric would cut its dividend twice. You'd have been mocked and ridiculed.

At the time, GE was one of five U.S. industrial companies with AAA-rated credit, had just increased its dividend by 11% (its 32nd consecutive annual increase), and was one of the largest companies in the world by market capitalization. Such an outcome would have seemed implausible.

Yet here we are. The GE story is complex (which in itself is a problem), but one of the causes of its recent decline was consistently poor capital allocation decisions.

Here's Morningstar's take: "(GE's) ambitious overhaul came with an overly aggressive midterm financial target of \$2 in earnings per share by 2018, which probably colored management's capital allocation decisions in a manner that ultimately exposed GE's investors to unnecessary risk."

As the GE story illustrates, the way management allocates capital can have a massive impact on long-term shareholder returns.

Simple doesn't mean easy

At Ensemble, the two things we look for in a management team are their intent to optimize return on invested capital (ROIC) and their skill at allocating capital to maximize shareholder returns.

You'd think that these two things would be common, but they are more the exception than the rule. Indeed, our eyes light up when we see multiple mentions of ROIC (or return on equity) along with a discussion on capital allocation in annual reports, management meetings, or quarterly earnings calls. It's that rare.

Why might this be the case? One reason is poor incentives. You never hear of a stock jumping 10% because ROIC beat expectations. No, it's usually because the company reported better-than-expected revenue or earnings per share. Perhaps not surprisingly, two of the [most common financial metrics](#) used in management bonuses are – you guessed it – revenue and EPS. Unfortunately, neither of those metrics alone tell you if the company is creating shareholder value.

Revenue and EPS growth are essential, of course, but we believe that if the company aims to [widen its moat](#) (that is, optimize long-term ROIC) and thoughtfully allocate capital, revenue and EPS will take care of themselves.

Decisions, decisions

There are three ways a company can return cash to claimholders: pay a dividend, buyback shares, or reduce debt. There are smart and dumb uses of each. What we want to see is that management has thoughtfully weighed their options based on return opportunities.

To illustrate, at its 2017 investor day, Verisk Analytics showed how the firm allocated capital between buybacks and M&A over the previous 15 years.

Investor Day 2017



Capital Allocation 2002–2017

\$ Billions	2002-2012	2013	2014	2015	2016	2017	Total
Buybacks	2.6	0.3	0.8	0.0	0.3	0.3	4.2
M&A	2.0	0.0	0.0	2.9	0.1	0.9	5.8
Total	4.5	0.3	0.8	2.9	0.4	1.2	10.1

Historically balanced; will vary based on return opportunities

Notes: Through Q3 2017 plus PowerAdvocate
Figures may not sum due to rounding

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As the slide mentions, Verisk decides on buybacks or M&A depending on the available opportunities. Even if they don't always make the correct assessment in hindsight, we like that there's a process in place.

We were further impressed that Verisk followed the above slide with IRR results from their capital allocation decisions.



Buyback Performance

Year	Shares (M)	Dollars (\$M)	IRR (%)
2010	15.1	437	19
2011	11.3	382	19
2012	3.5	163	15
2013	4.5	279	12
2014	10.8	778	13
2015	1.1	20	14
2016	4.3	327	24
2017 YTD	3.4	276	19

Notes: IRR is calculated using value at buyback and December 01, 2017, stock price (\$95.64). 2017 YTD total return.

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M&A 2002–2017

	#	\$B	IRR*
Deals > \$100 million 2002–2016	6	\$4.1	19%
Deals < \$100 million 2002–2016	35	\$0.8	12%
Deals > \$100 million 2017	4	\$0.8	N/M

Notes: See appendix for IRR methodology.

* Deals > \$100M include Wood Mackenzie and tuck-ins, Argus and pre-2017 tuck-ins, and all healthcare

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Again, this level of transparency is rare, but we welcome it and would like more companies to follow suit.

Companies with moats are rare, as are companies led by thoughtful capital allocators. Companies that have both are exceptional and are precisely the kind of firms we want to own in our portfolio.