

DORSEY ASSET MANAGEMENT

Maximizing Moats: Reinvestment Runways & Capital Allocation

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Introduction

Pat Dorsey, CFA

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

Dorsey Asset Management

- ~\$680m AUM, seven employees, largely institutional clients
- Concentrated (10-15 positions) global equity strategy, focused on businesses with economic moats & reinvestment runways
 - Eleven positions currently, with 60% of capital in top five
 - Process emphasizes primary research & qualitative insights



ECONOMIC
MOATS



REINVESTMENT



CAPITAL
ALLOCATION

What Creates a Moat?

The primary test of an economic moat is **pricing power**, generally created via:

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

Why Moats Matter

- Moats **increase business value** by lengthening the period during which capital can be reinvested at a high incremental return on capital.



Why Moats Matter

- Moats **increase business value** by lengthening the period during which capital can be reinvested at a high incremental return on capital.
- Moats **reduce business risk** by insulating the business from competition and exogenous shocks.
- Moats can be **inefficiently priced**, because a go-forward evaluation requires qualitative analysis.

Why Reinvestment Matters

A long runway for reinvestment **maximizes the value of competitive advantage**, and lowers the risk of value-destructive capital allocation.

The Value of Reinvestment

- Company A: 20% ROIC; reinvests 30% of cashflow; uses 70% for dividends, buybacks, M&A.
 - Only one-third of cashflow earns 20% ROIC... assuming incremental ROIC = total ROIC.
 - Potential for value destruction: Overpriced repurchases & unsuccessful M&A.
 - Income paid out to the investor **must be re-deployed in a competitive public equity market.**

The Value of Reinvestment

- Company B: 20% ROIC, reinvests 70% of cashflow.
 - Assuming sufficient opportunities, **the bulk of cashflow earns 20% ROIC.**
 - **Lower capital allocation risk** → capital is reinvested
 - **Return on reinvestment is higher** than what is typically achievable in public equity markets.
 - The set of companies with sustainable ROIC > 20% is much larger than the set of equity managers with long-term net returns >20%.

Analyzing Reinvestment

- Investment also happens on the income statement
 - Sales, advertising, SaaS development costs...
 - Expensed investments can have LT value
- Corollary: Low current margins \neq a bad business
 - Are some expenses actually investments?
 - Structural LR margins may $>$ current margins
- Limited reinvestment opportunity \neq a bad business
 - Capital allocation takes on greater importance as a source of value creation or destruction

Analyzing Reinvestment

- Is the investment incremental or fixed?
 - Software & salespeople vs satellites & gigafactories
- What is the possible competitive response?
 - If you poke the bear, it might poke back.
- Widening / marketing a moat or digging a new one?
 - Extensions are less risky than *de novo* creations.

Analyzing Reinvestment

- Most important: Are the CEO's palms facing outward or upward?



Capital Allocation

- The link between **business value & shareholder value**.
- At a minimum, shareholders should **benefit fully from the value created by the business**.
 - Rarely, capital allocation **creates incremental value**
 - Often, shareholders **do not receive** all of the value created by the business due to poor capital allocation
- Three types of capital allocation choices:
Reinvestment, returning capital, and acquisitions.

Reinvestment vs Returning Capital

- Plentiful high-ROIC internal opportunities?
 - **Reinvest!**
- Insufficient high-ROIC internal opportunities?
 - **Return capital!**
- Obvious, right? Sadly, no.
 - In the U.S., dividends perceived as waving a white flag.
 - In Europe and Australia, dividends are fetishized.
 - Buybacks are often used passively to mollify shareholders rather than actively to create value.

What About M&A?

- Large-scale, infrequent M&A usually fails → used to paper over strategic failures rather than create value.
 - Microsoft/aQuantive & Nokia: \$15b set on fire
 - H-P/Autonomy: \$18b flushed down the toilet
 - Caterpillar/Bucyrus: \$6b thrown in an open-pit mine
- If M&A is to have even a faint hope of creating value, it must be a central part of corporate strategy, using a process that is iterated & measured.

Summing Up

- Moats matter because they can **increase business value, reduce business risk, and be inefficiently priced.**
- Reinvestment runways **maximize the value of competitive advantage,** and reduce the risk of value destruction via capital allocation.
- **Capital allocation links business value and shareholder value,** and requires more analytical focus as reinvestment opportunities decrease.

The Value of Qualitative Insight

- The **outputs** of competitive advantage, reinvestment, and capital allocation may be **quantitative**, but the **inputs** require **qualitative** evaluation.
 - You can't screen for switching costs → **you must talk to customers to understand the value proposition**
 - You can't assume reinvestment is NPV-positive → **you have to analyze the long-run economics**
 - You can't trust management to rationally allocate capital → **you have to understand their incentives**

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

Qualitative insight is less
efficiently priced

$$\begin{aligned}
 \overline{\int_a^b f(x) dx} &= \lim_{n \rightarrow \infty} \overline{A(f, n)} = \lim_{n \rightarrow \infty} \frac{b-a}{n} \sum_{k=1}^n \overline{f_k} = \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n x_{k+1} \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n \left(1 + \frac{k+1}{n} \right) = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \sum_{k=1}^n (k+1) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \left(\sum_{k=1}^n k + \sum_{k=1}^n 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \frac{1}{n} \left(\frac{1}{2} n(n+1) + n \right) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{1}{2} (n+1) + 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{n+1+2}{2} \right) \right] \\
 &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{2n}{2} + \left(\frac{n+1+2}{2} \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{3}{2} n \right] = \frac{3}{2}
 \end{aligned}$$



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Thank You

Pat Dorsey

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