DORSEY ASSET MANAGEMENT

Competitive Advantage & Capital Allocation

January 2024

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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
- Concentrated (10-15 positions) global equity strategy
- Focused on owning competitively-advantaged businesses with reinvestment potential, managed by strong capital allocators
- ~$1.09b AUM, seven employees, large institutional clients

ECONOMIC MOATS

RUNWAYS FOR REINVESTMENT

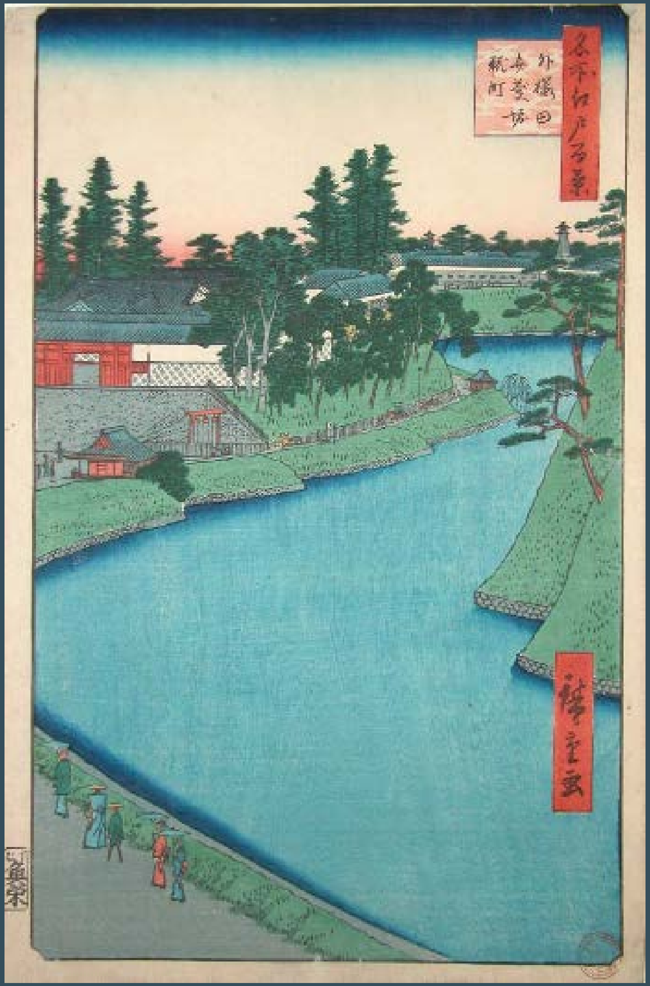
SUPERIOR CAPITAL ALLOCATION

Today's Topic

Critically evaluating the durability of competitive advantage and how capital allocation affects shareholder value can create a variant perception when selecting equities for long holding periods.

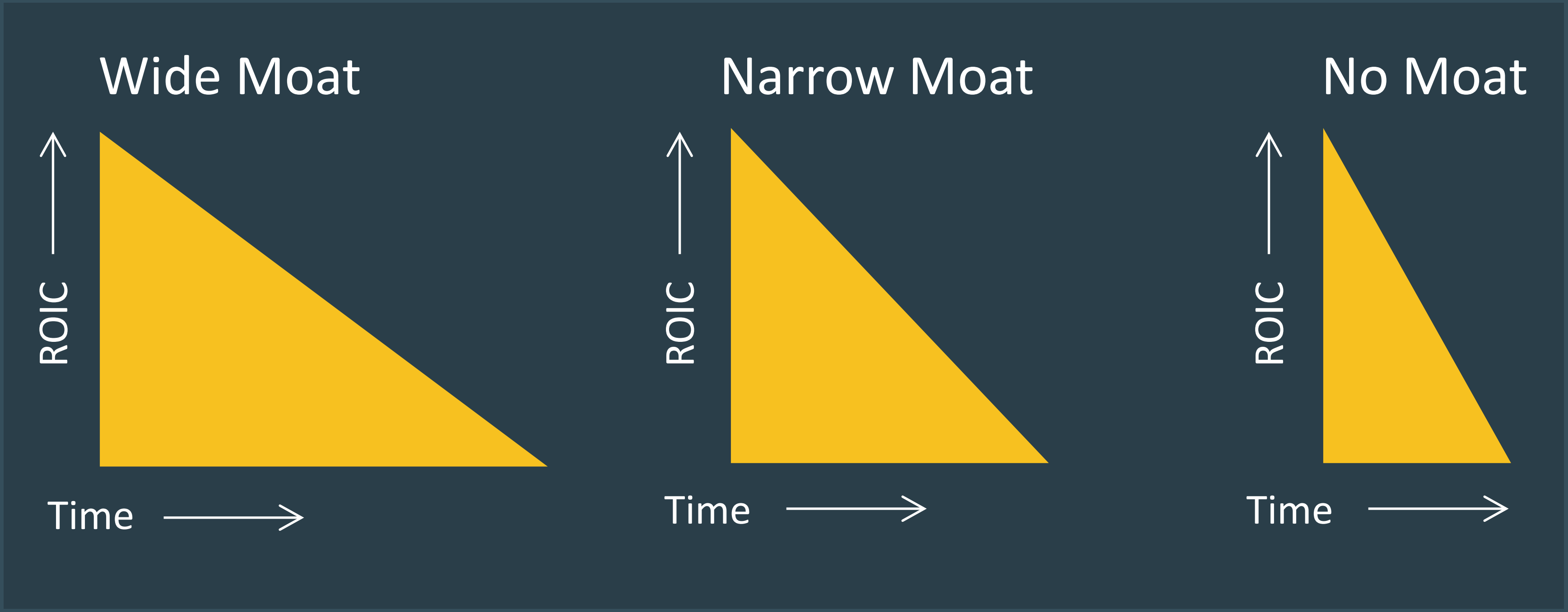
Beating the Odds

- 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. (TIF, MCO)

Low-search-cost brands are more vulnerable.

- Challenger brands do not require a change in social consensus to deliver full value to new users.
- Fragmentation of mass media has dramatically lowered the cost of reaching a mass market.
- Dollar Shave & craft beer vs. Moody's & Nielsen

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.

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, CME)

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, Costco, Amazon, Cimpress

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

- Constellation Software, Wabtec, Spirax-Sarco

What's Not a Moat

Dominant Market Share

- High absolute market share. (GM, Dell)

Technology

- Commoditization & disruption are inevitable absent customer lock-in. (GoPro, Fitbit)

Hot Products

- Can generate high returns for a short period of time, but <u>sustainable</u> returns make a moat.

Moats & Management

What will widen the company's moat?

- *The answer should drive management's strategy.*

- Amazon: Improve the customer experience.
- Costco: Share scale economies.
- Uber: Increase vehicle liquidity.
- Howden 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 in ways that destroy value, shareholders do not fully benefit from increased business value. *Value is vaporized.*
- If capital is deployed in ways that amplify value, shareholders benefit from both increased business value and from value-accretive actions. *Value compounds.*

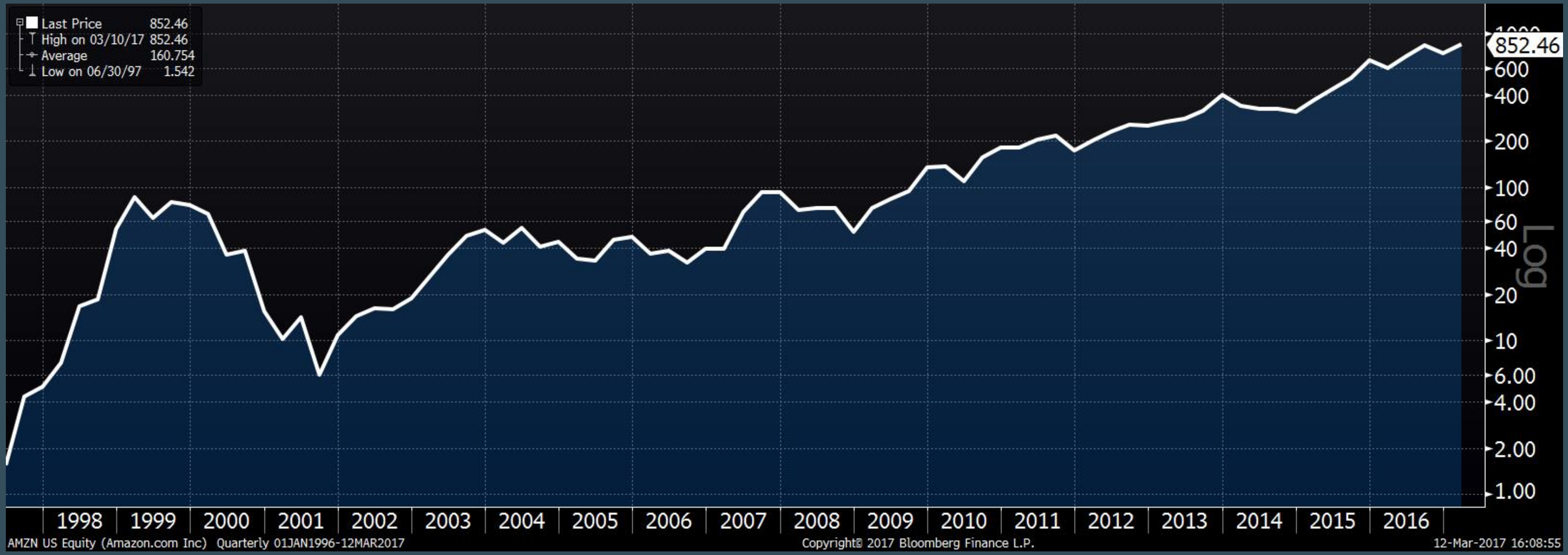
Capital Allocation: Basics

- Internal growth is not normatively good.
- Dividends can destroy value, if funded poorly or if paid out in lieu of investing at a high NPV.
- Repurchases are value destructive if executed above intrinsic value.
- M&A is usually a destructive use of capital…but there is a right tail of companies that have built huge value this way.

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

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

- Buybacks should always be driven by an objective assessment of intrinsic value.
- *“We don’t have an opinion about the value of our shares.”*

What About M&A?

M&A is not a substitute for growth → "Defensive" deals are a recipe for disaster.

- Microsoft/aQuantive: $7b set on fire
- Microsoft/Nokia: $8b flushed down the toilet
- Cisco/Flip: $600m destroyed
- Mattel/The Learning Company: $2b kaput
- H-P/Autonomy: $18b kissed goodbye

The bigger the deal & the less similarity between buyer and target → the more likely $$ will be torched

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

Look at the past 10-15 years of financials

- 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 simultaneously pay a dividend and tap capital markets?
- If ROIC has declined, is capital being returned?
- Does M&A serve strategic goals, or does it paper over strategic failures?

Assessing Capital Allocation

Read the current AR, MD&A, and the proxy.

- Is capital allocation discussed explicitly and 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 misallocate capital will do so. *Incentives matter.*

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.
- Superb capital allocation can compensate for a lack of competitive advantage. (Buffett's textile mill).
- A massive moat can compensate for poor capital allocation (Ballmer's blowtorch).

Summing Up

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

Pat Dorsey

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