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

- ~$1.09b AUM, seven employees, largely institutional clients
- Concentrated (10-15 positions) global equity strategy, focused on businesses with economic moats & reinvestment runways
  - Twelve positions currently, with 54% of capital in top five
  - Process emphasizes primary research & qualitative insights

ECONOMIC MOATS

REINVESTMENT

CAPITAL ALLOCATION

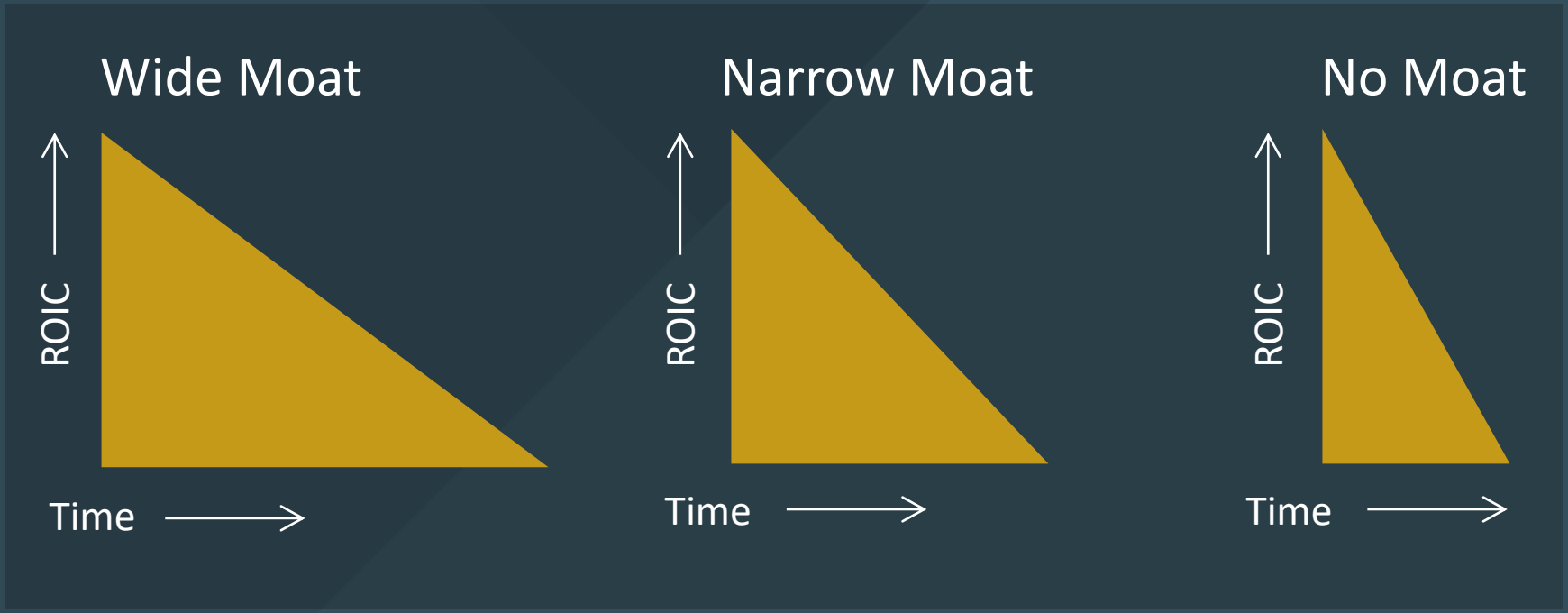
What Creates a Moat?

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 & unsucessful 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 ≠ a bad business
  - Are some expenses actually investments?
  - Structural LR margins may > current margins
- Limited reinvestment opportunity ≠ 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

$$\overline{\int_a^b f(x)dx} = \lim_{n\to\infty} \bar{A}(f,n) = \lim_{n\to\infty} \frac{b-a}{n}\sum_{k=1}^{n}(\bar{f}_k) = \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n} x_{k+1}$$

$$= \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n}\left(1+\frac{k+1}{n}\right) = \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\sum_{k=1}^{n}(k+1)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\left(\sum_{k=1}^{n}k+\sum_{k=1}^{n}1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\frac{1}{n}\left(\frac{1}{2}n(n+1)+n\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{1}{2}(n+1)+1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{n+1+2}{2}\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\frac{2n}{2}+\left(\frac{n+1+2}{2}\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[\frac{3}{2}n\right] = \frac{3}{2}$$

Qualitative insight is less efficiently priced

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Thank You

Pat Dorsey

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