

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

- ~\$1.37b\* 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 59% of capital in top five
  - Process emphasizes primary research & qualitative insights



ECONOMIC  
MOATS



REINVESTMENT



CAPITAL  
ALLOCATION

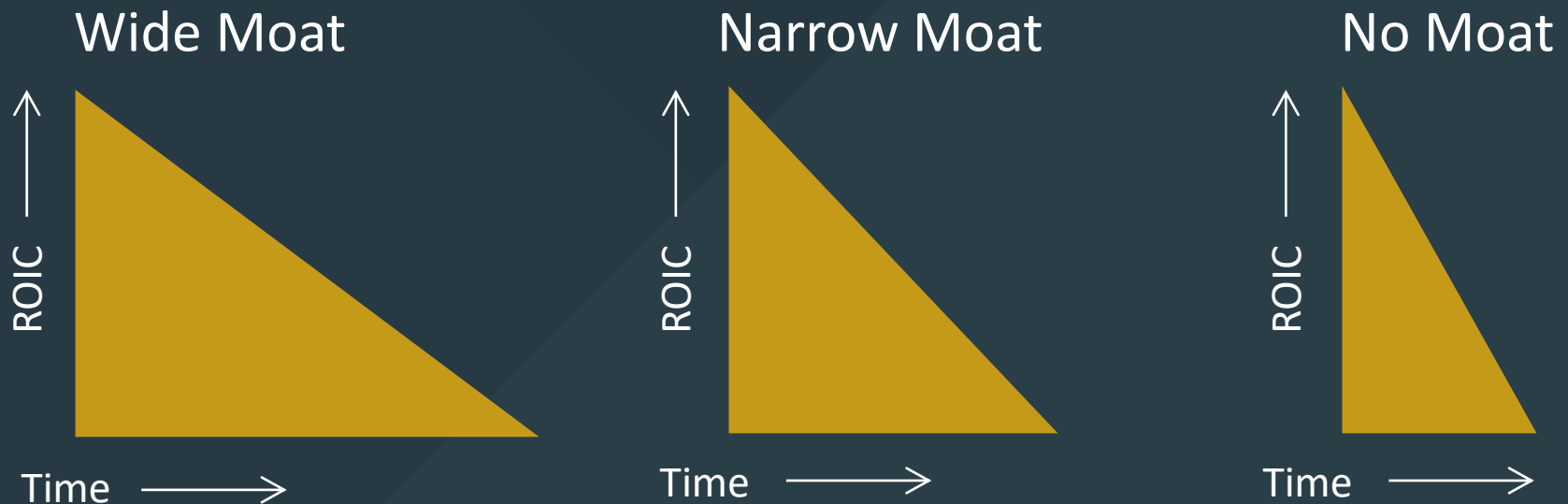
# What Creates a Moat?

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.

# 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

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



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# Thank You

Pat Dorsey

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