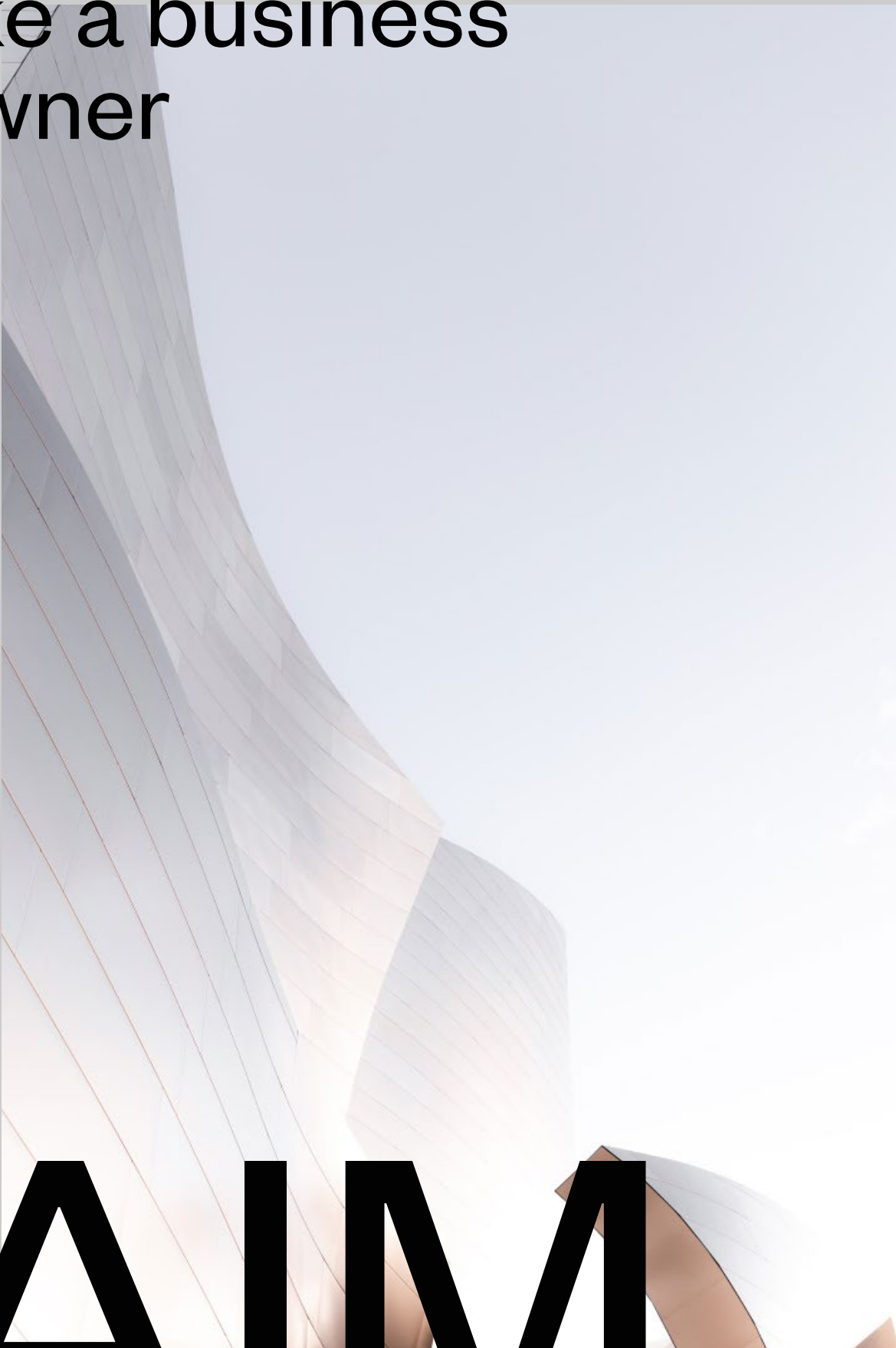


Investing like a business owner



AIM

Investing like a business owner: owning businesses vs. renting stocks

If the stock market were closed for a year, how would you evaluate whether a stock you own is performing well?

In the absence of a daily quoted price, you would have to look at the fundamentals of the underlying business to judge its success. Stated differently, you would have to think like a business owner, and not a short-term trader. You would be concerned with things like the strength of the balance sheet, the amount of cash (not earnings) a business generates, the returns on capital (and prospects for reinvestment of said capital), and how the competitive landscape might impact future returns on capital. This approach – thinking like the owner of a business – is very different from trying to make money by betting whether a company can produce earnings a few cents higher than quarterly or semi-annual market expectations.

We believe investing with a business ownership mindset is built on two core concepts:

1. To an owner, the return on invested capital a business generates is far more important than growth in earnings.
2. Over the long term, the return an investor will generate will approximate the underlying return on capital a business earns, even if paying an optically high price at the point of investment.

Let's explore both points in a bit more detail.

To an owner, the return on invested capital a business generates is far more important than growth in earnings

Consider the statement below, written by Warren Buffett to shareholders of Berkshire Hathaway in March 1980:



“The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share. In our view, many businesses would be better understood by their shareholder owners, as well as the general public, if managements and financial analysts modified the primary emphasis they place upon earnings per share, and upon yearly changes in that figure”.

**Warren Buffett, Chairman & CEO of
Berkshire Hathaway**

We wholeheartedly agree with Mr. Buffett. Growth only creates value for owners if the capital that has been invested to generate it earns a return above the cost of said capital.

If all of the above sounds like a bunch of financial gobbledygook, let's make it a bit more applicable to the real world.

Imagine you were opening up a coffee shop in your neighbourhood. To keep the numbers simple, assume it would cost you \$100,000 in start-up capital to fit out the store and get it ready for business. You are funding it with your own money, and in choosing to do so, are giving up a certain 6.5% return in a different investment, but you are willing to take the risk since you believe you can earn a higher return by running your coffee shop.

After a year, you find that you have \$15,000 in after-tax net profit. At first glance, this looks like a very successful business venture: you are earning a 15% return on \$100,000 of capital!

However, consider that net profit (found on the income statement) does not reflect that you have some cash tied up in yet-to-be used inventory, or that you have had to spend some money to properly maintain your coffee machine. These investments in working and maintenance capital amount to a further \$5,000, reducing your net profit to \$10,000 of owner's cash earnings, and implying a cash return on invested capital of 10%. Happily, this is still above your cost of capital of 6.5%, meaning you've generated an economic profit of 3.5% (or \$3,500 in dollar terms).

The table below summarises all the information above, as at the end of year 1 of your new business venture:

	Year 1 Total
Invested Capital (start of year)	100 000
Net Profit (Income Statement)	15 000
Working & Maintenance Capital	- 5 000
Owner's Cash Earnings	10 000
Cash Return on Invested Capital	10.0%
Invested Capital (end of year)	110 000
Cost of Capital	6.5%
Economic profit	3.5%

Crucially, note that you start off year two with \$110,000 in invested capital (the original \$100,000 plus the \$10,000 earned in year one).

Assuming you can reinvest the additional \$10,000 worth of capital at the same 10% rate of return (say, by hiring new staff, expanding your selection of beverages, or sprucing up the shop, some combination of which attracts more customers), your owner's cash earnings should be \$11,000 at the end of year two.

You would still be earning a 10% return on invested capital (\$11,000/\$110,000), and you would have grown your cash earnings by 10% (from \$10,000 to \$11,000). If you can keep delivering this kind of outcome, the value of your coffee shop will continue to increase over time.

By year 7, you will have roughly doubled your initial capital investment of \$100,000; by year 10, your initial invested capital will have compounded to roughly \$260,000 at a rate of 10% per year. The value of your initial capital investment will have increased steadily by the rate of return you've earned on the underlying business.

	Year 1 Total	Year 2 Total	...	Year 10 Total
Invested Capital (start of year)	100 000	110 000		235 795
Net Profit (Income Statement)	15 000	16 000		35 369
Working & Maintenance Capital	- 5 000	- 5 000		- 11 790
Owner's Cash Earnings	10 000	11 000		23 579
Cash Return on Invested Capital	10.0%	10.0%		10.0%
Invested Capital (end of year)	110 000	121 000		259 374
Cost of Capital	6.5%	6.5%		6.5%
Economic profit	3.5%	3.5%		3.5%

Now, let's imagine a slightly different path. At the end of year one, feeling very happy with how your first coffee shop turned out, you decided to open up a second shop a few blocks away. You invest a further \$100,000 to outfit this second shop. However, as it turns out, the second venue is not located as conveniently, and received considerably less foot traffic, leading to lower sales and profitability.

The first shop is still doing absolutely fine – earning \$11,000 on the \$110,000 worth of capital invested in it – but the second shop only earns \$5,000 on the \$100,000 you have had to sink into it.

	Year 1 Total	Year 2 Shop 1	Year 2 Shop 2	Year 2 Total
Invested Capital (start of year)	100 000	110 000	100 000	210 000
Net Profit (Income Statement)	15 000	16 000	10 000	26 500
Working & Maintenance Capital	- 5 000	- 5 000	5 000	-10 500
Owner's Cash Earnings	10 000	11 000	5 000	16 000
Cash Return on Invested Capital	10.0%	10.0%	5.0%	7.5%
Invested Capital (end of year)	110 000	121 000	105 000	226 000
Cost of Capital	6.5%	6.5%	6.5%	6.5%
Economic profit	3.5%	3.5%	-1.5%	1.1%

Looking at this scenario *purely* from the perspective of **growth** in owner's cash earnings, it seems like the business is doing absolutely fine: you've gone from earning \$10,000 in year one, to \$16,000 in year two (\$11,000 from the first shop plus \$5,000 from the second shop). That equates to 60% growth: a fantastic outcome at first glance.

In reality, what has happened is that you have increased your invested capital base by \$100,000 and invested that sum below your cost of capital of 6.5%. The second store is earning a 5% return on invested capital (calculated as \$5,000/\$100,000).

For your consolidated coffee shop business, your return on capital has decreased from 10% to 7.6% (\$16,000 in owner's cash earnings divided by \$210,000 in invested capital). While the overall business is still earning an acceptable return, the economics are worse than in year one.

If you continue to operate the second shop at a 5% return or – even worse – open up more shops that earn returns below 6.5%, you would be destroying value every day you keep the shops open. In this case, you would be far better off shutting down the second shop, and either reinvesting in the first shop (assuming the 10% return on capital remains intact) or take a dividend from the business.

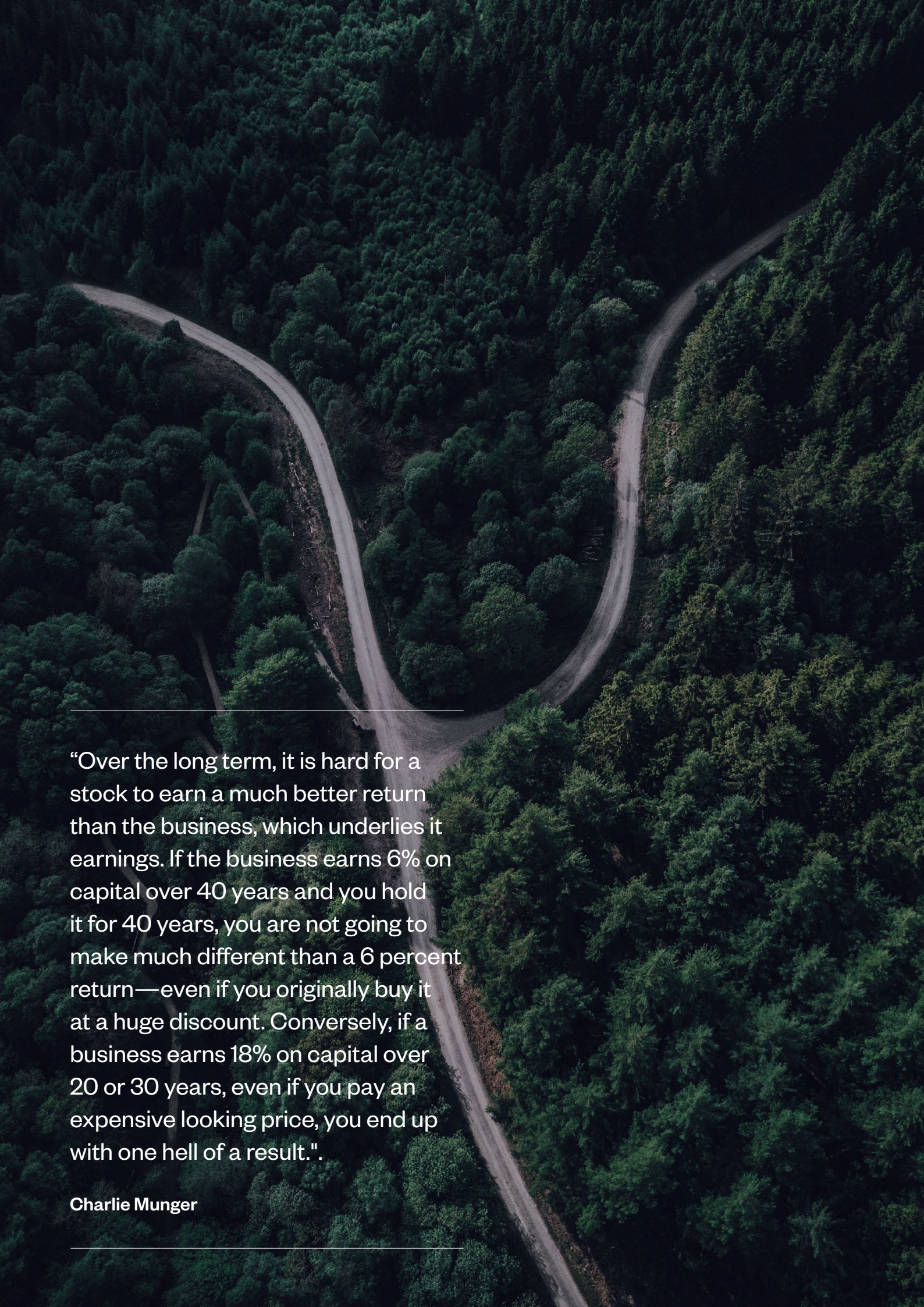
The key point is this: the rate of growth in owner's cash earnings (60% in our second example) is not nearly as important as knowing the rate of return on the capital that has been invested to generate the growth. As the example has demonstrated, it is quite possible to generate 'growth' without creating a single dollar of ownership value (or, in fact, destroying value).

Investing like a business owner means thinking about the underlying economics and returns of the business, not the year-over-year growth rate that is generated.

Over the long term, the investment return will approximate the underlying return on capital of a business

If we accept the first concept – that a private business owner would choose to invest in a business generating a high return on invested capital – it follows that this owner looks to enjoy the economics of the underlying business. Put another way: if we could earn a sustainable 30% cash return on invested capital in a private business, we'd want to own that business for a very, very long time, regardless of whether revenues or owner's cash earnings grow at 6%, 8% or 10% in any particular year.

Charlie Munger – Warren Buffett's business partner – once remarked:

An aerial photograph of a dense, dark green forest. A light-colored, unpaved road winds through the trees, forming a large, stylized 'V' or 'Y' shape. The road starts from the bottom center and branches out towards the top left and top right. The forest is thick and covers the entire background.

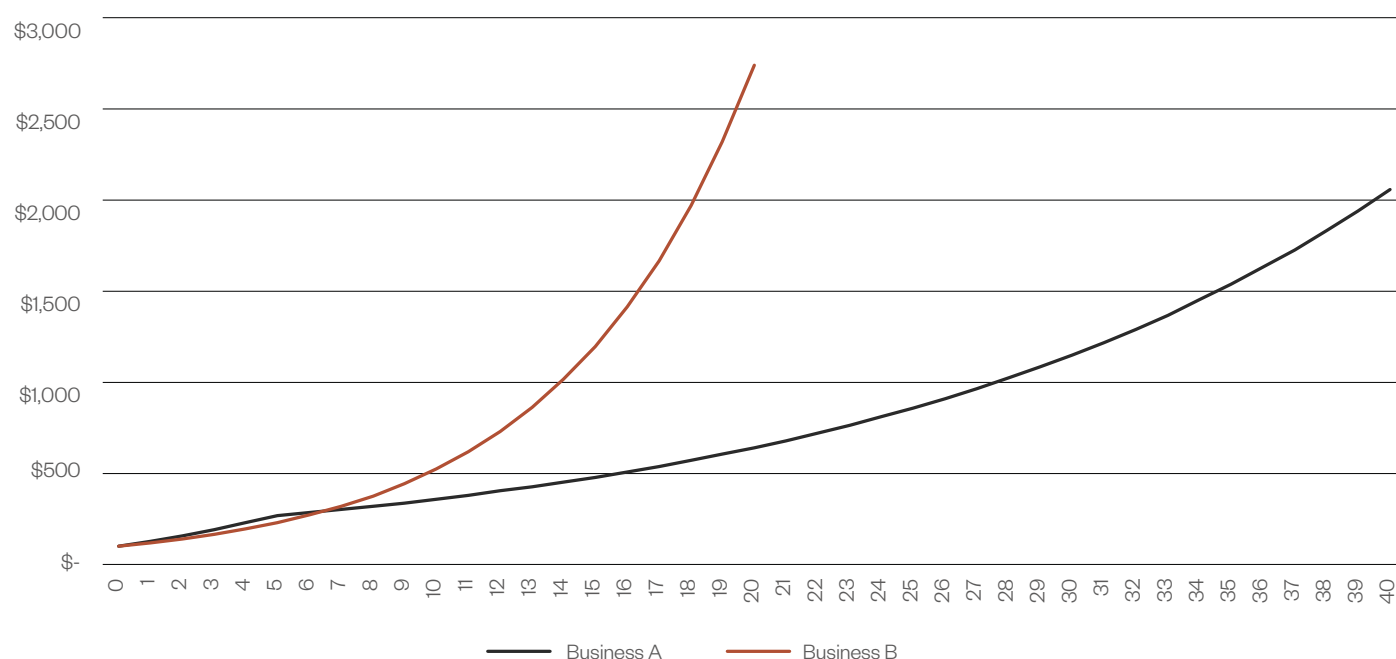
“Over the long term, it is hard for a stock to earn a much better return than the business, which underlies it earnings. If the business earns 6% on capital over 40 years and you hold it for 40 years, you are not going to make much different than a 6 percent return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you end up with one hell of a result.”

Charlie Munger

This statement neatly summarises the heart of investing from a business ownership perspective: if you can earn high returns on capital on the underlying business for a long time, you will have a tremendous result from the internal compounding of capital.

The critical factor is to make sure the high returns on capital are sustainable, which means performing a qualitative assessment of the industry structure and competitive advantages of the business you are invested in.

Let us test Mr. Munger's assertion. The graph below assumes the economics outlined above: business A earns a 6% return on capital for 40 years, while business B earns an 18% return on capital for 20 years. We'll assume that both businesses pay no dividend and reinvest all of their returns into the business. Finally, let's assume we buy business A at a bargain price: 7.5x its current earnings, when it deserves to trade at 15x. The market eventually figures this out and correctly values the business at 15x earnings by year 5. Conversely, let's assume we buy business B at 15x earnings today, and it constantly trades at that level. What would \$100 look like over time?



While it is difficult to see on the chart above, you make slightly more out of owning business A... up to year 5. After that, the tailwind from the closing of the valuation gap of business A (from 7.5x earnings to 15x earnings) can no longer provide any uplift to the low returns it persistently earns and reinvests.

Business B – which, in line with Mr. Munger's statement, we only own for 20 years (we took the liberty of using the shorter suggested time period) at a constant valuation of 15x earnings, delivers a far superior return over time, even though business A has the benefit of compounding for 20 years longer and being purchased on the cheap.

Interestingly, over time, the compound return on the investment starts to approximate the return on capital of the underlying business, as can be seen from the table below: the longer the holding period, the more the returns for business A trend to 6%, despite the attractive starting valuation.

Compound Annual Returns after Ownership Period of...

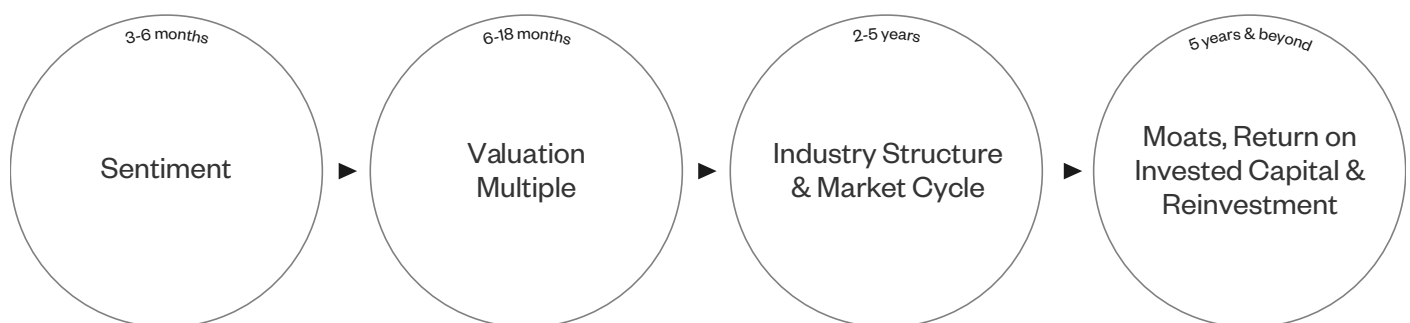
	5 Years	10 Years	20 Years	40 Years
Busniess A	21.8%	13.6%	9.7%	7.9%
Busniess B	18.0%	18.0%	18.0%	18.0%

This is what Mr. Munger means when he says the returns on an investment will – over the long term – approximate the underlying returns on capital a business earns. The critical point when investing from a business ownership perspective – and to be clear, this is no small task – is to own businesses that generate sustainably high returns on capital over the very long term.

Given that capitalism is a pretty Darwinian place, any business earning high returns on capital will attract competition, so having structural competitive advantages are important. Transitory advantages leading to rapid year-over-year growth are very dangerous, as people tend to overpay right at the point when the narrative becomes too appealing to ignore (and the stock is priced for ongoing growth), but miss the new entrants coming for their slice of the market, which starts the process of eroding the returns on capital for all players.

Pulling it together

In the short term, stock prices are driven by sentiment. However, if we look beyond a year or two, we know for fact that returns are driven by industry structure, competition, competitive advantages, high returns on invested capital and the opportunities for reinvestment.



Our investment approach is ultimately fairly straightforward: we look to own businesses that generate superior returns on capital. We believe that, over the long term, our investment return will trend towards the underlying return on capital of the businesses we own; this is what we mean when we say we take a business ownership approach to investing in public markets.

We view the market as a venue to buy into attractive ownership economics when it offers us the opportunity at the right price. All the other day-to-day drama is ultimately of little interest to us. This is why we don't intend to trade frequently, nor feel the need to introduce new ideas to fit every market mood or chase every theme. We believe our long-term return will come from the economics of the businesses we own, not from trading their stock in the marketplace.

Because the type of business we want to own – those that sustainably generate high returns on invested capital – will generally trade at elevated valuations, our portfolio will likely always look at least as expensive, if not more expensive, than the market. We believe this is justified, particularly when keeping in mind that we look for rock-solid balance sheets, which should provide resilience in period of distress.

However, when buying a new business, we will mostly be doing so when a high-quality business is priced like an average one, meaning our entry point is more attractive. In short, we hope to buy a business with high returns on capital (like business B, above), but at a lower valuation multiple (like with business A). If we get it right, we will not only have a valuation uplift as the market revalues the business, but then also enjoy the ownership economics for a long time to come.

When do high quality businesses trade at attractive valuations? In our experience, it generally only occurs for one of two reasons: either a high-quality business experiences a short-term issue – mostly in the form of an earnings miss – and has been sold off, or the entire market has been sold off due to some external event.

- In the case of the former, we are expressing the view that the work we have done gives us sufficient comfort to believe that whatever issue has caused a short-term sell-off is transitory, and the business will return to earning high returns on capital because its competitive advantages are intact.
- The latter opportunity is rarer, but psychologically much less taxing (provided one can keep calm during a market crash), since there is nothing ‘wrong’ with the business in question – the market has indiscriminately sold everything. We would argue the crash in March 2020 was one such opportunity.

Infrequently, a high return on capital business may trade at a valuation where we do not think we can generate an attractive investment outcome on a three to five year time horizon, given its range of opportunities to continue reinvesting its capital base. When this happens, we might sell a business on valuation grounds. Beyond that, we generally just sell when the facts – as it relates to the business and its fundamental soundness – take a turn for the worse.

Beyond that, we’ll take Mr. Munger’s advice yet again: if you own a quality business – and you bought it for a reasonable price – sit on your hands and do absolutely nothing if the facts don’t change. Own businesses, don’t rent stocks.

Bibliography

Buffett, W. E. (1980). 1979 Shareholder Letter, Berkshire Hathaway.

Munger, C. T. (1994). The Art of Stockpicking: A Lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business. *Lecture at University of Southern California*.

