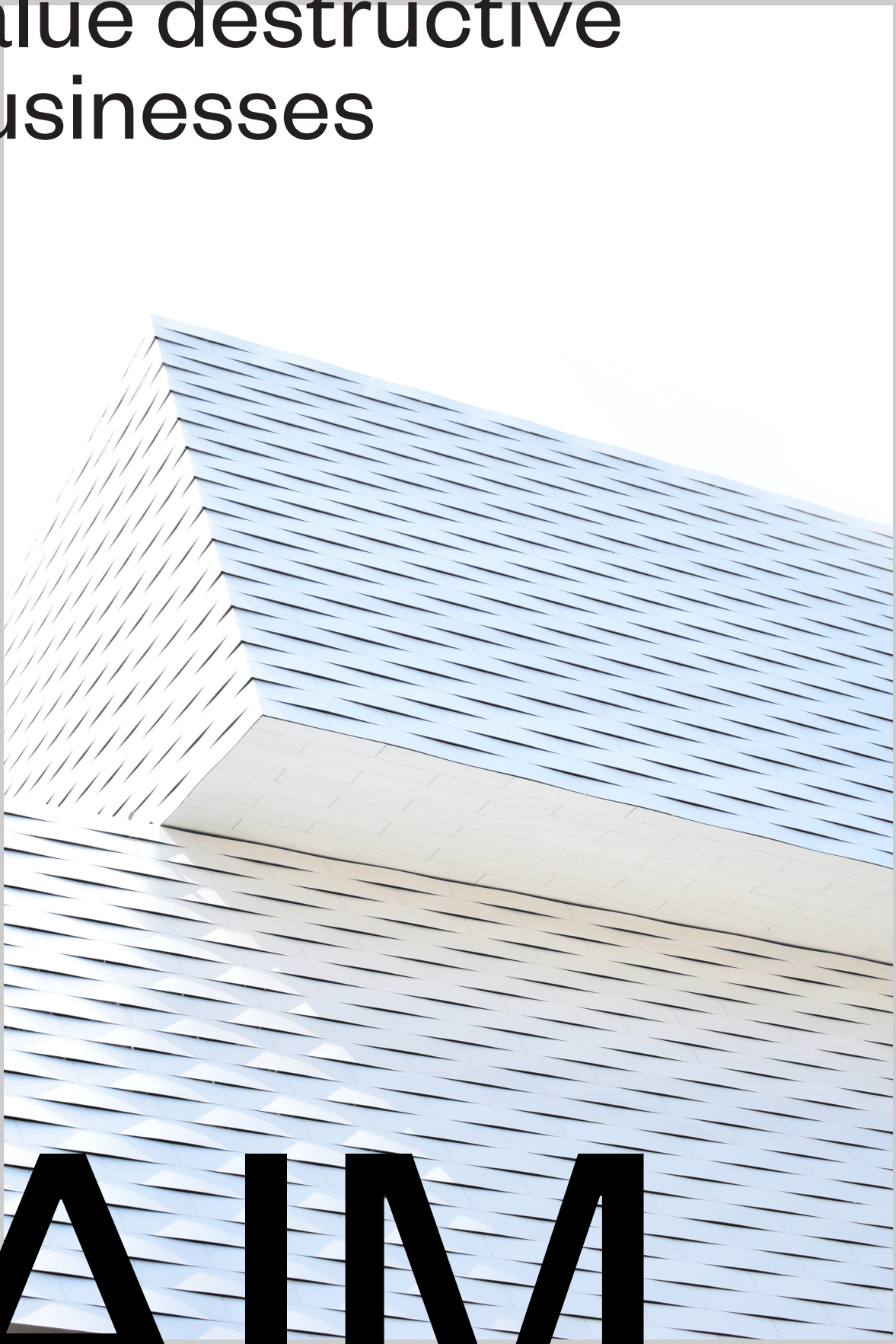
Avoiding value destructive businesses



AIM

Cheap or priced for value destruction?

When investing in publicly traded equities, we believe that taking a business ownership mindset leads to better long-term investment outcomes. Practically speaking, that means we look to the underlying cash returns on capital a business can earn over the long term as the primary source of value creation, rather trying to exploit the day-to-day fluctuations in quoted market prices.

With all else being equal, investing in businesses that earn a higher return on capital is preferred to those that earn a lower return on capital. This is particularly true for businesses that can re-invest the majority of their capital at similarly high rates of return. Provided the business can continue to do so for an extended period of time, the ultimate investment return is rather spectacular, despite paying a 'high' multiple to start off with. (The ideal, of course, is to buy such a business at a low valuation multiple, because then investors benefit twice: firstly, from the valuation uplift as the market reappraises the business to a higher multiple, and secondly, from the compounding of the internal capital of the underlying business.)

By applying this business ownership mindset – a focus on cash flows over earnings; a focus on returns on capital rather than growth; and a focus on a strong balance sheets to withstand periods of distress – we look to own businesses that are resilient during a crash or a crisis, even if their stock prices are volatile. Academic research suggests that such businesses tend to hold up better in a crash, mostly because their risk of permanent capital loss is much lower (Bouchaud, 2016). Our practical experience tends to bear this out: this kind of business finds an incremental buyer much sooner in a crash, providing support to the quoted stock price even as the overall market continues to be volatile.

The implicit 'risk' of such a strategy is that from time to time (but particularly during the rebound after a big market crash) it underperforms for a period, as much lower quality businesses – those with structurally lower returns on capital, or distressed balance sheets – rally from very depressed valuation levels as the economic outlook improves. Stated plainly, high quality businesses don't fully participate in the 'recovery trade', as they have much less to recover from.

This begs an obvious question: should an investor consider switching into these lower return on capital businesses at the 'right price'? Effectively, is it better to own 'quality' to protect during the initial phases of a crash, but then rotate into very cheap businesses to capture the rebound?

Ignoring the fact that getting the timing of such a portfolio rotation right is nigh-on impossible on a repeatable basis, our opinion is it is not worth pursuing this approach at the expense of investing for the long-term with a business ownership mindset.

Economic profits are the key to long term value creation

To understand our answer, we must first address one or two theoretical concepts.

Every business – public or private – has a cost of capital. For businesses that use a mix of debt and equity to fund their operations, this 'cost' is determined by weighting and then summing the cost of debt (essentially, the after-tax interest rate on outstanding interest-bearing liabilities) and the cost of equity; for businesses using only equity, the cost of capital and the cost of equity are the same.

The cost of equity is a topic about which entire textbooks has been written and discussing it in detail is beyond the scope of this paper. Suffice to say, it cannot be directly observed (which makes it distinct from the cost of debt); it is normally constructed by using the return of a risk-free asset (mostly a long-dated government bond yield) and adding some risk premium to compensate for the uncertainty of future cash flows or riskiness of the business being evaluated.

Regardless of the exact value of the cost of capital or how it is constructed, the key point is that a business must earn a return on capital above its cost of capital to create value for its owners over the long term. This is known as generating an economic profit. A business that cannot generate an economic profit is demonstrably destroying value for shareholders the longer it stays in business, even if it reports year-on-year revenue or earnings growth.

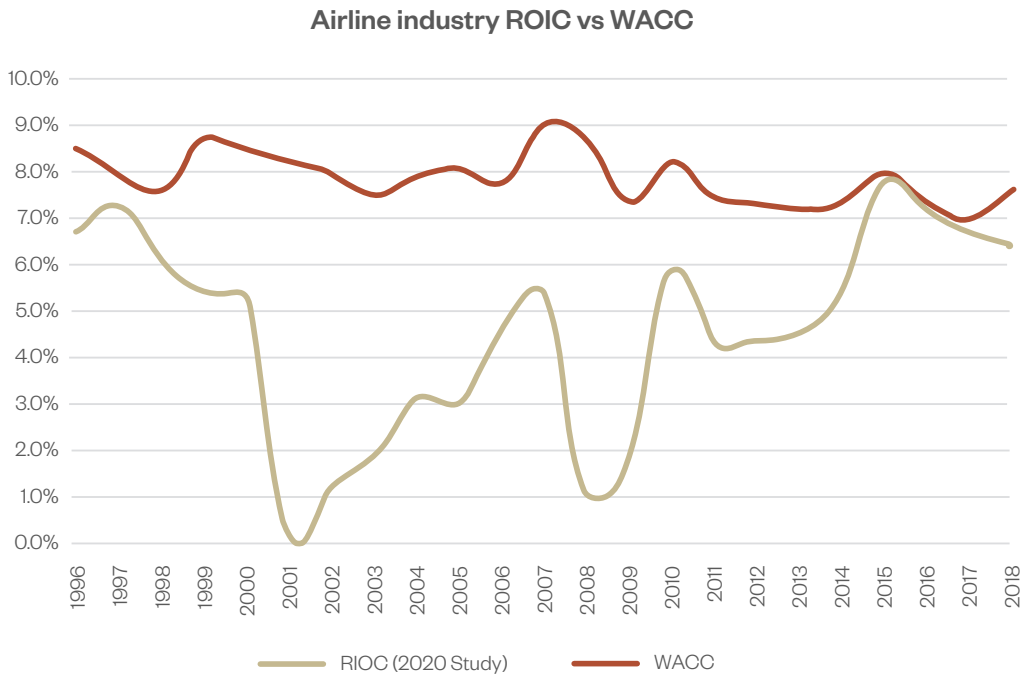
All of this stuff is business school 101, so it might be natural to assume management teams understand this dynamic and are doing everything in their power to earn economic profits for their owners. However, this assumption ignores the fact that one of the chief determinants of the return on capital a business can earn is essentially outside of its control: industry structure.

Industries with low barriers to entry or engaged in selling highly commoditised goods/services are typically so competitive that no business can earn sustainable economic profits. In some industries, the majority of players earn returns below their cost of capital.

Owning a melting ice cube

The global airline industry is a prime example of this phenomenon. Even before the impact of COVID-19 in 2020, the industry as a whole had failed to earn its cost of capital for most of the past twenty years.

The chart below is taken from a report produced by the International Air Transport Association (IATA) in February 2020, and is based on work performed by McKinsey & Co.



Source: McKinsey & Co., *International Air Transport Association. New study on airline investor returns: regional divergence impacting overall performance*, Feb. 2020

As can be seen, the return on invested capital (ROIC) has been stubbornly below the estimated weighted average cost of capital (WACC) for a very long time. While industry level returns have improved somewhat from 2010 to 2015, it has more recently started to decline again... and this does not even begin to show the impact from the pandemic in 2020.

What are the major causes of this extremely poor return profile for the whole industry? In short, airlines are extremely capital intensive, have high fixed costs, and require specialised labour to operate. In addition, the service they offer – a seat on a plane to travel from point A to B – is largely a commodity. The vast majority of passengers select their airline based on who offers the lowest airfare. Because it costs a fixed amount (in fuel, labour and other overhead costs) to fly from point A to B regardless of the number of passengers aboard, airlines are incentivised to compete on price to fill as many seats as possible per flight.

Combine this with the fact that many airlines around the world are (at least partially) state-owned. This implies that there are non-economic incentives (such as national pride, or avoiding major job losses) in play, meaning certain airlines continue to operate at breakeven (or worse) because they are not being run to make a sustainable economic profit. Such skewed incentives erode the profitability for all airlines that operate in the same region or routes.

With industry economics like these, you may be wondering how airlines stay in business at all. The fact is, they frequently don't: the airline industry is notorious for how often businesses fail or go into liquidation. (Keep in mind, this generally means that equity holders find the value of their ownership interest reduced to zero, given their ranking in the capital structure.) However, there seems to be no shortage of investors willing to recapitalise a failed airline (presumably assuming that 'this time will be different'.) Frustratingly for the better-run airlines, this often means a poorly run competitor that has gone into liquidation emerges as a new entity with a clean balance sheet, which allows it to compete more aggressively with the businesses that did not fail. This barrier to exit further serves to increase competition and reduce returns.

To be fair, certain markets have finally undergone a period of airline consolidation, leading to some improvement in underlying returns on capital as competition becomes more rational. Still, the average outcomes are hardly inspiring, leading to cash return on invested capital that, in general, do not exceed the cost of capital by much. For some context, we generally target businesses that can earn much higher cash returns on invested capital .

Still, there is an inevitable allure to buying a business like this since they can get undeniably (but in our opinion, justifiably) cheap. Owning a business priced for outright disaster can be profitable if the actual outcome is merely ongoing hardship: essentially, one is buying for the *improvement* in returns on capital from cyclically depressed levels.

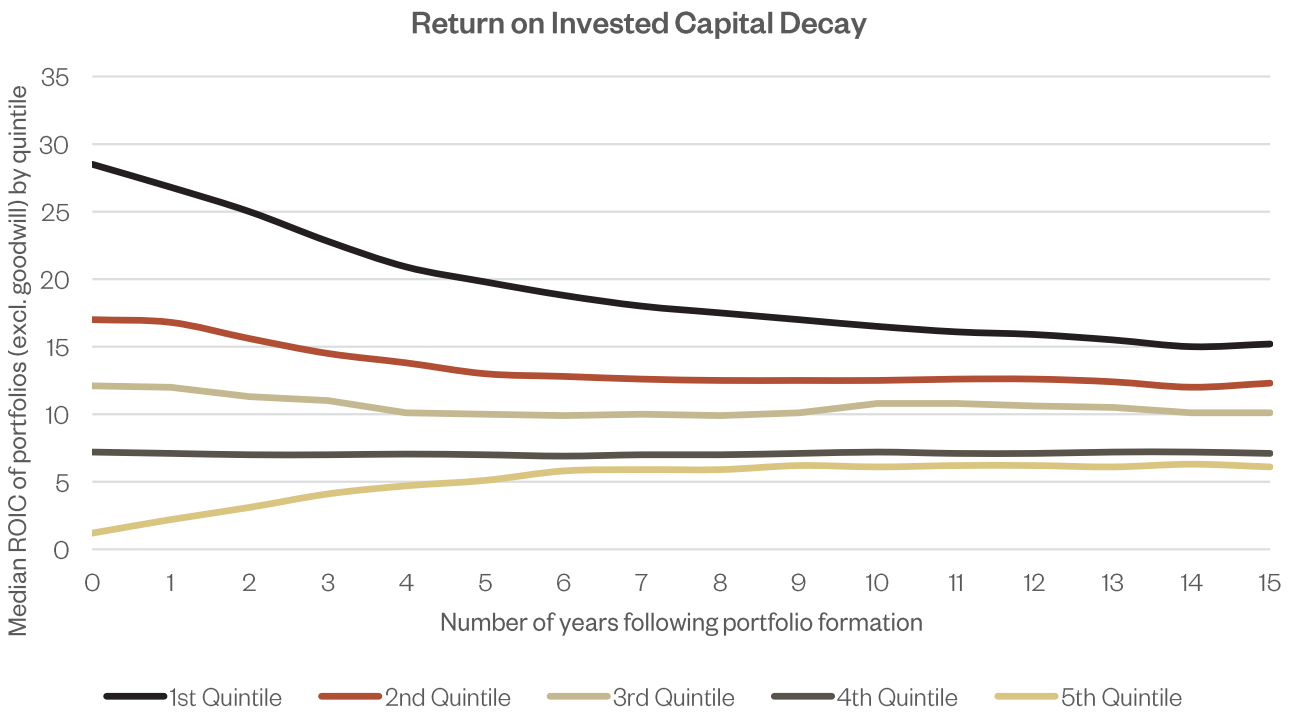
While we acknowledge this fact, we believe the risk of this approach is that one is still left owning a business with unattractive returns on capital operating in an extremely competitive industry. And while the clock is running on the eventual improvement in industry profitability, the fact that the business is likely earning a return on capital below its cost of capital means value is being eroded by the day. Investing in a business like this may be compared to carrying an ice cube in your hands, with the hope of selling it to someone else prior to it melting away entirely.

Backing improving returns on capital based on permanent structural changes

There is a rare exception to be made for investing in a business with historically low returns on capital if there are permanent and structural changes in its business model or industry landscape that allow for it to earn sustainably higher returns on capital. Examples may include a business changing its distribution channel to cut out a middle-man (and capturing better economics for itself), or an industry undergoing consolidation (particularly after a period of overinvestment).

While a business ownership approach doesn't rule out such investments, we believe such situations are in practice few and far between, requiring a wide margin of safety to account for the fact that – empirically – such improvements are both rare and unlikely. Assessing the skill and ability of management is also crucial in such investment situations, as their efforts will have an outsized influence on whether such a structural change is successful.

The chart below is drawn from another study by McKinsey & Co. (Koller, 2015), and highlights the development of five portfolios of businesses, classified based on their starting return on invested capital in year zero.



Source: Tim Koller, Marc Goedhart, David Wessels, McKinsey & Co. (2015), Valuation *(6th Edition),* Wiley.

As can be seen, the returns on invested capital for the businesses in the top 20% do erode over time, but they remain firmly above the weighted average cost of capital, meaning they still create economic profits over the long term. Conversely, the 20% of businesses with the lowest starting returns on invested capital do see their returns improve somewhat, but they never become materially better businesses to own over the long term and continue to generate an economic loss.



To us, the critical test remains whether we can earn an acceptable economic profit over time. Merely improving returns on capital from 4% to 8% may make for a good short-term trade, but does not present a compelling investment from a business ownership perspective, given that we generally assume a cost of capital between 8% and 11% for most of our businesses (and demand a higher return on capital to consider investing.)

The price of quality

If all of the above reads that we advocate investors pay any price for a business that consistently generates a high return on capital, let us categorically state this is not the case. There has been much confusion between value investing (which is defined as buying a business for less than its intrinsic worth) and the value factor (buying stocks that trade at low price/earnings or price/book multiples) of late. We do not see paying a high multiple as inconsistent with a value investing approach or a business ownership mindset, but we believe having a margin of safety at the point of allocating capital is a timeless principle.

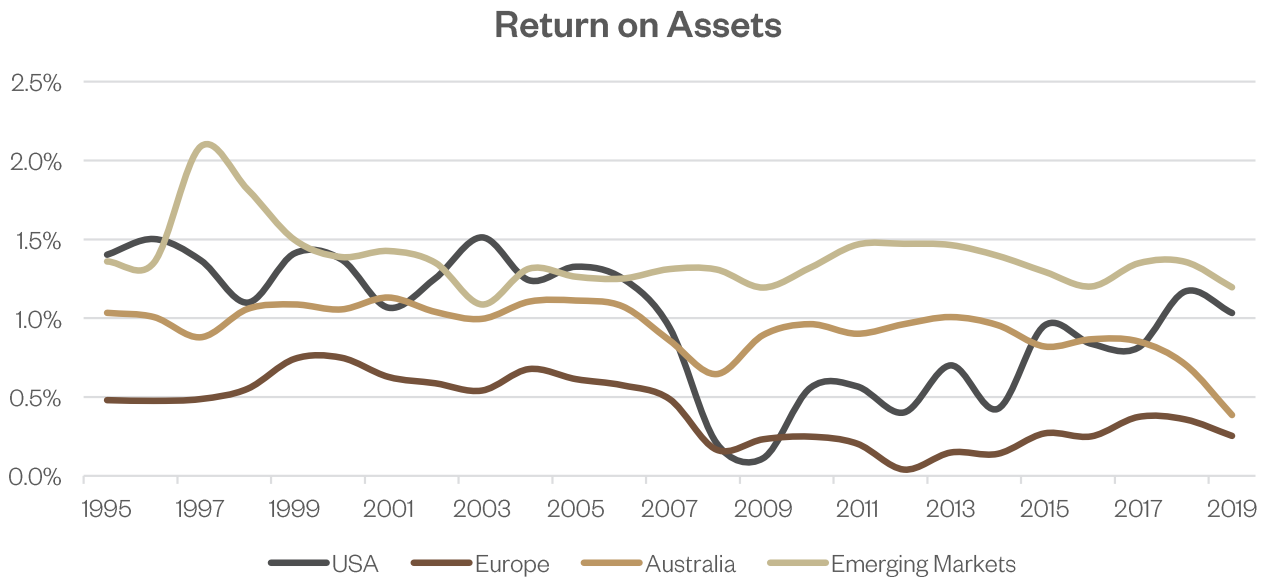
However, what happens when high return on capital businesses become very expensive in the market?

The good news is that businesses that can sustainably earn high returns on capital eventually 'bail out' a high multiple, though it can take several years for this to occur. (See our first paper in this series for more detail). However, it is entirely possible for this kind of business to underperform during a true risk-on rally as the weight of money shifts from owning 'quality' to owning 'cheap.'

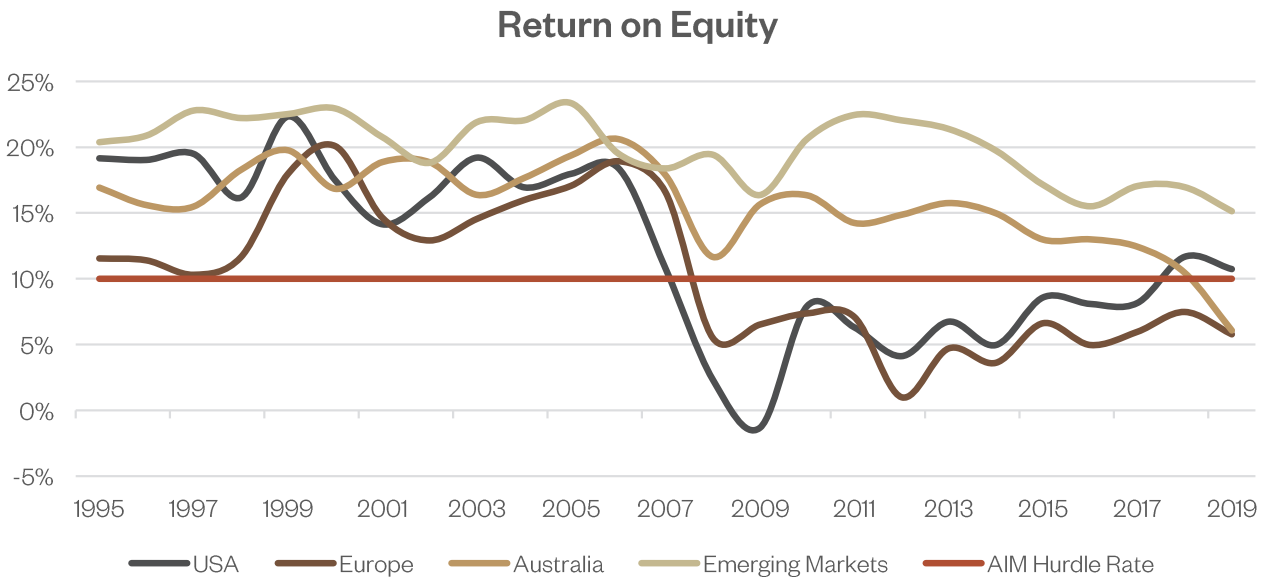
As explained in the previous section, the approach we advocate avoids buying a business that cannot sustainably earn an economic profit due to structural reasons, regardless of valuation. But what about more cyclical businesses that do, at some point in the cycle, earn economic profits? Examples of such businesses would include banks, mines, energy and heavy industrial companies.

The challenge faced by this kind of business is that their product or service is mostly undifferentiated, meaning that their respective business models are not particularly conducive to earning superior economic profits even when the economy is growing. In addition, most businesses in these sectors tend to use large amounts of debt capital to finance their operations. Thus, in addition to the normal cyclical risks such businesses face, investors must further contend with the risk of an economic slowdown at a moment when the balance sheet can potentially not bear it. Applying a business ownership mindset, we do not think this is an attractive way to invest for the long-term: cyclical upswings interrupted by periods of potential risk of permanent capital loss.

Banks tend to do well when economic activity levels rise and interest rates move higher (though not too high, as this begins to raise the spectre of a default cycle.) The charts below show the median return on assets (ROA) and return on assets (ROE) for the major banks in the US, Europe, Australia and emerging markets over the last 20 years. (Banks, given their unique business model, must be assessed using ROE and ROA as opposed to returns on capital).



Source: FactSet. Note: figures for Australian banks represent FY20 numbers.



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There are a couple of points worth making.

Firstly, note how banking profitability plunged during the global financial crisis of 2008/2009, and never recovered to pre-crisis levels. This is largely due to banks being forced to hold more regulatory capital to protect against extreme credit events. This is completely sensible from a societal standpoint – banking failures should be avoided at all costs – but does mean that equity holders must live with paltry economic returns on their capital – particularly in a low interest rate environment.

Moreover, banks can only earn acceptable returns on equity by using a large amount of leverage. To oversimplify, the difference between the ROA and ROE of a bank is the leverage: a bank earning a 1.5% return on assets must lever this 10x to earn a 15% return on equity. It is exactly this fact – combined with the risk of writing bad loans during the 'good' times of an economic expansion – that renders bank balance sheets as potentially fragile during an economic downturn or crisis. If it turns out that credit quality is lower than thought, the impairments and subsequent losses can be huge, and equity holders may have to bear the brunt of this.

Ultimately, banks are a leveraged way to invest in GDP growth, with the drawback that they can suffer from unexpected and non-linear risk when the economic cycle turns down. We believe there are businesses with more attractive returns on capital and less risky balance sheets that can give the same exposure to GDP growth that aligns more closely with our business ownership mindset.

To summarise, overpaying in the short term for high return on capital businesses is definitely possible, though we believe one is unlikely to incur a permanent loss of capital over the long term. Thus, we agree that it is eminently sensible to look for businesses that earn more modest (~15%) returns on capital if that is where valuations are more reasonable; the key point is to ensure the economic profits of the business are structurally positive, and that the balance sheet quality is very high to be able to withstand the vagaries of the economic cycle. Practically speaking, this kind of business is more likely to be found in the light industrials space than in the banking, energy or mining sectors.

Conclusion

The point of investing with a business ownership mindset is to buy into businesses with high returns on capital when they are attractively priced, and then benefit from the compounding of internal capital over time. These businesses tend to trade at optically expensive valuations relative to the market as a whole, particularly if they have strong balance sheets.

Following such a strategy can lead to a period of relative underperformance, particularly during the initial phases of a risk-on rally at the start of an economic expansion, when cheaper businesses tend to outperform as the economic outlook improves.

Our view is not to compromise on business or balance sheet quality to participate in these kinds of rallies, no matter how tempting it may be. We do not believe that owning a business that struggles to generate a sustainable economic profit for structural reasons is a good idea, no matter how cheap it may be. These businesses are unlikely to compound internal capital over the long term, making them at best a short-term trade – and a risky one at that, if the investment case takes a while to play out.

Our guiding principle is straightforward: own businesses that can generate favourable economics for a long time, rather than rent stocks that will hopefully generate a quick profit as risk appetite increases. Stated plainly, to us it makes very little sense to buy into businesses that persistently fail to earn an acceptable return on capital and have the added risk of permanently impairing equity holders during a crisis, simply because it's 'cheap' and stands to benefit from an improvement in the economic environment.

Bibliography

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Koller, T. G. (2015). *Valuation: Measuring and Managing the Value of Companies, 6th Edition. Wiley.*