A Perspective on Investing for Income



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For many investors, receiving some level of income from their equity investments is a particularly important goal. As such, the dividend yield is the primary consideration when evaluating a security for potential investment.

We think such an approach runs the risk of confusing cause and effect. A dividend is the outcome of a capital allocation process: it may be entirely appropriate for management to pay out cash to the owners of the business, but without assessing the other potential options for how capital may be deployed, there is no way of knowing whether a business paying a dividend is the right decision. In fact, cases abound where management teams have continued to pay dividends long after it stopped making sense for them to do so from a business perspective – a situation that never ends well for shareholders.

Our view is that no dividend – regardless of size – will turn a poor underlying business into an attractive long-term investment that appeals to someone following a business ownership mindset. Moreover, fixating on the dividend misses the fact that far more value can be created when businesses retain capital and invest it back into the business at high rates of return.

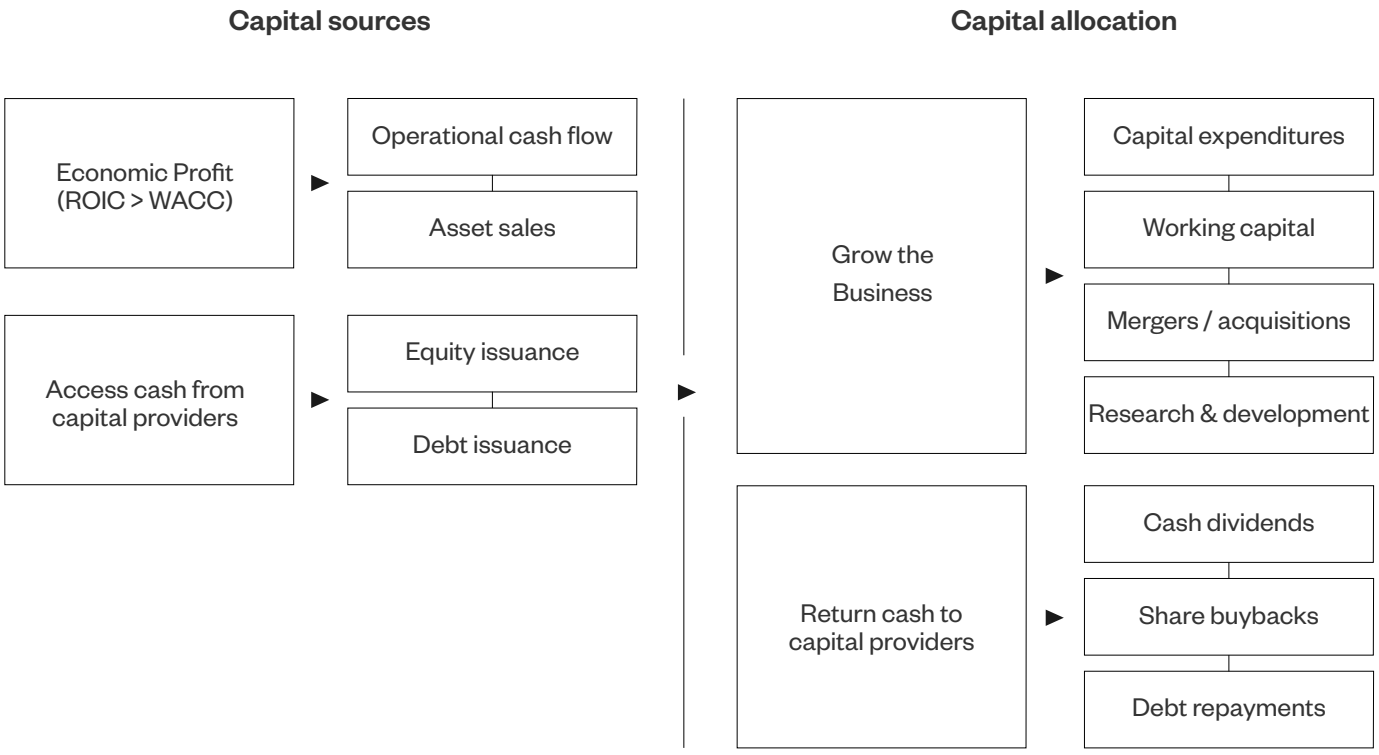
With that in mind, we believe it is worthwhile exploring how to think about dividends when applying a 'business first' rather than a 'security first' mindset.

Capital allocation principles

When a business pays a dividend to its owners, it is in effect saying, 'we don't have a better use of this cash, and therefore we return it to you.' Implicitly, this places any discussion about dividends firmly in the realm of capital allocation.

At its most basic, capital allocation simply refers to the process by which management decides what to do with the cash a) investors have entrusted to them or b) has been generated internally in the normal course of operations. In some sense, good capital allocation may be thought of as the primary responsibility of the senior management team of any business, as it translates corporate strategy into actions that ultimately seek to create value.

The image below summarises both the potential sources and uses of capital a management team must consider.



Source: Adapted from 'The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success' by William Thorndike

As can be seen, there are essentially only two broadly defined uses of cash: management can either invest capital to grow the business, or return it back to the providers of equity or debt capital. Because capital is (in theory) a scarce resource, management is forced to evaluate between a variety of uses of capital and choose those that create the most value.

Said another way, sound capital allocation decisions are made by applying the idea of an opportunity cost. Every possible use of capital should be weighed against the other uses, which forces management to compare between the various options to find the optimal strategy. Paying a dividend could be a perfectly appropriate use of capital, but it needs to be understood as the outcome of a process.

We are cautious of businesses and management teams that commit to a steadily increasing dividend well into the future. In effect, management are promising an increased cash distribution to shareholders every year, without taking into account the fact that they might have better opportunities to redeploy the cash internally, or – more importantly – they might be starving their existing businesses of much needed capital to respond to competitors who are reinvesting in their business and not paying a dividend.

A sustainable return *of* capital first requires a sustainable return *on* capital

We have written extensively about why we believe that investing with a business ownership mindset focuses first on the underlying returns on capital a business can earn over long term. This is no less valid when considering the income component of the total return.

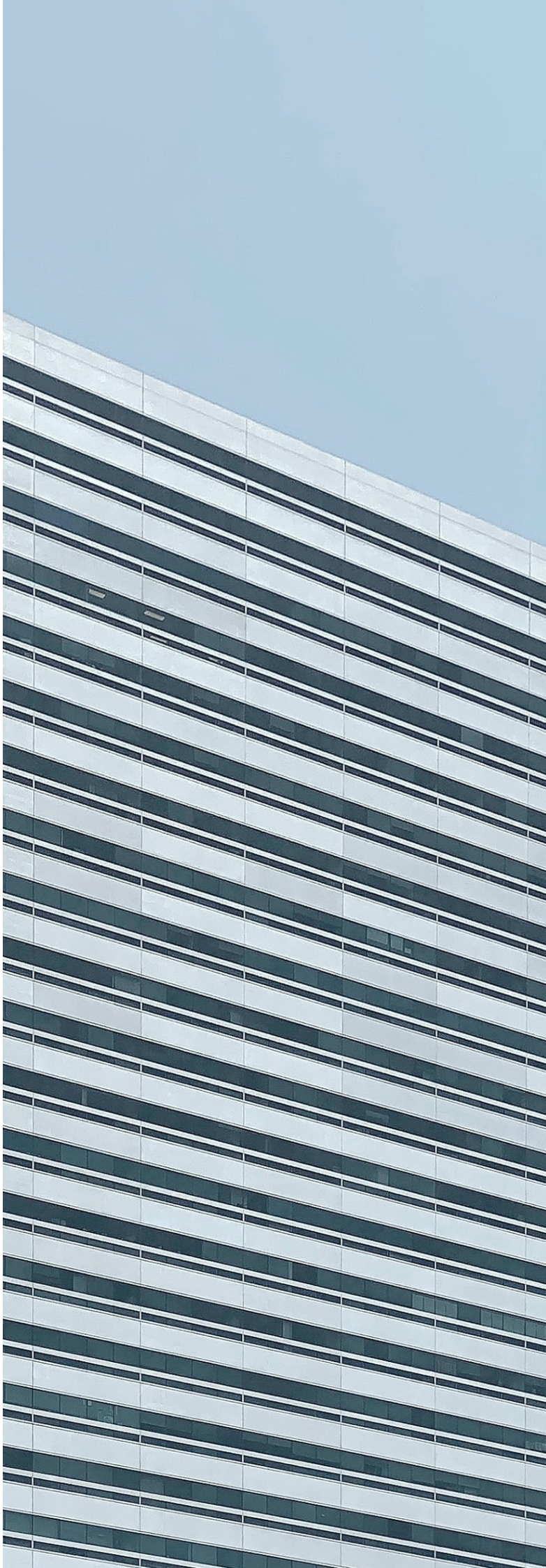
When investing with a business ownership mindset, we place great deal of importance on only owning businesses that can sustainably earn an economic profit – that is, a return on invested capital greater than the cost of capital – throughout an economic cycle. In addition, we favour owning businesses that not only earn a high return on invested capital, but can reinvest a very meaningful component of those returns back into the business at similarly high rates. This enables the compounding effect of internal capital which we seek to capture.

To us, a business that cannot sustainably generate an economic profit has no internal mechanism for creating surplus capital. In choosing to return capital (e.g., paying a dividend) to equity owners, such a business is either eroding its capital base, or it will need to raise capital (most likely in the form of debt) to cover the dividend sooner or later. We view this kind of situation as unsustainable on the face of it (unless it is the unique situation of a business that is actively winding down or shrinking its operations and returning capital to its owners specifically because it cannot earn an economic profit.)

However, if a business that cannot earn a sustainable economic profit is being managed (and presented to investors) as a going concern, the choice to continue paying a dividend dramatically raises the risk to equity owners. The best-case outcome is likely a dividend cut; the worst case is a wholesale equity recapitalisation, which has substantial dilution risks for current owners.

The first step in our framework is therefore to evaluate what return on capital a business earns (or can earn through a downturn) and focusing only on those that can earn an economic profit on a sustainable basis. Logically, high returns on capital can only be sustained by some sort of competitive advantage or economic moat, which requires a qualitative assessment of the business.

By focusing on businesses that earn a sustainably high return on capital – and controlling for balance sheet quality, which we will discuss in brief later – we attempt to lower the risk of permanent capital loss by eliminating businesses that may run into capital issues in adverse market conditions. We think this is sensible, whether the business in question pays a dividend or not.



The big question: reinvest or return capital?

This brings us to the central debate: does it make more sense for management to pay the capital out, or to retain and reinvest it in the business?

At this stage, it is worth pointing out a unique feature of equities as an asset class that is rarely remarked upon: they can retain a portion of their profits (or more accurately, the surplus capital generated) and reinvest it in the business. If you own a bond, you will receive interest, but it will not be automatically reinvested on your behalf; the same is true for the rental income received from real estate.

In contrast, if a company earns a high return on its capital, and management sees an opportunity to reinvest this capital at similarly healthy rates, the decision to retain $1 of capital and invest it on your behalf will create much more than $1 of market value. This compounding effect of internal capital is a key source of returns for equity investors, and is in essence what our approach seeks to capture.

Consider the formula below:

Growth (g)= Return on Capital (ROC)×Reinvestment Rate(RR)

All this basic formula says is that the growth rate of a business can be described as a function of a) the return it earns on its capital base, and b) how much of that management chooses to reinvest in the business.

Reinvesting capital

Assume a business can earn a 20% return on capital, and it sees enough runway for growth to reinvest all of that return back into the business at a similar rate of return. In this case, its growth rate will be 20%:

Growth (g)= 20%×100%=20%

For as long as this situation persists, the business should see its intrinsic value increase by 20% per year.

The best real-life example of this is Berkshire Hathaway. The company has famously never paid a dividend, and has only begun to return capital to shareholders (in the form of share repurchases) sporadically over the last few years. The net result has been a compound return of equity owners' capital of more than 18.9% per year over 55 years ended of December 2019; it is why the value of a Berkshire Hathaway Class A share (purchased by Warren Buffet in 1965 for $7.50 per share) trades today (at the end of 2020) at a per share value north of $300,000. By retaining the capital generated by Berkshire's operating businesses internally and judiciously reinvesting it, Berkshire Hathaway has turned $100 (in 1965) into nearly $1,340,000 today.

Note that reinvestment can take many forms: spending on brand-building, ongoing research and development, or investing in working and/or fixed capital. However, the most frequently adopted strategy is to spend capital on mergers and acquisitions (M&A). While evaluating what makes for 'good' M&A is beyond the scope of this paper, there is substantial academic evidence to illustrate that only about one-third of deals create long-term value for acquirers; the balance is at best value neutral, or more likely value destructive. (Koller, Goedhart, Wessels; *Valuation (6th edition)*, 2015)

Regardless of what method a business chooses to reinvest its capital, they key question to ask is what returns the business will earn on the incremental capital being invested. If a business is able to earn a high cash return on invested capital, and reinvest those returns at similarly high rates, this delivers dramatically greater value creation for owners over the long run. The key is to make sure competition does not erode the high returns on capital, which is where our qualitative analysis is focused.

Returning Capital

So, when does it become appropriate to return capital to shareholders? In short, if management cannot reinvest capital at returns that beat the cost of capital, a dividend or share repurchase may make sense. (For purposes of this paper, we will ignore the debate on the relative merits of dividends versus repurchases. Suffice to say investor preferences may differ due to tax treatment, and there are ways to engage in share repurchases that can both create or destroy value for owners.)

Let us revisit the growth formula outlined above, but now assume that management, after careful evaluation, believe they can only invest 40% of its 20% return on capital at rates that exceed the cost of capital. The investment should either a) maintain the competitive position of the business and b) enable the business to grow in the future.

Growth (g)= 20%×40%=8%

In this case, intrinsic value should increase by roughly 8% per annum, whilst the other 12% is essentially distributed to the providers of capital.

Consider a more mature business, such as those operating in the consumer staples sector. Businesses in this sector that own well established brands in niches frequently have some pricing power, meaning they tend to earn high returns on capital, frequently in the 15% to 25% range – well above any reasonable estimate of the cost of capital. With few exceptions, consumer preferences or shopping requirements do not change rapidly. For example, no one is likely to drink twice the amount of juice, or use twice the amount of washing powder, from one year to the next.

As such, the problem these businesses face is that they cannot reinvest all the cash they earn back into the business at the same rates for the above mentioned reason: demand for their product simply does not grow rapidly from one year to the next. Thus, after investing to a) maintain and grow the brand, b) create line extensions in existing product categories, or c) launch products in new categories, these businesses usually have a substantial amount of surplus capital left over. In this case, it makes complete sense to consider returning some capital back to equity owners, with two qualifications:

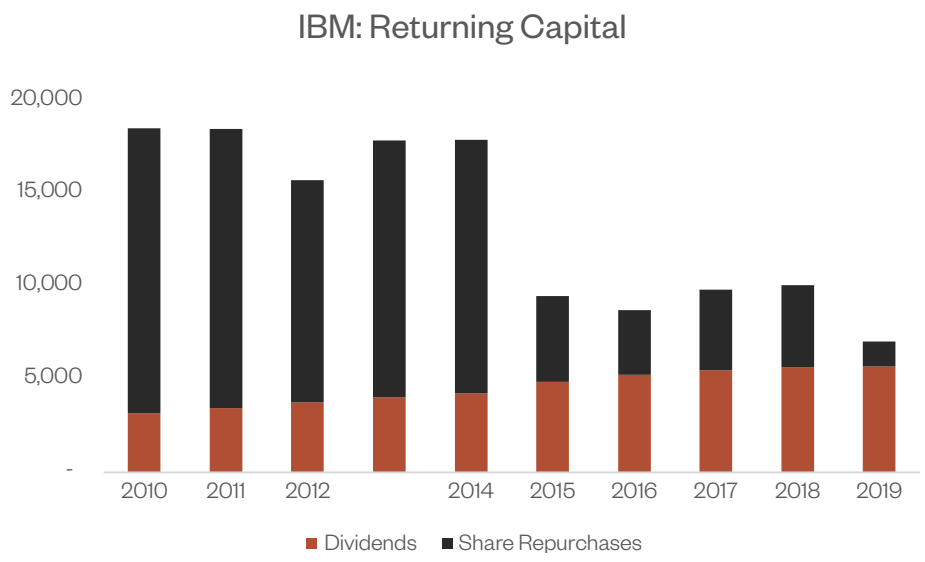
1. Management should not return capital to owners at the cost of underinvesting in the business and depriving it from the capital required to compete and at the very least maintain its current competitive position (or hopefully improve upon it).
2. The balance sheet should be reasonably unencumbered by debt.

Selling the family silver

Despite the two points above being – in our opinion, at any rate – only common sense, the opposite happens with surprising frequency. Examples abound of management persisting in returning capital to owners while highly indebted (or worse, actively issuing cheap debt to fund returns to equity owners), or returning capital but underinvesting in the business, thereby undermining its ability to compete.

Underinvesting

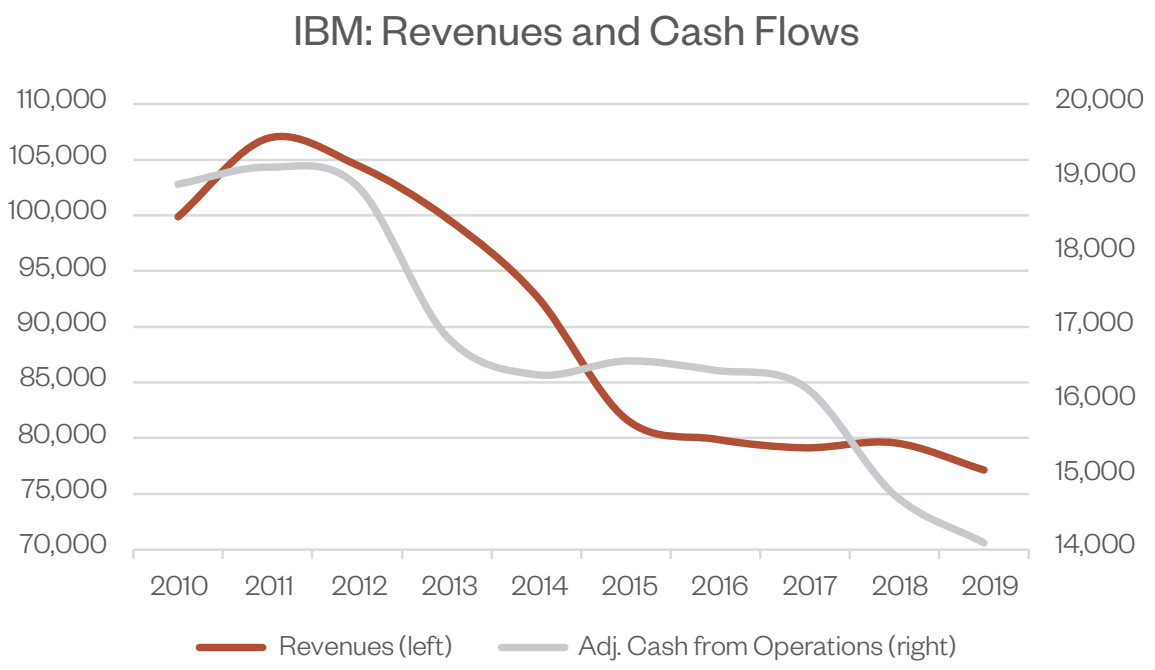
Over the last decade, IBM may serve as case study highlighting the issue of underinvestment. After seeing revenues peak at roughly $107bn in 2011, sales have declined persistently, to the point of being nearly 28% lower as at the end of 2019. In early 2011, the business released a much vaunted '2015 Roadmap' which featured as a key objective returning $70bn in capital to shareholders by 2015 (as well as growing earnings per share to $20.00 from $11.52 in 2010). IBM were true to their word, at least as far as the return of capital was concerned: from 2011 to 2014, the business returned a cumulative $70.15bn in cash to shareholders in the form of dividends and share repurchases. However, as can be seen in the chart below, the party stopped rather abruptly in 2015, due to IBM abandoning their original 2015 roadmap in October of 2014.



Source: IBM company filings

By 2014, cloud offerings from rivals had made material inroads in encroaching on IBM's traditional hardware business, yet management persisted in returning capital to shareholders instead of aggressively re-positioning the business to remain competitive. IBM's fixed capital investment for the whole decade added up to roughly $36.8bn; in contrast, Microsoft spent a bit more than double this amount ($79.7bn) over the same period to invest in cloud infrastructure.

Unfortunately, the trajectory of revenues and operating cash flows over the rest of the decade tells the story rather succinctly: because IBM missed the cloud revolution in the early 2010's and underinvested in the business (but returned a shedload of capital to investors), revenues and cash flows have been pretty much one-way traffic for the best part of the decade. (It should be noted that IBM divested of several businesses in the last few years, accelerating the decline).



Source: IBM company filings

Needless to say, IBM never got close to delivering $20 in earnings per share, either in 2015 or subsequently.

The point of this example is not to highlight the strategic or competitive issues faced by IBM, but rather the fact that management putting a capital return programme on autopilot can do tremendous harm to shareholders in the long term, even if they collect a healthy dividend over the short run.

Balance sheet risk

One part of the capital allocation process is to optimize the mix of debt and equity by which a business is funded. Given the incredibly low interest rates charged on debt since the global financial crisis, the direction of travel has been one-way: businesses have substantially levered up their balance sheets to take advantage of cheap capital.

In one sense, this is smart: replacing 'expensive' equity with 'cheap' debt lowers the cost of capital, with all else being equal. Businesses with excess cash have been accused of running 'lazy' balance sheets, and activist investors have been reasonably successful over the last decade to convince management teams to engage in this push towards balance sheet efficiency.

Of course, this ignores the fact that sometimes, being caught with a substantial amount of leverage at the wrong moment can be extremely dangerous to the business as a going concern. In particular, the March 2020 crash bought on by COVID-19 highlights exactly the risk we are referring to: the debt may be fine in normal circumstances, but highly 'optimised' balance sheets have a habit of being fragile when things do not go as planned.

While we accept that some level of debt capital is appropriate to fund a business, we get nervous if management seem set on the idea of perpetually increasing leverage whilst also engaging in ongoing dividends and share repurchases. It could work out reasonably well in most instances, but when it doesn't, equity holders are generally left to pick up the pieces.

This is particularly true of cyclical businesses – such as those in the commodity and banking sectors – that tend to earn acceptable returns on capital only when the overall economy is growing. In other words, they do earn an economic profit, but only under specific conditions. The risk here is that when economic growth slows or an unexpected crisis develops, returns on capital tend to drop below the cost of capital. If this happens whilst the business is highly geared (which is generally the case for cyclicals), the dividend is almost always the first casualty on the path to shoring up the balance sheet and preserving the business.

Investing in cyclicals for yield is almost guaranteed to end in disappointment for equity owners at least once per economic cycle, particularly if the business is highly indebted.

We have several metrics we monitor when assessing the balance sheet risk of a business. These include (among others) the cash interest coverage ratio, the maturity schedule of outstanding debt, the relative net debt/net cash position, the nominal amount of debt, the total- and net debt to EBITDA ratios, and the ratio of total debt to capital. When these ratios begin to look stretched, we would rather that management take the correct (and brave) call to pre-emptively de-emphasize returning capital to equity owners in favour of improving the Balance sheet. Over the long run, we believe this 'just-in-case' approach to balance sheet structure materially lowers the risk of permanent capital loss when investing with a business ownership mindset.

As a final note, keep in mind that by paying down debt, a business is also indirectly creating value for equity owners. By reducing the amount of outstanding debt (which has superior claims over equity in the capital structure), the equity is essentially worth more. It is no different to paying down a mortgage to increase the value of owners' equity in a property.

Conclusion

Investing in equity for income can make sense in the low-interest rate world we find ourselves in. However, we feel that when following a 'business first' over 'security first' approach, the focus should remain on the level of returns on capital a business can earn through the economic cycle.

Our preferred business is one that consistently earns a high return on invested capital and chooses to reinvest the majority of those returns back into the business at similar yields. This is the compounding of internal capital we seek to capture over time.

However, we expect that several of our businesses will return some component of capital to owners, given how much excess cash they generate. As such, we expect that several of our businesses will engage in returning some component of capital to its owners. We welcome this, provided the following three criteria are met:

1. The business can earn an economic profit (ROIC > WACC) throughout the economic cycle.
2. The business is not paying out capital to satisfy a certain constituency of shareholders who expect a dividend, at the cost of starving its operations of the necessary capital to maintain or improve its competitive position.
3. The balance sheet is not overly indebted, and the business is resilient to external economic shocks.

Capital allocation is ultimately not an 'either-or' exercise, and it is entirely feasible that management can pay both a healthy dividend and continue to grow the business. However, to understand whether this is the case, their overall capital allocation strategy and track record must be analysed. Simply assuming a high yielding stock is a good investment may prove to be an expensive assumption down the road if the underlying business cannot earn sufficient returns on capital to justify it.