COMPANIES AND THEIR CAPITAL ALLOCATIONS

In February, Markéta Bidrmanová and I recorded an episode of the podcast "Ve vatě", which was dedicated to dividends. Judging by the discussion set off on social media after the podcast aired, people often look at the issue of dividend payments somewhat incorrectly, and, above all, they do not evaluate dividends in the context of companies' overall asset allocation, which includes paying dividends as one of several options. It therefore occurred to me that it might be worth dedicating this letter to shareholders to the allocation of capital by companies and explaining how we ourselves view it.

Ideal CEO

Imagine that the CEO of a company has been in his or her position for a not unusual 6 years. If, during that time, the company achieves more or less an average return on capital of 10%, then the CEO makes asset allocation decisions equal to approximately three-quarters of the company's assets at the time that he or she took on this role. How well or how poorly assets are allocated on an ongoing basis has a dramatic impact on the value of the company.

The primary task of a company's management (often forgotten) should be to maximise the value of the company per issued share. Capital allocation plays a key role in this. For market participants who measure the time of their shareholding in days or weeks, these considerations are irrelevant. For investors like us, however, who view shares primarily as a stake in a company's business and who see the point of investing in shares as the long-term effect of values created by humans and compounded returns on capital, these considerations are crucial.

When we analyse some company as a potential investment, we consider it ideal for a CEO to have two basic skill sets: to be able to manage the company's business well and to be able to allocate the earned capital efficiently. In practice, it is much more common that a CEO performs better as a business manager and poorer as an investor in allocating capital. This is altogether understandable, as a large part of company bosses have worked their way up to their positions during their time in the industry, and primarily thanks to their professional and managerial capabilities. Once they reach the very top of the company, however, they are suddenly given an additional set of responsibilities related to capital allocation. This activity requires a completely different mindset, skills, and aptitudes, and its successful mastery is much rarer in practice. A CEO who can manage a business well and, moreover, allocate earned capital excellently, is a golden treasure. Especially if his or her tenure is for the long term.

Capital allocation

Companies have a wide range of options in allocating capital. They can invest it back into their own businesses in the form of capital spending (for either maintenance or growth), into research and development, or into selling, general, and administration expenses. In a growing business, some of the additional capital will typically be swallowed up by strengthening working capital. Another relatively common direction in which capital

flows is to acquisitions. If all attractive options as mentioned above are exhausted, the capital can be used to reduce debt or it can be paid out to shareholders. There are essentially two basic options for paying out capital to shareholders – paying dividends and buying back the company's own shares.

Some of the possibilities mentioned above also may occur in reverse. The company's own shares not only can be bought back but also issued. Debt can be reduced but also increased, and the opposite of acquisitions would be to sell some assets. The main source of capital for companies in the long term tends to be their own generated profit. Debt comes second. Speaking generally, it can be said that companies growing faster than their return on invested capital (ROIC) tend to have a need to raise external capital, and companies that grow slower than their ROIC tend to have excess capital and are more concerned with where to allocate it.

As you can see, every CEO has several options for generating capital on the one hand and even more possibilities for allocating capital on the other. Theoretically, a CEO should always consider all the options available to him or her on both sides of the scales, compare the profitability of each capital allocation variant (while taking into account the risks involved), and then choose the possibilities promising the highest returns. From our investor perspective, good and well-managed companies can be considered those that have a high overall ROIC. Corporate management can then be considered an efficient asset allocator if there is a high return on incremental invested capital (ROIIC).

"Agent–principal" problem

To be successful in this, a CEO must not only have the appropriate skills, but also must think and act like a shareholder. A lot depends upon his or her goals and motivation. We often find that this shareholder mindedness does not exist in fact. This is a textbook example of what is known as the "agent–principal" problem. The point is that there is often a conflict between the interests and priorities of management, who are in the position of the hired "agent", and of the owners (shareholders), who are in the position of "principals". Management acts on behalf of an entity that is owned by someone else. And management often has its own objectives. First and foremost, it is about the management's own remuneration, importance, and prestige related to the size of the business it leads. Managers often give priority to their career risk and generally have a shorter thinking horizon. The firm's shareholders are not really interested in these things. They are (or should be) interested in long-term value creation per share they own. How closely management succeeds in aligning its own goals and ambitions with those of its shareholders very often corresponds to the way it allocates assets.

Acquisitions

Our study of market events and our own investment experience lead us to conclude that the greatest potential risk for value destruction in asset allocation is through acquisitions. This is because, overall, it is the form of capital allocation to which the largest amount of money is directed. In individual cases, the sums can be enormous compared to the size and capitalisation of the acquiring company. Moreover, in these transactions,

management's egos may play a large role and their interests and objectives most often diverge from those of shareholders. Furthermore, management's appetite for acquisitions is cyclical. It increases as share prices rise, and the greatest number of acquisitions generally occur when a bull market is near its peak. The room for error is simply greatest here. We consider the worst acquisitions to be those that are very large, that are paid for with stock instead of cash, and that are outside the buyer's existing core business area. It often is the case, too, that the announcement of these acquisitions is unexpected, the market is caught off guard by it, and an immediate negative price reaction follows. Our portfolio, too, has seen two instances of these large acquisitions in earlier years (Sanofi, Teva) and our decision to sell these stocks quickly proved to be correct. We try to avoid companies and managements that have a history of making large acquisitions or where there is a risk of their making them.

It nevertheless should also be said that there are some companies that have for a long time based their growth on acquisitions and have done very well. They do not overpay for individual acquisitions, they are able to integrate them well, they do not have megalomaniacal plans, and, when there are no attractive acquisitions available, they can wait patiently for an opportunity. In such companies, then, acquisitions do not destroy value but create it. An example of such a company in our portfolio is Alimentation Couche-Tard. It is no coincidence that this company is still controlled by its founders, who to this day still own a substantial stake in it and therefore think of it as would a real shareholder. Coincidentally, Alimentation Couche-Tard announced another of its acquisitions last month. We like the transaction very much.

Inward investment

The other two big possibilities in terms of capital allocation, second only to acquisitions in terms of size, are investments in selling, general, and administrative expenses (SG&A) and capital expenditures. The share of capital expenditures has been gradually declining over the past few decades as investment in companies in general has tended to shift from tangible to intangible assets. Some previously non-existent companies or entire sectors now operate with relatively few tangible assets, which logically changes the nature and direction of their investments. This trend places new demands on the analysis and valuation of companies, as investments in intangible assets are often difficult to distinguish in accounting terms from regular operating expenses, making it difficult to assess their efficiency, life spans, and sometimes even their releveance.

Dividends and share buybacks

Let us now turn to those types of asset allocation that channel capital from companies to shareholders. This occurs in fundamentally three ways: by paying dividends, by buying back the company's own shares, or by selling the whole company. Selling of the whole company is a bit of a special case, so we will put it aside and focus upon dividends and share buybacks. These are very important items in companies' overall capital allocation, they can have big impacts on a company's value, and often they are rather misunderstood by shareholders. In terms of their relative size, dividends are historically older and used to be the preferred form of paying out money to

shareholders. Share buybacks have become increasingly important in recent decades, however, and in the US market, for example, they now surpass dividends in size.

Many investors buy certain stocks primarily for their dividends. They like to have the dividend money landing in their accounts on a regular basis. This more or less regular and predictable income gives them the feeling that they are actually getting something from the companies they own. That may be true, but the reality is that dividend payments alone do not make an investor richer. This is just an illusion, which can be thought of as a standard psychological reasoning error known as mental accounting. In mental accounting, investors evaluate dividends separately and apart from the rest of their investments, which is a mistake. Dividend payments do represent a nice cash flow for the investor, but it is at the expense of the "principal" or value further held through the shares.

Receiving a payment from a dividend does not really create wealth. This can be easily demonstrated in simple numbers. Imagine that shareholders collectively own a company that has equity of 1 billion before dividends are paid. When the company pays a dividend of 50 million to the shareholders, the shareholders own a stake in a company with equity of 950 million plus 50 million in cash. Their wealth is unchanged by the dividend payment. In essence, it can be said that they have been paid something that they had already owned through shares. The same conclusion is reached by standard valuation models, which set the value of a company as the sum of discounted future cash flows minus net debt. The payment of dividends increases the company's net debt and reduces its value accordingly by exactly the amount received by shareholders in dividends. After all, the stock market quotation reflects this, as dividend stocks tend to open the day after a dividend is paid at a price one dividend lower than where the stock closed the day before. In the real world, where taxes are paid on dividends, the shareholders are worse off after dividend payments by the amount of the dividend withholding tax. Financial theory talks about the so-called "dividend fallacy". The dividend fallacy – a belief that dividends are "free money" – is one of the most common mistakes investors make. In reality, dividends are not "free money" and this simple and trivial matter is sometimes almost impossible to explain to some people.

The dividend policies of companies must therefore be considered in the context of their overall asset allocations. Dividends are beneficial if a company has surplus capital, does not have too much debt, and has no better use for that capital. In practice, unfortunately, it is very often the case that when considering capital allocation, corporate management prefers to cut off a portion for dividends without giving much thought to whether this is the best use of resources. Dividend policy is often established in advance and quite rigidly. Most common dividend plans assume a regularly increasing dividend, a minimum "guaranteed" dividend, or a fixed pay-out ratio (dividend/earnings). Managements do this knowing that investors (and analysts) like things to be regular and predictable, and while understanding full well that dividends often have a special status in the eyes of investors due to their mental accounting. Moreover, they fear that investors would interpret a dividend cut or even its elimination as an admission of concern about

the company's future. This does not, however, make much sense from the viewpoint of companies and their capital allocation. If management has a very attractive opportunity within which to invest capital, it should give it maximum priority and simply not pay any dividend. Conversely, in cases where the business does not have attractive investment opportunities, it would make sense to pay an unusually large dividend. Something that is actually common in the world of privately held companies is very rare in the world of publicly traded companies. We have companies in our portfolio where we think their paying relatively high dividends is the right thing to do (e.g., S&U, Quálitas Controladora) and companies where we are happy they do not pay dividends and would even consider their doing so to be a mistake (e.g., Berkshire Hathaway, Markel).

Now, what about share buybacks? Do they bring value to shareholders? The answer depends upon the price at which those shares are bought back. If a company buys back its own shares at a price equal to the actual value of those shares, then 100 cents are exchanged for 1 dollar and no value is created. Only the shareholders are divided into those who retain shares in the company and those who exchange them for cash. What happens if the company buys back its own shares at a price lower than the actual value of those shares? In these buybacks, those shareholders who sell receive less for their shares than the shares are really worth, and the value of the shares still held by the other shareholders increases along with their percentage ownership of the company. That means there is a transfer of wealth from the selling shareholders to those who still hold the shares. Analogously, if share buybacks occur at a price higher than the real value of the shares, then wealth is transferred from remaining shareholders to those who sell them. So, the price at which share buybacks are made matters a great deal in evaluating share buybacks. Last year, companies in the US market spent approximately 1 trillion dollars on share buybacks. In our view, the majority of these buybacks were made at prices above the value of the shares, and were therefore capital-destroying from the shareholders' point of view. Very often, companies buy back their shares to immunise (cover) the impact of massive share issues to management and employees (SBC, stock-based compensation). This is another incarnation of the "agent–principal" conflict.

We often consider share buybacks made at prices below the value of the shares to be the best use of capital. This is essentially an investment by the company into itself with a return on capital usually higher than is offered by available investment opportunities and without the risk associated with large acquisitions. If management can maintain the discipline to buy back shares only at favourable prices, and if this is not at the cost of growing the debt, then share buybacks can have a highly positive impact on both share value and share price over the long term. It is perhaps not surprising, then, that we seek out companies that think and act in this way and, when their share prices are good, we include them into Vltava Fund's portfolio. Currently, about 80% of the Fund's portfolio is comprised of stocks of companies that place buying back their own shares at attractive prices at the very top of their asset allocation considerations (e.g., Berkshire Hathaway, Alimentation Couche-Tard, NVR, BMW, Asbury Auto, Williams Sonoma, and others). Not only is that their priority but, most importantly, they execute those buybacks successfully.

As a point of interest, about 60% of the Fund's portfolio is made up of companies that pay dividends, and about 50% of the portfolio is made up of companies that both pay dividends and buy back their own shares. The volume of buybacks is about twice that of dividends and the portfolio's adjusted dividend yield (net dividends + share buybacks) is about 4.3%. For some companies it is as high as 11%. The portfolio's historical P/E measured by the trailing 12 months' earnings is approximately 9.5×.

Even from this brief and, in the interest of reasonable length, somewhat superficial description, it is perhaps clear that efficient capital allocation is absolutely crucial over a longer investment horizon. The average length of our investments is measured in years. So we want the managements of those companies into which we invest to think long term, to strive to create value per share, to think and act as if they were shareholders themselves, and to have that rare combination of skills that is knowing both how to run a company's business and how to invest its capital. We endeavour to seek out such companies and, if the share price is attractive, to invest in them.

Changes in the portfolio

We used most of the available and newly received money to increase several existing positions. There were more than enough opportunities to do so during the past quarter. Nevertheless, two minor changes occurred in Vltava Fund's portfolio last quarter. We sold the rest of our shares in the Canadian company Magna International and opened a new position in the Swiss company Jungfraubahn.

We have twice had Magna in our portfolio. The first time was during 2004–2006 and then again since 2015. We sold it the first time precisely because we were not satisfied with the asset allocation made by management and the main controlling shareholder. After a few years, we re-entered the company after the original main shareholder and founder sold his shares and at the same time the entire management was replaced. While we consider the new managers and their actions both in terms of running the company and in terms of asset allocation to be very good and there has been little to fault them for in the period of just over 7 years, the company's results have remained below our expectations. This is probably because the overall characteristics of the company's business type have been less profitable and less attractive than we had originally anticipated. Magna has turned out to be a rather enigmatic stock, as times of high expectations alternated with moments of disappointment. Gradually, we were losing our justification for holding the stock any longer until it disappeared from the portfolio altogether. Our gain on Magna since 2015 has been just over 50%. Even though we have only held the full position for about 4 years, it has been a disappointment.

Now about our investment in Jungfraubahn shares. In 1893, the Swiss industrialist Adolf Guyer-Zeller requested permission to build a cog railway from Wengernalp station (1,874 m a.s.l.) through Kleine Scheidegg to the summit of the Jungfrau (3,454 m a.s.l.). The route was to run through a tunnel inside the Eiger and Mönch mountains. Construction began in 1896 and was completed in 1912. When I first visited the site in the 1990s and went up the Jungfrau, it was an unforgettable experience. The view from the window of the intermediate station in the middle of the Eiger's fabled north face made a particularly big impression on me as

someone who used to do a lot of rock climbing in my youth. As a side note, one of the four climbers who were the first to climb the north face of the Eiger in 1938 was Heinrich Harrer. A few years earlier he had spent his *Seven Years in Tibet*. Harrer wrote a great book about the conquest of the Eiger, *The White Spider*.

Today the railway is owned and operated by Jungfraubahn, which is one of the leading tourist-oriented companies in Switzerland and the largest mountain railway company. In addition to the original railway on the Jungfrau, the company operates and owns still other railways and cable cars around Grindelwald and Wengen, ski slopes, ski tows and winter sports equipment, a hydroelectric power station, restaurants, shops, and car parks. Altogether, and especially thanks to the Jungfrau railway, this is perhaps the biggest tourist attraction in the Alps.

From an investment point of view, the company caught our attention during the covid pandemic. Its operations were temporarily suspended and its share price responded by plummeting sharply. The situation today is that the winter season is hitting new all-time highs and the summer season is gradually returning to its previous levels. The share price, meanwhile, remains well below its pre-covid highs and seems to us attractive. We think this is a unique business, essentially a local monopoly (sort of like the Eiffel Tower in Paris), with high margins and a decent ability to pass on inflation to its customers. It is a smaller and less liquid company, however, and will therefore be one of the smallest positions in our portfolio. On the other hand, an advantage is that the size of our fund allows us to invest even in relatively small companies at times. In short, we bought a piece of Switzerland and now we are joint owners of the largest Alpine tourist attraction, which also is very profitable.

Here are a couple of photos.
https://www.jungfrau.ch/imagedb/en-gb/images

And here are some videos:
https://www.jungfrau.ch/en-gb/corporate/videos/

Daniel Gladiš, April 2023

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