

SELECTED INVESTOR QUESTIONS RECEIVED THROUGH JUNE 26, 2018

Question

Let's say that at some point CSI was not able to deploy anywhere near its FCF into acquisitions that meet its hurdle rate and large acquisitions were too scarce and expensive, and it was expected that this would continue going forward. Would management consider not only returning the excess capital via special dividends, as has already been mentioned in the past, but also leveraging the balance sheet a little (via long-dated bonds?) to increase ROE?

In other word, I'm seeing that M&A is a big source of value creation for the company right now, and it's also the main source of uncertainty (you never know how much you'll be able to deploy, when big opportunities will show up, when a mistake could be made about an acquisition that could cause problems, etc). If suddenly M&A became a much smaller part of the business, it seems to me like the remaining business would be much more predictable and stable as a result, and so some reasonable amount of financial leverage would make more sense (if risk went down on one side, it could be increased a little on the other without changing too much the overall level).

This is more of a thought experiment to better understand how management thinks about things, as I don't expect M&A to dry up any time soon or larger VMS companies to stay expensive forever (and just one of those could all of a sudden radically change the excess cash situation).

Response

One of the few lessons that stuck with me from B-school was "Toy's law of constant concern" which our entrepreneurship prof phrased as "business risk + financial should equal a constant". Although he didn't specify the units of measurement for risk, I think Toy's law captures the essence of your question.

We would definitely consider special dividends if we felt we had excess cash. We might consider buybacks if we felt the stock was fairly valued. I would personally fight against a buy-back if I felt the stock was under-valued. Buybacks of under-valued stock feel to me like insiders preying upon their weakest shareholders using superior information. I'd argue to our board of Directors that there is no "Mr. Market" whom we can take advantage of without qualm. Buybacks of over-valued stock hurt your continuing shareholders, so I can't see us doing that.

I don't know whether we'd use high leverage or not to increase dividends. It feels like a manoeuvre that gets shareholders maybe a 20%-25% one year pop in their return, but then hobbles the company with debt and covenants for a very long time. That hobbling has obvious (i.e. you are less likely to take on turn-arounds and high business risk situations when you have high financial risk) and less obvious (i.e. more short term focus) ramifications.

Moderate leverage with "friendly" debt (similar to our existing debentures) might be worth considering if our acquisition growth slows considerably.

I think our dividend/debt/buyback decisions will get made in the context of the environment and alternatives at any particular time. We have a very financially sophisticated board of Directors, so this

isn't an issue that currently keeps me up at night (although when our PE investor proposed a leveraged recap a few years before our IPO, it greatly concerned me).

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