SEPTEMBER 19, 2018 - Additional sectors for investment, Buybacks, ROIC, Value Investing

Question

In the president's 2017 letter, you mentioned the competitive environment and possibly finding other sectors with high ROE and asset light businesses. Can you talk a little more about what other sectors interest you and if we are likely to see constellation make an acquisition outside of VMS in the medium to long term? Additionally, what would be the hurdle rate (ROE) targeted for these other sectors?

Response

I hope that we eventually find ways to invest beyond the VMS sector, but our current priority is to refine our capital deployment process within the VMS sector. If we are successful, that will probably delay our move into other sectors.

There are structural factors and trade secrets that contribute to moats. The latter tend to leak into the market over time, gradually diminishing moats. Alerting potential competitors to investment opportunities that we find interesting feels like a way to deliberately introduce leaks into our moat. When we do invest in another sector, we'll keep it as quiet as legally possible.

We use a weighted four-scenario approach to assess investment prospects. Academics call this mutually exclusive collectively exhaustive scenario modelling or "MECE". The cash flows of each of the four scenarios are probability weighted, allowing us to use a single hurdle rate across all investment prospects, even if the investments have very different risk profiles. I encourage our folks to use the MECE method and similar hurdle rates for all of our investment prospects, whether they be VMS acquisitions, internally generated Initiatives, or investments outside of the VMS sector.

If we continue to generate strong and growing free cash flows, we will eventually lower our hurdle rates. That will both broaden the field for alternative investments and increase the size of our addressable market within the VMS sector. It will also mean that there is less excess return to share between CSI's employees and investors. I'm hoping that doesn't happen for a long time.

ML

Question

Your previous Q&A answer about buybacks created some interesting discussion among a group of CSI shareholders. One of them raised the point that when a company buys back undervalued stock, it is providing liquidity counter-cyclically at a time when some shareholders might need it (some of them will be making sales whether the company is buying or not, and might get better prices if the company is increasing demand for the stock).

It also helps protect the company from staying undervalued too long, protecting it from short-term thinking activists and takeover attempts (the original PE investors tried to have the company sold because of undervaluation, according to the president's letters).

So the argument is basically that undervalued buybacks might help selling shareholders by providing them more liquidity and a better price and help remaining shareholders by stabilizing the price and possibly protect some from human nature that makes people panic when prices fall rapidly (something that the company's less sophisticated and experienced shareholders are probably more prone to). Only those who are would-be shareholders and are waiting for low prices might have fewer opportunities.

Do you agree or disagree with these points and do they change your thinking about buybacks any? Thank you.

Response

Those are good arguments in favour of buybacks. There are some counter-arguments. The question about when to use buybacks is a difficult one.

My second inclination when confronted by a difficult question, is to ask what problem we are trying to solve. Once that has been nailed down, I like to use scholarly research in the field, well-constructed experiments (if the cost/benefit of our experiments can be justified), case studies, and experts to help me seek solutions.

My first inclination is to rely upon my own biased and subjective experience. Tapping personal instinct and experience is nearly effortless and works fine a lot of the time, particularly with simple questions. Unfortunately, habitual or instinctive responses to difficult questions can sometimes lead to very poor outcomes. With difficult questions, I try to follow my second inclination, and only resort to my own experience and judgement if I have no alternative.

Buybacks are sometimes used to return capital to shareholders when management can find no better way to deploy capital. They can also be used as a signaling device — a way for directors and officers to communicate to existing shareholders that they think the company's current stock price is trading below intrinsic value and that shareholders should not sell at prevailing prices. My second inclination would be to figure out which of these problems you are trying to solve. That may point you to a better solution than a buyback.

History is replete with examples of directors and officers using insider information to abuse shareholders. Regulators eventually twigged to the problem and market-making by insiders is now illegal except in highly prescribed circumstances. Despite these regulatory efforts, the scholarly research is clear that buybacks commonly increase short-term share prices and are more frequently associated with insider selling than insider buying. My sense from the research is that most buybacks help short-term sellers rather than long-term owners. I'd prefer that our employees be aligned with Constellation's long-term owners. Alignment with long-term owners may not work in PE-backed or venture-backed companies or when the majority of your investors are transient. In those instances, catering to the objectives of short-term sellers is more rational.

There are a minority of cases where a company designs a buyback to benefit long-term owners by acquiring shares at less than intrinsic value. If you consider only long-term owners, the "success" of this kind of buyback is dependent upon the company acquiring as many of its shares as far below intrinsic value as possible. In that case, the directors and officers could maximise "success" by 1) convincing the market not to buy the company's shares, and 2) convincing some existing company shareholders to sell their shares below intrinsic value. This is one of those instances where the moral compass and the apparently common-sense definition of "success", point in opposite directions. When there are reasonable alternatives, I try to avoid such dilemmas.

If the problem is determining how to return capital to shareholders when its shares are trading for less than intrinsic value, why expend energy on the inherent conflict of a buyback, when dividends are a good alternative? In those circumstances I can think of only a couple of examples where I might prefer a buyback to a dividend… i.e. if most of our shareholders were taxable entities, or if I'd had a sincere conversation about the company's prospects with a sophisticated large block shareholder who still wished to sell.

If the problem is that company shares are trading at a value significantly below or above intrinsic value, and the directors and officers have exhausted all other methods of broadly communicating that fact, then a buyback or share sale may be warranted. In those instances, I'd say a common-sense measure of success would be getting the company's shares to trade at approximately their intrinsic value with as little market intervention (and as little capital deployed/raised) as possible. The greatest good has been achieved for the greatest number of our shareholders, when none of them buy too expensively and none of them sell too cheaply.

ML

Question

Thank you for your answer to my previous question about leverage. If possible, I'd like to dig a little deeper into your answer. You mention:

"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."

This sounds like CSI will not take the John Malone approach, but I'm curious what you think of the Henry Singleton and Warren Buffett approaches, and whether they make a difference in how you see buybacks. Singleton did large tender offers. Does it make a difference to you if the stock isn't bought back in the open market but rather shareholders are given advance notice of the company's intentions and allowed to decide if they want to participate or not?

Buffett's approach has been to either buy large blocks of stocks from sophisticated early shareholders who approached him (I know it happened at least once, maybe more -- I think it might have been related to succession planning). At some point CSI might have large early shareholders who want to sell, and it could be made known to them that the company could buy the stock back rather than have them try to sell large amounts on the open market. In recent years, Buffett also set pre-announced levels where everyone knows that he might buy (ie. at 1.3x of book value), and he's made it clear publicly that he thinks the stock is a good value at those levels.

Seems to me like these approaches might remove or at least reduce the potential moral issues with buybacks, though they might also be self-defeating and put a floor on the share price (though in a future period of large market dislocation, there might be large opportunities for such buybacks, and a lot of the churn in the stock might come from indexers, algorithms and other "accidental" shareholders that haven't invested much thought into their ownership).

Hindsight being 20/20, we can see that CSI stock has been undervalued for most of its public history, so any buybacks would've provided excellent IRRs for remaining shareholders, if they could have been done in a manner satisfactory to all. We can't know the future, but similar opportunities to deploy meaningful amounts of capital this way may be available in the future. Thank you.

Response

Teledyne and Berkshire are examples of buy-backs where the companies were seeking to return excess capital to shareholders and management believed that their shares were trading for less than intrinsic value. For most of Constellation's history management were not seeking to return capital to shareholders and did not think their stock was undervalued, so we do not yet have any practical experience with this issue.

I agree with you that some things can be done to reduce the moral hazards inherent in buybacks.

The prospectus-like disclosure used in tender offers gets far more attention from multiple layers of company managers than do the normal quarterly disclosures. The prospectus usually lays out the price and/or terms on which the company will be purchasing a specified number or dollar value of shares. That feels better to me than playing cat and mouse with selling shareholders over an extended period as the company buys in the market.

If the company resorts to frequently trading in its shares, it could press release its purchases every day rather than wait until it is forced to do so by regulation. That is more likely to give an immediate indication of intrinsic value to shareholders, than the periodic anonymous purchasing of shares which isn't reported until quarter-end. This is a good way of signaling intrinsic value but is unlikely to deploy much capital.

A large block purchase of company shares at or below market value from a sophisticated investor who has been personally warned by company management that the directors and officers believe the shares are trading below intrinsic value, strikes me as a one of the better sets of circumstances in which to buy back shares instead of paying dividends.

The buyback vs dividend debate isn't black or white. However, I'd rather have a rule with which I'm comfortable and consider exceptions based upon an analysis of the circumstances of specific exception, than have no rule and act instinctively as each decision arises.

I asked our outside securities counsel to review my responses regarding the buyback questions. She reports that directors and officers cannot legally do buybacks while in possession of material undisclosed information ("MUI"), and that quarterly disclosures by directors and managers should be held to no lower a standard than prospectus disclosures. That strikes me as legally correct but unlikely to be the observed practice. For instance, I would not publicly disclose the specific customers and products with which CSI is getting the most traction and the extent of that success, the techniques that generate the most M&A opportunities for us, nor the places and processes by which we have recently hired and trained our best employees, etc., etc.. Those trade secrets are part of our moat. We protect them jealously. Are they MUI? My gut tells me that if we did publicly promote them, it might increase our share price in the short-term (the legal definition of MUI) and hurt it in the long-term. This illustrates a conundrum. More information is always better for long-term investors… until its availability becomes a competitive disadvantage for their investee.

ML

Question

In your 2018 letter, you wrote that the best way to measure CSUs change in intrinsic value is through ROIC+ Organic Net Revenue Growth, growth in operating cash flow per share & growth in free cash flow per share. Would you mind sharing with us what inputs you use to calculate ROIC - namely the denominator?

Response

Invested Capital represents the cash that has been retained in the business. The following calculation can be used to approximate our invested capital.

	2016	2017	
Ending Retained earnings	394	532	Per BS
Less non-controlling interest in the Adjusted net income of TSS (**Accumulated**)	(37)	(59)	Per MD&A 2014-2017
Non-Cash Adjustments:			
Add accumulated amortization of Intangible assets	1,019	1,286	Per note 9 of FS
Less Deferred income tax asset	(50)	(38)	Per BS
Add TSS membership liability revaluation charge (**Accumulated**)	44	94	Per IS 2014-2017
	1,371	**1,814**	
Average		1,592	
Average per Shareholder Letter		1,622	

Additional non-cash adjustments are made that are not as easily obtained from our disclosure including accumulated unrealized foreign exchange gains and losses.

JB

Question
Hi Mark
… [some discussion of *** recently becoming an owner/manager/director]
I have a question about your comment regarding value investors-- your response to the question appears to suggest that these IFTODH (or beliefs) are what's behind value investors success - being 'correct contrarian', etc. This seems to suggest that value investors do well when making an investment decision "against the crowd". I generally do agree with this approach and have been doing this ... but lately, I find that there are just as many instances where the "crowd is right".... for example.. if you look at Adobe... it's been consistently trading at 40x+ and has delivered tremendous return over many years for its shareholders. Google, Amazon, Netflix, etc have too. An investor who followed the crowd clearly did really well.

Because of this.. I have in recent years started to invest in good businesses that will likely do well in the future, and pay the 'premium' that the crowd has assigned to those shares.

I was wondering if you might have any advice (since your investment history is much longer than mine) that you could share with me about this approach.
Thanks
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Response
Congratulations on becoming a business owner and leader. Too few smart people aspire to that responsibility.

There appear to be two methods documented in the investment literature that consistently work to generate above average returns: Value and momentum. Sometimes the two overlap, but that is rare.
I think you are perhaps conflating "momentum" (a proven technique) and the "crowd is right" (the crowd, by definition, gets average returns). Momentum works, but it seems to be rooted in emotion, not logic, so I've always shied away from it.

A very special case of value investing, is the example of a company that is growing quickly, that the market expects to stop growing within the next 5-7 years, but that actually keeps growing quickly for much longer. If you can spot one of those, it may appear expensive on a PE basis, but actually be an attractive long-term investment on a "value investing" basis. Spotting this kind of investment requires the ability to foretell the distant future… which is extremely difficult to do with consistency.

Mark L