The primacy of long-term wealth creation in business analysis

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What we must learn

- We need to understand how businesses create values (wealth).
- We need to understand how value created by corporations can be extracted by holders of securities. Substantive characteristics of securities.
- We need to understand how to appraise the values created by businesses.
- We need to understand if there are relationships between security prices and corporate values (if any) (i.e. understand what market efficiency depends on, and whether efficiency is prevalent or not and why)

Earnings or Wealth creation?

- The goal of most businesses is the **creation of wealth** rather than the **generation of reported net income.**
- Of course the generation of reported net income and the generation of wealth are related: *the generation of reported net income is just one method of creating wealth.*
- Not only it is only one method, it may be an undesirable method to create wealth because reported earnings are less tax-sheltered than other methods of wealth creation.

Example

- A company could sell a subsidiary for cash and then distribute the proceeds to shareholders in the form of a cash dividend.
- If the sale generates a gain (which often does), the gain would be taxed at the corporate level, and the cash dividend would be taxable at the investor level.
- The wealth generated was taxed twice, at the corporate level and at the individual level. Good business for the US Treasury.

Alternative?

- Instead of selling the subsidiary, distribute its stock to shareholders of the company in a tax-free spinoff.
- In this case, investors get a stock dividend instead of a cash one. The distribution is not taxed at the corporate level, and it is only taxed at the individual level IF the investor sells the stock.
- On top of that, the amount of wealth generated by this transaction could be much larger since instead of selling the subsidiary to a sophisticated buyer, the company lists new publicly traded stock, which could trade at prices much higher than what a sophisticated private buyer would have paid.

Just in case you ask

- "A tax-free spinoff occurs when a company divests a portion of its business in a manner that qualifies as a tax-free transaction under Section 355 of the Internal Revenue Code and thus does not require the company to pay capital gains tax on the divestiture."
- www.investinganswers.com/financial-dictionary/tax-center/tax-free-spinoff-4967

So you may ask yourselves…

- Why do PUBLIC companies seem to focus so much on reported earnings?
- Not because business people think that current earnings are *per se* so all important BUT because the ability to report favorable earnings will have:
  1. The most favorable impact on stock prices in the short-term; (academic literature is littered with evidence of this). Read Chapter 5, pp 61-68
  2. As a result improves company's access to capital markets, which in turn:
  3. May provide greater potential for wealth creation

So

- High common stock prices gives insiders opportunities to realize values by selling (exercising their options, for example) or borrowing against the value of their holdings;
- Also gives the company opportunities to issue new equity in public underwritings for cash or,
- Acquire other companies for cash or by direct issuance of common stock.

What do you learn?

- The appraisal of extractable value is always contingent on what someone does.
  - Sale of a subsidiary assets or spinoff?
  - Reinvestment of earnings in productive assets or in share repurchases.
  - Repatriation of cash or debt financing (Apple case to pay dividends).
- Knowing the set of options requires knowledge of tax law, securities law, corporate law, insiders' historical behavior, activists, etc., etc.

- Let us now learn how companies create wealth.

Methods of wealth creation

1. Free cash flows or Unlevered free cash flows from operations.
   - UFCF = EBIT – Taxes + D&A – CAPEX – CNWC
     - EBIT = earnings before interest and taxes
     - D&A = depreciation and amortization
     - CAPEX = capital expenditures
     - Δ NWC = changes in net working capital
   - UFCF are rare. Money management firms tend to create UFCF. More often, companies create earnings.
   - This is what in Chapter 5 of the book we call "cash flows from operations" (see pages 57-58)

Methods of wealth creation

2. Earnings: defined as the creation of wealth while consuming cash.
   - Earnings = EBIT – Interest – Taxes
   - Many companies do not generate UFCF but generate earnings while consuming cash, cash that comes operations and capital markets.

Methods of wealth creation

- See Chapter 5: “Earnings cannot create lasting values for an economic entity unless that entity, sooner or later, has access to capital markets to meet cash shortfalls” (p57) Example?
- Example of these companies are capital intensive businesses that have substantial CAPEX needs over time. Examples: Oil and Gas, Miners, Real Estate, etc.

- PURE GOING CONCERNS CREATE WEALTH ONLY THROUGH (1) and (2).

Methods of wealth creation

3. Resource conversion activities including Mergers, Acquisitions, Recapitalizations, Spinoffs, Restructurings, Leveraged Buyouts.
   - One way of summarizing this way of generating wealth is in the saying: “one good deal can generate more wealth than 10 years of brilliant operations”.
   - Example: We shall see examples of this in Case 2. Zahn vs. Transamerica.

Methods of wealth creation

4. Access to capital markets on super attractive terms.
   - Credit markets: The typical example is income producing real estate financed with debt at super attractive rates and terms (non-recourse financing).
     - LBO sponsors use this method. Read Chapter 25 of Modern Security Analysis.
   - Equity Markets: being able to issue equity securities in IPO booms.

Creation of Wealth

- Wealth creation is reflected in: book value of equity growth (retained wealth), and wealth distributed to shareholders (dividends)
- Forms:
  - *Appreciation of assets.* See “Book Value Handout, page 128-129.”
  - *Earnings.* *(Going concern method)*
  - *Resource conversions:*
    - *Issuing shares* *(see Book Value Handout page 129)*
    - *Acquisitions* *(same, page 130).*
    - *Holding cash in the bank* *(same, page 130).*

Measuring wealth generation over time

- A portion of the total wealth created is retained by the company and reflected in increases in the book value of equity.
- Another portion of wealth is distributed in the form of dividends

- Let us look at a simple framework for the analysis of wealth generation.

The Dynamics of wealth creation

- We can summarize the dynamics of wealth creation as:

EOY_Equity = BOY_Equity + Going Concern – Dividends + WRC

- EOY_Equity = end of year equity
- BOY_Equity = beginning of year equity
- Going Concern = Operating Income After Interest and Taxes
- WRC = Amount of wealth created by resource conversion activities.

WRC = [EOY_Equity – BOY_Equity] – [OIAIT – Dividends]

Our Experience

- Our most successful investments have revolved around being associated with managements who were able and willing to be opportunistic on a log-term basis, in taking advantage of the resources in the business.

How do businesses generate wealth?

- In creating wealth, these “opportunistic” managements recognize that there tends to be many ways of creating wealth besides enjoying operating earnings.

What resources?

1. **A strong financial position.** Why a resource?
   - You are not a supplicant to creditors.
   - You will have large amounts of unused credit capacity.
   - You will be able to withstand times of turbulence in capital markets.
   - Strong financial position is a *necessary* condition to meet one of the needed criteria of what an investment is.

More examples of resources

2. Having highly efficient manufacturing abilities (Toyota Industries)
3. Having the ability to make attractive acquisitions (Brookfield Asset Management, Wheelock & Company)
4. Having the ability to access capital markets, specially credit markets, on a super-attractive basis (Brookfield Asset Management)
5. Having prime resources in prime locations and being the leader in a particular technology. (Range Resources)

Resources?

- It is your job to identify those business resources, which management can use opportunistically.

Summary

- Wealth generation mechanisms:

  1. Unlevered free cash flows from operations
  2. Earnings defined as creating wealth while consuming cash
  3. Resource conversion activities
  4. Access to capital markets on a super-attractive basis

  - 1 and 2 are going concern means of wealth generation
  - 3 and 4 are resource conversion

Summary

- Focusing on wealth generation rather than only periodic earnings changes the way we see many aspects of business and security analysis:
    1. How we appraise managements
    2. How we use accounting numbers
    3. Whose needs must accounting numbers address
    4. How we view growth
    5. What risks we care about
    6. Etc.