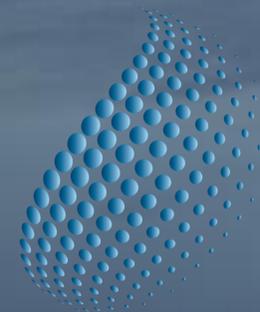


Trust, but verify

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REQ CAPITAL

INVESTING WITH INSIGHT

Focusing on high-performing serial acquirers requires an analytical reorientation because these companies are essentially vehicles for capital allocation. They are associated with above-average entrepreneurship, generating multiple streams of income across industries and geographies. Hence, the failure of a single company in the group should not sink the entire fleet. As long-term investors, we don't bet on home runs or binomial outcomes depending on what OPEC decides next week or next month.

The analysis starts at the top by assessing the three key ingredients for exceptional performance: capital allocation, decentralization and people. It is a trust-based approach where we rely on the management team, which in turn often takes a religious approach to decentralization, treating the underlying business units as true owners and giving them a high degree of autonomy. Unlike most large organizations, cost savings are often sacrificed in the belief that they will be offset by the cumulative effect of ownership, autonomy and entrepreneurial spirit¹.

It follows that some investors may feel they are giving up some of their hard-earned analytical superpowers, which occasionally raises existential questions:

As portfolio managers, what are we actually paid to do?

In fact, our investment decisions are outsourced to the management teams of publicly traded companies that have proven their ability to redeploy large amounts of free cash flow at high rates of return. The opportunities available to these management teams in the private markets are far greater than what most public managers can achieve directly. After all, there are not many public managers who can compound capital at high double-digit returns, measured over periods of several decades.

At a deeper level, it is a system based on common sense principles for long-term value creation, where trust is a central component and superior entrepreneurship is the end result.

For this reason, some parts of the investment community may not like what we like to call “sidecar investing”. As Warren Buffett once said; investors should keep in mind that their scorecard is not calculated using Olympic-diving methods: Degree-of-difficulty doesn't count. In addition to the analytical framework for finding these high-performing serial acquirers, we should not forget that the overall goal is to stay the course and thus take full advantage of compounding.

Our common goal is to find that rare combination of management teams that simultaneously have excellent capital allocation skills and are outstanding operators. This is a tall order, as most good operators are not necessarily good investors.

Why should we expect the management teams of individual companies, often without skin in the game, to wear both of these hats? Incentives play a big role, but hired hands often rise to the top not because of per-share value creation but due to a completely different scorecard.

In contrast, the decentralized nature of these companies lends itself to centralizing responsibility for capital allocation while unleashing entrepreneurship at the business unit level, focusing only on what they do best. In practice, the best-performing serial acquirers take a holistic approach to capital efficiency that includes organic and non-organic initiatives, and they generally deploy resources more efficiently.

In-depth analysis of unit economics at the segment level is replaced by evaluating capital allocation capabilities. We are not in the game of shuffling stocks and chasing the new and shiny; instead, we take full advantage of compounding through management reinvestment of capital. That said, we spend a lot of time on any data that provides clues about management execution, corporate culture development, and reinvestment potential.

Trust, but verify; stay in the sidecar - but don't fall asleep!

Sources:

1) [Interview with Nick Howley \(CEO of TransDigm\)](#)