Finding outstanding capital allocators

By Oddbjørn Dybvad

REQ CAPITAL

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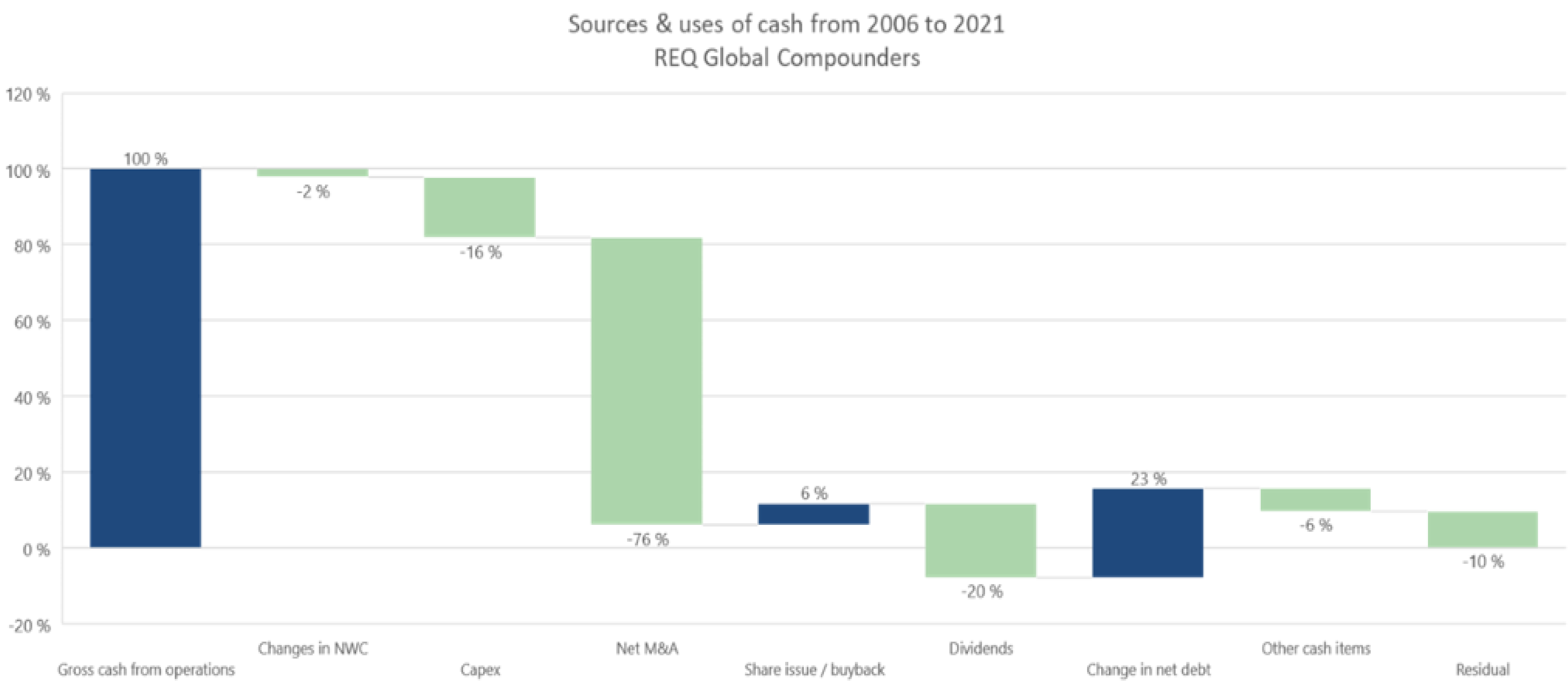
Our investment philosophy is based on investing in value creators, companies that can reinvest a lot of cash at high returns for a long time. Our strategy is to find companies with a unique and profitable capital allocation skillset.

We invest in listed companies that repeatedly generate high free cashflows, have a proven skillset in capital allocation, and have a track record of creating strong shareholder value. Our two portfolios are represented by acquisition-driven compounders, businesses that have the acquisition of small private companies at the heart of their strategy. These companies are excellent at sourcing and closing acquisitions in the private markets at highly attractive multiples.

Companies that can reinvest a lot of cash flow (typically 70-80% of cash flow) at a high return on capital (typically 15-20%) for an extended period (preferably decades) will generate a lot of value for us as shareholders.

Not surprisingly, given our strategy, we see a common way of deploying cash flow among our companies. Below, we study the sources and uses of cash flow for the portfolio over the last 15 years, weighted by the position sizes in the fund. The blue bars show the sources of cash, and the green bars show how that cash has been deployed historically. The starting point is the aggregated cash from operations after taxes and interest payments for all our companies combined.



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Working capital
We invest in asset-light companies with limited working capital needs. Only 2% of the cash generated from operations is tied up in net working capital. Some portfolio companies enjoy a net negative working capital position, meaning customers fund the underlying business operations. We often see this phenomenon in software companies where customer payments are usually made in the year's first quarter.

Capex
We recently met the CFO of Swedish-based Indutrade, who told us that they "*do not manufacture products that are bigger than a horse*," meaning large and highly complex products which require high capital expenditures. Many of the businesses we own are assembly businesses or value-add distributors. These companies do not need heavy asset investments to grow. Despite limited capex, the companies can still generate good organic growth.

Bolt-on acquisitions (net M&A)
The companies we invest in spend most of their cash flow to acquire small, private, and profitable companies at attractive multiples. We typically observe transaction multiples in the range of 5-8x EBITA, in other words, a mid-teen return on capital, in addition to minor incremental improvements in EBITA and cash generation after transactions. We look at this as a highly attractive way to deploy capital when the proper decentralized organizational structure is in place.

Share issues
As the illustration shows, our companies fund these small private transactions through cash generation, not by issuing shares. Some private sellers choose a part of their settlement in shares of the acquiring firm. The increase in the number of shares outstanding for our companies has been only 6% over 15 years.

Dividends
Despite attractive reinvestment opportunities at high returns on capital, the companies we invest in tend to pay dividends. Given the attractive return on capital, we would instead want companies to reinvest the cash flow than pay dividends, but we also understand the "*disciplinary factor*" behind a dividend policy. Many companies in the fund are controlled by a family that often wants dividend payments.

Change in net debt
Over 15 years, the change in net debt for the companies in the fund has increased 23% to a level of 1.0x net debt to EBITDA today. The conservative capital structure is often due to family ownership in the businesses. These businesses have experienced what it means to go through tough times and hence keep leverage low.

Summary
We try to find management teams with a strong capital allocation mindset. Their toolkit is to deploy large amounts of free cash flow at a high return on capital for many years. They decentralize their operations to unleash entrepreneurial energy and own a significant part of the underlying companies.

We invest behind what we think are the best decision-makers regarding capital allocation. Finding outstanding capital allocators is of utmost importance when investing for the long run.