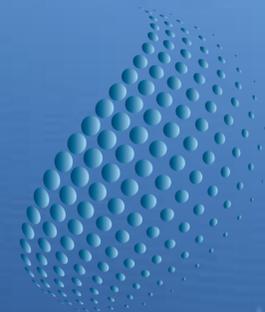


The Value of Great Capital Allocation



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Investing in a company requires trust in its management's ability to create value. Therefore, it is crucial to identify and invest in management teams that excel in capital allocation, effectively utilizing the company's resources to maximize returns on investment.

The significance of CEOs with strong capabilities in human and cultural aspects, combined with adept capital allocation skills, cannot be overstated. While many CEOs may ascend the corporate ladder based on their excellence in production, sales, or political acumen, the role of capital allocation becomes a critical responsibility when leading a company. It's essential to recognize that two companies, even if they have similar earnings but different approaches to capital allocation, can yield vastly different long-term results for shareholders.

Consider this scenario: imagine we have two companies, Company A and Company B, both generating hundred dollars of earnings. These earnings are converted fully into cash flow. Let's assume that the management team at Company A can reinvest their capital at a rate of 10%, which coincidentally matches their cost of capital. Moreover, they can reinvest 100% of their earnings every year over a 20-year period. In this case, a reasonable Price-to-Earnings (P/E) ratio to consider would be 10.

	Company A	Company B
Earnings	100	100
Invested capital	1 000	714
Return on capital (ROIIC)*	10 %	14 %
Reinvestment rate	100 %	100 %
Reinvestment period	20	20
Cost of capital (WACC)	10 %	10 %
Value of company**	1 000	1 971
Fair P/E ratio	10	20

*Return on incremental capital invested

**Growth = ROIC x Reinvestment rate

Future value = Earnings x $((1+Growth)^{Years}-1)$ | Company A: $100 \times ((1+0.1)^{20}-1) = 611.6$

Terminal value = Future value / WACC | Company A: $611.6 / 0.1 = 6116$

Value of company = $(FV+Terminal) / (1+WACC)^{Years}$ | Company A: $(611.6+6116) / (1+0.1)^{20} = 1 000$

Fair P/E ratio = Value of business / Earnings | Company A: $1000 / 100 = 10$



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However, now put yourself in the shoes of an investor tasked with evaluating the management team at Company B. This team not only excels in day-to-day operations but also possesses good investment skills. They manage to reinvest 100% of their capital at returns of 14% over a span of 20 years. Given these circumstances, you could justify paying a price-to-earnings (P/E) ratio of 20 and still achieve a return comparable to the market over the entire holding period. Thanks to their shrewd capital allocation abilities, Company B's value surges by 100% compared to company A, all attributable to the astute investment acumen of its management team.

Now, let's shift our focus and analyze two other companies, still generating 100 dollars of earnings, that achieve identical incremental returns on their capital investments. However, they diverge significantly in terms of their reinvestment opportunities.

Company A can generate an impressive incremental return of 20% on invested capital. However, it operates within a niche market, selling a single product with restricted distribution potential. Another scenario is that it could be a company that already commands a substantial market share in a market characterized by slow growth. Consequently, it can only reinvest 35% of its capital at this attractive 20% rate. The remaining 65% is distributed to its shareholders, who must diligently seek comparable returns in the broader public markets. Because there is a “leak” of 65%, a fair P/E ratio to pay for Company A is 15.*

In contrast, Company B operates across diverse end-markets globally and consistently acquires small private companies of which there are many. The company has a long runway of growth opportunities. This strategy enables them to reinvest a substantial 75% of their cash flow each year at the same incremental return of 20% as Company A. Company B not only maintains an extensive list of potential acquisition targets but also benefits from the illiquidity of private markets, the relatively small size of transactions, and limited competition for these targets. This favorable landscape allows them to secure acquisitions at highly advantageous multiples. If Company B can sustain this compounding rate for 20 years, you might find it justifiable to pay a multiple of 30 times earnings and still achieve a market return throughout the entire holding period.

Despite both companies achieving a similar incremental return on capital of 20%, Company B experiences minimal leakage compared to Company A. Consequently, the reinvestment trajectory for Company B, in comparison to Company A, is worth double as much. To put it differently, public shareholders of Company B can effectively leverage the exceptional capital allocation expertise in the private market. As long as they remain invested, they can enjoy compounded returns** that are typically elusive for most fund managers when investing in publicly traded equities over extended multi-decade periods.

*Computed through a 20-year discounted cash flow (DCF) analysis, where the terminal value is determined using the Gordon growth model without assuming constant growth. Subsequently, the Price-to-Earnings (P/E) ratio is derived by dividing the DCF value by the earnings of \$100.

**Assuming the market values the company based on a theoretical DCF framework.