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ValueLine: Directors behaving badly

By Roger Montgomery

PORTFOLIO POINT: They might be able to run a business, but many managers are incompetent at allocating capital.

Warren Buffett is famous for his ability to select good investments, but the way he runs his business interests is rarely discussed. It's a shame really because there is much that could be learned from his approach.

When Buffett makes an acquisition for Berkshire Hathaway, he asks the vendor or their family to continue to run the business and retain a small stake. Most people are aware of that. What many don't appreciate is why he asks that all the cash be sent to him for the purposes of allocation.

Running a business and allocating capital are two very different things and it is common to find managers adept at one but incompetent at the other.

The most obvious example of this is the frequency with which Australian company directors happily report their dividend payment policy but rarely explain why or how they have reached the decision.

You may hear something along the lines of, "We will maintain our stated policy of paying 50% of earnings out to shareholders as a dividend", but not a single word as to why this is the appropriate course for the company or the shareholders.

My previous column about dividends (click here) discussed the importance of retaining profits when returns on equity where high; and returning them in the form of dividends and buybacks when returns on equity were low, declining or had plateaued.

Overlay on this non-disclosure of dividend policy the habit of raising money from shareholders in the same year that dividends are paid and – the most galling event – the emergence of the unfranked dividend, and you have billions and billions of dollars being destroyed constantly.

There are exceptions to the rule and good managers who generate modest returns on equity will elect to increase their payout ratios. This was evident when Mark McInnes joined David Jones in 2003 after the retailer had posted a prolonged period of single-digit returns on equity. Of course he promptly set about increasing returns significantly.

But executives able to manage both the business and capital allocation decisions are rare. Channel Ten is a company with a mixed track record on return on equity. Between 2000 and 2002, and again in 2006, Ten paid dividends that exceeded profits by running up increasing amounts of debt.

In 2009 dividends also exceeded profits but strong cash flows enabled management to seize an opportunity and conduct a cash-boosting equity capital raising that reversed the legacy of previous debt binges. Not surprisingly, the ultimate outcome of all this capital allocating activity is diluted shareholder wealth.

There's no course, seminar or workshop in Australia for managers to

The ValueLine portfolio, as at March 30, 2010

Company	Buy price	Price today	Est value**	Margin of safety	Shares bought	Invested	Capital value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	20.3	19.65	-3.3%	845	$12,500	$17,145	0.62	$5,169	41.35%
Cochlear	56.36	72.84	56.3	-29.4%	102	$5,744	$7,424	1.9	$1,873	32.61%
CSL	31.81	36.43	32.87	-10.8%	163	$5,197	$5,952	0.75	$877	16.88%
Woolworths	26.16	28	26.85	-4.3%	206	$5,377	$5,756	1.09	$602	11.20%
Reece	17.8	25.75	17.78	-44.8%	236	$4,209	$6,089	0.53	$2,005	47.64%
Platinum Asset Mgt	4.06	5.2	4.45	-16.9%	854	$3,467	$4,440	0.2	$1,144	33.00%
CommBank	46.51	56.29	47.37	-18.8%	215	$10,000	$12,102	2.35	$2,608	26.08%
Since July 1, 2009										
Security Value										$58,909
Cash Value										$57,268
Total Value										$116,177
Total Return ($)										$16,176.62
Return Invested (%)										34.61%
Total Return (%)										16.18%
XAO Change										23.90%
Negative Watch										
Company	**July 1 price**	**Price today**	**Est value**	**Margin of safety***				**Divs rec**		**Total return**
ISOFT	0.635	0.565	0.19	-197.4%						11.02%
Amcor	4.79	6.39	3.63	-76.0%						-33.40%
*** Outperformance of invested portion**										**10.71%**
*** Outperformance of total portfolio**										**-7.72%**

***Last Intrinsic Value update 3/3/2010* attend specifically about capital allocation and, unfortunately, it is particularly evident in the business of takeovers.

You may have heard my views about corporate Australia being full of toads that no amount of kissing will turn into princes. But poor decisions are also made on the other side of the bargaining table, where boards fail to negotiate the best possible prices for their businesses more often than you could imagine.

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Take Forge Group, a company that I really like and am assessing for inclusion in the ValueLine portfolio.

Here is a business that ticks many of my criteria. It has virtually no debt, profits have grown from $2.7 million in 2007 to an anticipated $40 million in 2010, generates high rates of return, has great cash flow and, perhaps most importantly, its intrinsic value has risen at an impressive rate from just 50¢ in 2007 to over $3 today.

Further, based on my estimates for the demand of our resources and the services of the companies servicing the sector, Forge's value could rise to over $4.60 and close to $5 in the next couple of years. My 2012 valuation and the current one are both substantially above the current price of $2.93.

So if management knew something about allocating capital, why would they recommend the placement of 15% of the company to Clough at $1.90 – a full dollar less than the current price and much less than the company's 2012 intrinsic value?

And with the share price at $2.93, how can they in good conscience continue with an agreement to recommend to shareholders the sale of 50% of the company to Clough at $2.10, even if there is a genuine strategic alliance?

Dilutionary issues and placements of shares at prices below their intrinsic value, destroy wealth and suggest that management would have difficulty passing any course set on capital allocation (for more on this, see *GFC-hardened blue chips*, page 4).

Now it may be that Forge reached some agreement with Clough in the past when the share price was indeed lower, but to recommend it today indicates directors' lack confidence in themselves. Indeed, Clough might also like to consider whether trading away Forge's shareholders' intrinsic value for a strategic benefit is the best way to begin a partnership.

Unfortunately, this is not an isolated example and Australian corporate history is littered with the written-down shells of acquisitions and the fleeced bank accounts associated with poor investment decisions.

Capital allocation is about investing, about assessing alternate proposals: to pay dividends or to reinvest in one's self; to put the money in the bank; make an acquisition; or even to buy back shares and acquire oneself. But capital allocation is a field of expertise that business operation experience does not automatically qualify you for.

As an investor it is important to assess not only management operational expertise but their investing capability as well. The very best businesses can be undone by the poor investment decisions of those charged to be stewards of shareholders' ownership stakes in the business. ◆

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