HollAnd Advisors

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Engine overhaul

Imagine a friend of yours had a car for sale over Christmas. Normally it might be worth £20,000, but it has had to go in to a garage for a major engine overhaul. Your friend however is desperate for the cash and offers it to you for £10,000. You are interested so ask to have a look. You go to the garage. You find bits of the car all over the place and the body work covered in winter salt. The engineers have not touched it for two weeks during their Christmas break it turns out – you decline your friends offer and wish him luck.

You find out later that his father lent him enough money to get by and pay the garage bills. In April you see your friend again. It is a nice sunny day and his picks you up to drive to a pub, 20 miles away. The car is looking spotless and driving beautifully on both the tight country roads and at speed on the motorway. You mention that the car is looking good and ask if he is still wants to sell it. 'Yes' he replies, in fact this is my last trip in it as a dealer is coming to pick it up in the morning – they paid me £19,000 for it.

Investment Phases

We use the car analogy as when it is in pieces maybe only the owner and the mechanic have some confidence of what it will perform like once it is put back together. The same we think can be said for some companies during periods of great change especially when they are run by owner managers – (i.e. those who are long standing and have a sizable stake in the company).

We have noticed now for many years the share buying opportunity that can arise from an investment phase a quoted business may sometimes need to go through. This can be to develop new products, new routes to market or just the need to update systems such as an SAP installation. The reason an investment opportunity often arises is that two unexpected factors often push down the share price.

1. Firstly, most such phases have uncertainty attached to them as to the time it may take to complete or the exact outcome that will be achieved
2. The second is that invariably things take a little longer than expected and cost a little more than originally planned, i.e. there are stumbles along the way

During these periods some investors will dismiss the outlook as too uncertain and others will try so hard to guess the ranges of possible future outcomes that they may miss the simple mispriced opportunity in front of them.

Simply put when the car is the garage we do not have to know exactly how much it might be worth when fixed to say its value will be £17k, £18k or £19k. We just need to know that its future operating performance ('earnings power' if you like) will result in it being worth a good amount above the price offered (i.e. £10k).

Owner-Manager Investment Phases

There are further observations we would make about the specific investment phases that can be experienced by companies with owner managers:

- These phases can last longer than an average company – lasting in some cases many years
- They can be deeper. In that we mean they may cost more in terms of lasting elevated OPEX (and the resulting often ongoing profit reduction) and CAPEX. The consequence being that with less operating cashflow being produced and significant capital being spent debt levels can rise in ways unusual for such a company
- Often little clear guidance is given by management to shareholders as to either the duration or depth of this investment phase. In addition any recovery targets given may indeed by missed as the new opportunity is explored by the manager further/was uncertain in the first place

At the outset the owner manager may be unusually open about how uncertain the outlook is and this unsettles many investors (Lord Wolfson last summer). Some years later when they maybe share their confidence in the coming recovery many investors are too weary to listen or believe them.

Assuming these observations are correct, i.e. that the investment phase of an owner managed company can be more severe than that for an average company – why might is this be the case?

- We suggest 'career risk' and the timescale involved are the main reasons – Owner managers do not have to worry in most cases about being fired, or even being agreed with
- As long-term owners of the business they are trying to make the necessary sacrifices today, if they believe them to be justified, to ensure a better and stronger lasting company is the end result
- This is maybe different from the actions of an ordinary five-year tenure CEO, for whom career risk is very real if he cannot keep the support of the shareholders he is answerable to. These shareholders rely on their appointed CEO to provide the future profit recovery forecast on which their investment bet is predicated. A leader who misses such targets might not be around to see the final recovery. Thus they can be inclined to deliver a quick fix if the alternative is a P45. (We accept that some may feel this point is actually just better accountability that shareholder appointed leaders have and there is some truth in this, but we still believe their timescales can be forced to fit career risk rather than the business cycle).
- We suggest that managers who are significant shareholders in the businesses they are running will be braver making the hard decisions to keep deferring shorter term profits if they think the resulting market position and ultimate earnings power are worth the sacrifice

What do you want your builder to say

Let's move the analogy on from a car to a house: There are cracks running down the back of your house inside and out. They have been there for a while but lately seem to have widened a little. You get two builders round. You tell both of them the same thing. "I am sure it is nothing but the walls are beginning to look ugly so I want them patched up. I hope it isn't anything serious as I really have not got the money to cope with a big expense right now".

- Builder A quotes £2,000 and says it is really nothing to worry about. He can fill and repaint all the affected rooms. He is friendly and mentions that other builders often exaggerate jobs when most things can be fixed quite cheaply. He can sort it for you next week.
- Builder B says – "I am sorry to tell you this but this house needs underpinning and it will likely cost at least £20,000". He said he was busy with other work and his tone was a little abrupt and you did not take to him.

You appoint Builder A and in two weeks your house looks like new. Six months later you are reading a local newspaper article about a couple whose back wall collapsed and they had just finished suing their builder who as a result had lost his licence and had gone bankrupt. You realised you recognised the deceptively friendly face shown in the paper. Your heart and stomach sink as you check your wall to see cracks reappearing.

Doing it right, for the long term, whatever the cost

Having watched many companies and managers now over the course of our long careers we, and you, our clients have witnessed almost all forms of manager. These range from visionary founders driving growth and constant innovation to outright frauds, and almost everything in between. Many good owner manager companies have the high returns on capital and the cash generative traits we seek. When something goes wrong (or right) and they feel the need to invest heavily, both of these traits can disappear and this comes as a shock to other investors who until now then had enjoyed their growing profits. Without a manager 'hand holding' investors throughout such investment periods it soon feels to them like a permanent change/deterioration has taken place. As more and more past supporters of the company give up waiting, the shares fall further.

Follow the money

During such periods we have also noticed a couple of other traits. Sometimes founders fall out of favour with previously supportive shareholders and sometimes with the market entirely. Often if they believe Mr Market's depressed share price fails to discount the long-term value of the business they will increase their stake either with their own or company money (i.e. buy-backs). As they are insiders who often already have c.90% of their wealth in this one enterprise, these are powerful messages. But this very action (i.e. taking advantage of the opportunity presented to them by the shareholders who they feel do not understand what they are trying to do) causes a conflict. Why try to spell out the future once again to an audience that does not want to listen, when the same audience will sell you their shares at a discounted price?

Earlier on we observed that investment phases for owner managed companies seemed to go on for longer, become deeper and seemingly offer less guidance to other shareholders. The conflicted position these opportunistic business owners find themselves in perhaps has an influence on these factors particularly after they have become exasperated with the investment market.

Not new

Whilst we hope readers will have relevant examples of their own we believe we have seen many of the traits outlined above in our experiences with companies such as **JD Wetherspoon**, **Sky**, **RyanAir**, **Microsoft**, **Liberty Global**, **Apple** and **WWE** to mention just a few.

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