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Don’t Be Wall Street’s Chump

Investing in stocks of public companies can generate returns which exceed those of fixed income alternatives and the rate of inflation, but one must tread carefully. As we look at the thousands of public companies available to us, we divide them into three categories. First are newly minted public companies (IPOs) that have in many cases already had the "upside" squeezed dry by the private equity groups that sponsor them. The second are the myriad "long in the tooth" outfits with too much debt and/or poor growth prospects and management. Finally, are established companies with a history of producing strong cash flow, whose management can be trusted to redeploy that cash in some combination of dividends, share repurchases and sensible acquisitions. These companies are not dependent on the public capital markets to execute their business plans—and those are the ones we seek for our Global Core portfolio.

Textbook IPOs

Allow some expanded discussion of Initial Public Offerings (IPOs) since these are the current rage on Wall Street. It used to be that entrepreneurs offered shares in their company to the public because they had an exciting investment idea but lacked enough money to carry it out. They sought funds from outside investors who then expected a handsome risk-adjusted return. An investment banker was then hired to evaluate the merits of the business plan, value the shares and sell them to the public. The entrepreneurs typically did not sell any of their own stock initially. Rather, all money raised went straight to the company bank account to fund the money-making idea—not into a selling shareholder’s pocket. After all, it was argued, who wants to buy when the owner is selling?

With the days of financial reason long gone in so many ways, investors in IPOs nowadays should first determine the role their money is going to have in the enterprise before investing. All too often, the prospectus states that the “use of proceeds” is to pay down debt. Although reasonable sounding at first, it can also be a red flag that cash proceeds have essentially been used to line someone else’s pocket.

Beware Selling Shareholders

Some elaboration is in order. More than half of the initial public offerings planned for this year are from private equity firms desperate to pay down debt[1]—debt incurred to reward previous “selling” shareholders. To our way of thinking, using IPO proceeds to pay down debt in this way violates the traditional corporate finance rule which frowned upon entrepreneurial shareholders selling any shares in an IPO. The rule has essentially been trampled upon by Wall Street as they combine a “little time with a lot of debt” in a successful effort to benefit from “corporate churn” at the highest levels. An egregious example occurred recently when **Kinder Morgan**—a company that morphed from public to private in 2006—and went public again this year—raised $2.8 billion for selling shareholders and investment bankers (including over $1 billion for Goldman Sachs) but not a penny for the company.

1. “Buyout Firms Offering LBOs to Flood U.S. IPO Market.” Bloomberg, January 3, 2011.

CONTINUED ON REVERSE >

The IPO cycle being "geared up" in 2011 is a continuation of the patterns developed in the last two decades that allow too many companies to take advantage of public investors. As a result, the public markets today are littered with scores of these companies with some combination of too much debt, limited ability to invest in growth opportunities without taking on even more debt, and a management team that has already "cashed in" and is drawing a nice paycheck courtesy of shareholders.

Follow the Cash

Now let's circle back to why Hamilton Point prefers investing in companies in the third group, that do not need to be public—which is to say that we want to invest in companies that *produce* cash, not absorb it. The answer lies in the familiar "cash-on-cash" return valuation criteria we use when evaluating Global Core Blue Chip stocks. Specifically, we calculate the excess cash a company produces each year after it has made appropriate investments in its infrastructure.

As examples, we own a handful of familiar consumer staples companies that our current calculations show are generating "cash-on-cash" returns ranging from 6-9%[2]. Likewise, in the case of some slower growing defense companies, the figure exceeds 10%. Since these companies have either gobs of cash or little debt, we consider these returns largely "unlevered;" and, because we expect steady growth, we believe these "cash-on-cash" returns underestimate our investment objectives going forward. Although future performance can never be guaranteed, you could say these metrics comprise our minimum equity return expectations, even if the economy stalls.

The benefit to owning cash producing companies is that they tend to give value back to shareholders in the form of increasing dividends and share repurchases. It is not uncommon for some of our holdings to deploy essentially all excess cash in this way, giving us funds to reinvest and ownership in a company with fewer and fewer shares—something that can increasingly reward the long-term investor. Other companies (especially in technology) use excess cash to make acquisitions to engender more growth, while others "stockpile" cash on their balance sheets. In any event, should there be another market correction, the fact that these companies pay solid dividends and/or have the flexibility to repurchase shares may either provide share support or result in fortuitous acquisitions.

A Healthy Skepticism

In conclusion, it is not just what we buy for our clients, but what we do NOT buy for them that is an integral part of the long-term returns we seek to achieve. We think it is wise to remain skeptical of Wall Street "innovations" of recent decades that have failed to improve on the options available to prudent investors, and we include the IPOs of companies not seeking growth capital in that list.

Instead we identify 35-40 companies whose management can be trusted to generate satisfactory cash returns without deploying excessive financial engineering. Our objective in so doing is for our clients to own unlevered, cash-producing companies that may receive a premium takeover bid from an LBO firm, rather than fall victim to their IPO exit strategy a few years later.

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Hamilton Point Investment Advisors is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

2. Intended to illustrate our methodology for selecting stocks—not guarantee a return for a portfolio. Based on current calculation of certain referenced holdings; actual return will vary for each stock based on market conditions and actual results.