HAMILTON POINT
Investment Advisors, LLC
CHAPEL HILL, NC

ANDREW C. BURNS
President/Chief Investment Officer

RICHARD S. WOODS, CFA
Chief Operating Officer

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Roy and Mike do Business

Investing is about generating a surplus cash return when tying up money for a period of time. The concept of lending money is readily understood; however, investing in a company's stock can be confusing, even though it is not terribly different from making a loan. In an effort to clarify Hamilton Point's logic when buying stocks, we will draw an analogy between investing in a stock and buying a rental property—concluding with adjustments needed when finding gobs of cash on a company balance sheet (think ***Apple****).*

Town and Gown

Living in a lively college town, we relate well to the fact that investors have prospered from investment properties in Chapel Hill. Using a simple example of a student rental home, we will build the case of how investors think about "cash-on-cash" returns[1] and any future change in the value of that investment. We assume a home near Franklin Street (i.e. near campus) is purchased by an investor named Roy and 99 other partners for $100,000 and is rented for $12,000 per year. Assume further that annual expenses total only $2,000. We quickly see that Roy's investors will make a tidy annual return before taxes of 10% ($12,000 in rent, minus $2,000 in expenses, divided by the $100,000 investment).

Many enterprises—like Roy's house and those companies Hamilton Point is interested in—are profitable and produce a fairly predictable amount of new cash each year. In Roy's case, the home produces $10,000 annually and he must decide whether to pay it out to all shareholders via dividends or perhaps buy out the interest of his partners. He can also invest that cash in new properties or upgrade the current house in order to command higher rents. Let's assume that even after making some of these decisions, he still has excess cash of $5,000 that he will hold for investors to strategically deploy at a later date.

Managing Expectations

Suppose the University announces a new graduate program that will enroll 10,000 more students. All other things being equal, future rents for student housing will subsequently increase in Chapel Hill. An investor from a nearby town hears the news—let's call him Mike—and speculates that houses that currently rent for $12,000 per year may command $15,000 in a few years. Mike, looking to get the same 10% long-term return that Roy looks for, buys Roy's property on December 31st for $130,000. In that year alone then, Roy's and his investors' total return would be 40% to include the 10% in new cash produced by profitable operations and the 30% appreciation when Mike buys the property.

Just as Mike speculated that rents would grow in Chapel Hill, a research analyst on Wall Street may decide to change her estimated future earnings (rent) expectations for a public company, causing investors to rethink that company's stock (house) value. The point is that stock prices—like rental house values—can move wildly if the predictions for future cash streams change. A recent case in point is **Apple Inc**. Akin to as if UNC Chapel Hill announced the *closing* of a graduate school, Wall Street research analysts recently lowered their estimates for Apple's future growth, causing the stock to fall by over 40% from its high. We decided to buy Apple for clients in our

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1) Cash-on-cash return as used herein is a projection of the cash generated by an investment over the next twelve months relative to the amount of cash a new investor would be required to pay when acquiring that investment (or portfolio of investments).

Global Core strategy at the lower price range because we believe the company's operations—though growing more slowly—should continue producing adequate amounts of new cash each year, which could translate into a healthy return on the current price paid for Apple shares[2]. Just as Roy's free cash flow return on the rental home was 10% annually, we calculate that Apple could produce comparable excess cash flow relative to the recent enterprise value paid for the shares[3].

Interestingly, and just like Roy's $5,000 savings for the future (and assuming he had been doing it for years), Apple has some $137 billion in cash and investments on its most recent balance sheet—so much that some activist shareholders are all in a twitter—the pre-2006 version. Before we comment on Apple, let's first look at the cash phenomenon from Roy's rental property. Before selling to Mike, some of Roy's shareholders may have asked reasonable questions such as, "Pardon me Roy, but if you are not going to use that $5,000 in extra cash to buy other rental properties or add another floor to the current building, why not return more cash to shareholders?" If Roy did not have a good answer he may well have instituted a dividend—and that is just what Apple did starting last year.

Follow the Cash

In 2013, we expect Apple to generate in excess of $35 billion of cash from operations[3]. Planned uses for the cash include dividends expected to total about $10 billion in 2013, which should be complemented by a $10 billion, three-year stock repurchase program[4]. These announced programs could return $15 billion of cash per year on average to shareholders over the next three years, while still adding substantially to existing cash reserves, if our cash flow projections prove accurate. This is why some hedge fund managers argue that Apple should pay out heftier dividends or change their capital structure to effectively do the same. It is true that much of the cash is located outside the U.S. and would be subject to some taxation if repatriated, but that is a subject for another Newsletter.

Turning back to Ol' Roy's real estate business—while we have oversimplified the real estate analogy, it does illustrate why cash-on cash returns are a core component of our investment philosophy and corresponding research efforts. There are other ways to invest. Just as many will speculate by purchasing real estate that is not producing much cash in the hopes that some outside factor will cause the property to appreciate anyway, so too do many speculate by buying stocks that do not produce enough cash to justify their value or that rely on debt to generate cash flow, a practice which can quickly reverse when markets turn, as we all were reminded in 2008. While we cannot guarantee performance and can misjudge an individual company, we believe that "real," largely unleveraged cash flow generated by an investment should reward patient investors by producing favorable long-term returns. It is that collective cash flow from a portfolio of companies owned in client accounts which helps us sleep at night, even when markets are volatile over shorter periods.

Royal Flush

What's more, not only do we believe the companies we invest in are well-managed and produce excess cash at rates we find satisfactory relative to the price paid for the shares, but we think that this crazy economic world we live in may go through another period like 2008 where cash is not only King, but also Ace, Queen, Jack, and Ten. Altogether, 14 of the companies on our Global Core and Equity Income Buy Lists have net cash on their most recent balance sheets totaling nearly $290 billion—an amount we are pleased companies owned in our investment strategies have available for potential future payments to shareholders or strategic initiatives.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA
RWoods@HamiltonPoint.com

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) For a full list of recommendations made by Hamilton Point during the last year, please contact us using the information below.
3) Based on Hamilton Point calculation of cash-on-cash return as described previously using analyst estimates and our own research.
4) "Apple Announces Plan to Initiate Dividend and Share Repurchase Program." Apple Inc. Press Release. March 19, 2012.