Why every Non Exec should think like Warren Buffett
A value investing framework for protecting Shareholder Capital

From the outside, Non Executive Directors have it easy, rolling up to the odd Board meeting and collecting a handsome pay cheque – it used to be described as a gravy train. As investment managers, we see it very differently. Non Execs have a very challenging and vital role, covering a broad range of responsibilities but based on a limited (by time) knowledge of the day-to-day workings of the businesses they help to govern. One part of the range of responsibilities which we see little written about or discussed is capital allocation.

As a role model for applying the responsibilities of a Non Executive, we look to the most successful builder of shareholder capital, Warren Buffett. Buffett has taken a number of high profile Board positions on many of the great companies in which his business, Berkshire Hathaway, has been a long-term investor. From a shareholder's perspective, we cannot think of a better representative to have on the Board. He has frequently articulated his strong views on Non Executive responsibilities with respect to executive salary, integrity of governance and allocation of shareholder capital. He is also comfortable taking a strong position, in opposition to the Executive Management, particularly when he sees the risk of mis-allocated shareholder funds towards an overpriced acquisition. A high profile example was when he stepped in to influence the Board of Coke to vote against the acquisition of Quaker Oats in 2003. A great learning experience for any Non Executive Director would be to attend Warren Buffett's shareholder meeting in Omaha to gain an insight into the philosophy and principles of a great capital allocator.

Ultimately, the role of an NED is of course that of protecting shareholders interests. To achieve this, the Non Exec team will focus on a broad array of corporate governance issues, not least of which is the selection, appointment and incentive packages of the CEO and CFO. They have to work on ensuring that the executive team is beyond reproach from issues such as fraud and conflict of interest. The function which requires a degree of capital allocation skill is ensuring that the free cash, generated by the business, is either distributed or re-invested sensibly and in the best long-term interests of the shareholders. Whereas the other functions operate within reasonably tight parameters and are well documented in terms of precedent, the potential approach to capital allocation is as broad as the range of investment management styles there are in the market.

There are numerous studies to show that the majority of public companies acquisitions have a negative impact on long-term shareholders returns for the acquiring companies. Famous

examples include the dismantling of Marconi in the late 90s, Lloyds Bank's acquisition of HBOS and it is very likely that history will not be kind on HP's acquisition of Autonomy – certainly the market rewarded HP with an immediate $10bn reduction in market capitalisation, which is almost exactly the size of the deal.

We see this lack of discipline within corporate acquisitions time and time again. It is clear that Non Executives often do not have the power or desire to stand in the way of value destroying "strategic initiatives". In part, this is caused by a natural deference on the part of Non Execs on this issue. Corporate Acquisitions are after all about implementing corporate strategy – surely this is the domain of the Executive team. We disagree with this, any allocation of the profit stream or excess cash on the balance sheet of a company is an issue for the Non Executive team. The default position for the Non Executives should be to return this cash to shareholders and to 'test' hard any proposals for re-investments outside the normal capex requirements of the business model.

At Metropolis Capital, we cannot reliably value a business if we are uncertain about the capital allocation discipline of the management team. After all, applying a discounted cashflow model to a future set of cashflows breaks down if the cashflow is going to be misallocated into value destroying investment decisions. As such we have developed a checklist to test this as part of our due diligence into any company in which we are interested in investing. An overview of this is provided below. Our hope is that this could form a useful framework for NEDs when they are assessing new acquisitions opportunities put forward to the Board by the Executive team.

The most important starting point is price discipline. The most common issue we see with acquisitions is simply paying too much. When a company deploys shareholders capital to buy another business, it should do so at a price which is very unlikely to fail to provide shareholders with a good return. We love it when we hear managers, who state that they will never pay more than an articulated and low multiple on earnings and stick to it religiously. We prefer management teams who are conservative in their assessments of targets: some cost savings have a high degree of certainty but many revenue synergies do not. A classic trap is to model "cross selling" opportunities – we rarely see these delivered. Management teams are often incentivised to grow the company and quickly lose price discipline when the adrenaline of the hunt kicks in, especially if a rival company may also be interested in a particular target. In these situations, the acquirer invariably suffers from the "winners curse" of over-paying. Barclays and RBS both wanted desperately to buy ABN Amro. Barclays now look smart for not having done the deal, RBS somewhat less so. We urge Non Execs to recognise this and use their position to persuade the Board to impose this discipline as a counter balance to the exuberance of the executive team.

The second question, we ask is whether the executive team has the competence and experience to pull off a successful acquisition. We find that some businesses successfully build a core competence in acquisitions; they have developed a clear template, road maps for integration and attainment of synergies. We run a mile when we hear management talking about a search for the "transformational acquisition" – too often these are just large gambles with shareholders money. If they get it right, they walk away with accolades and significant personal wealth, if they get it wrong, they get paid to leave. A study by Bain & Company suggested that companies who start small and build this competence through undertaking a series of small bets tend to perform better.

An extension of competence is whether the acquisition is "on strategy". We much prefer businesses which stick to their niche and grow within this. Often, businesses which hit a ceiling in growth potential within a market, look to diversify. This is a crucial point in the strategy of the company. The board should test hard whether the risks of such a move to diversify the business are likely to generate a sufficient return to compensate for that risk or whether alternatively, the business should simply return more cash to shareholders and allow them to invest their money in any sector or company they like the look of. Ancillary to this is for the Non Executive to consider whether the incentive structures are in place for the Executive team to be indifferent between returning cash to shareholders and a marginal or even poor acquisition decision.

Of the research on the impact of acquisitions, which generally shows that the impact of acquisitions is long-term negative for the shareholders of the acquirer whilst positive for the acquiree, Mahendra Raj and Michael Forsyth[1] conducted a particularly interesting study which attempted to compare acquisitions based on the underlying motivations behind each deal. They concluded that mergers which resulted in greater market share, market power and a larger customer base were generally positive over the longer term. However their study also provided strong support that higher priced acquisitions (measured by bid premium) were damaging to shareholder wealth. Raj and Forsyth concluded: "The losses found in the long-term study-period are due to management's overconfidence in creating value from the takeover, ensuing in an excess premium, thus transferring the value of the deal away from their own shareholders to those of the target."

[1] The Long-Term Performance of UK Mergers & Acquisitions: Separation by Bidder Motivation, by Professor Mahendra Raj and Michael Forsyth

In summary, we would urge NEDs to exercise their influence and guidance to ensure that:

(1) there is absolute discipline in price for each and every acquisition and that this price provides considerable room for error or to use Warren Buffett's terminology, "a margin of safety", rather than relying on bullish synergy calculations to achieve a sufficient return.
(2) the executive team has the skills and experience to execute and integrate; a way to achieve this is to start with small digestible acquisitions, where the risk of failure to the business is low.
(3) the acquisitions are "on strategy" and if not then the alternative strategy of returning cash to shareholders rather the diversification for the pursuit of growth has been thoroughly explored.
(4) the management team is incentivised in such a way that they are indifferent between returning cash to shareholders and a marginal acquisition decision.

…and we strongly advise NEDs to book their tickets now to attend the Berkshire Hathaway Annual General Meeting in Omaha in 2012.

Author: Simon Denison-Smith

Along with Jonathan Mills, Simon Denison-Smith is the Investment Manager for the SF Metropolis Valuefund. The fund has been set up to make long-term investments in a concentrated portfolio (10-20 holdings) of listed securities using a value-based approach, which draws extensively on the methodologies of Benjamin Graham and Warren Buffett.