How Does Management Spend Your Cash Flow?

By Chase Hinderstein, Senior Vice President and Portfolio Manager

As value investors, we focus on the fundamentals of a business. Of course, we look for opportunities in regard to the valuation a stock may hold; we try to buy earnings at a discount. But also, we know that it's important to look for strong businesses with a competitive advantage. We look for businesses that aren't subject to obsolescence but instead remain resilient in various economic conditions, and that will therefore deliver predictable and superior earnings growth, free cash flow, and a return on our investment.

However, there are other attributes of a business we must also consider, one of which is how management uses its spare capital. A company has a few choices to make once they've amassed free cash which is left over after paying for their overhead costs. In a basic sense, a company can pay some of that cash to its shareholders with a dividend; they can buy back some of their shares, which increases the ownership stake for its shareholders; they can invest the cash into the business or make an acquisition, with the hopes that the investment will return ever more cash.

While it's wonderful to find a company that's delivering copious amounts of free cash each year, if a management team demonstrates a pattern of poor decisions on how to deploy that cash, then the investment may not deliver any rewards, even if the core thesis was intact. The worst of these offenders are those that use the company's gains to manipulate their own fortunes or to boost their outside interests, while others are simply practicing poor oversight and a lack of focus on the shareholder/owner.

Management Conflicts of Interest

I've seen a few bad actors in the energy and commodities sector. These were companies whose management team made decisions on how to use capital that were contrary to the interests of their shareholders but served their own purposes.

As the CEO of Chesapeake Energy, the late Aubrey McClendon was eventually exposed for giving himself personal access to the most choice leases which were up for bid, ahead of the interests of the company. He was able to rebuild his own fortune by front running the interests of the company and his shareholders.

In another case, in 2012, Freeport McMoran, a copper and gold mining company, paid a steep premium over the market price for the troubled oil company McMoran Exploration. The companies shared the same executive chairman, James Moffett, who orchestrated the purchase of the oil concern at a 75% premium, despite its current problems and no other interests in the energy sector for Freeport that would make the deal seem logical. Today, the combined entity is worth less than the cost of that purchase alone.

Telsa also acted in similar fashion last year, as they bailed out their struggling sister company, Solar City, by taking them over. While I always found Telsa's approach to technology and its impact on society to be intriguing, many felt that their claims of synergies in this merger fell short. The combined entity may ultimately work towards Elon Musk's grand vision for the future, but paying a premium using Telsa's shares for a failing company surely didn't seem to meet the interests of his minority shareholders.

Management Worried About Their Taxes Not Yours

While these cases seem rather obvious, sometimes a management team's intent may be more nuanced. In 2012, Eaton Corporation completed the purchase of Cooper Industries and succeeded in moving its corporate headquarters from the Cleveland area to Dublin Ireland. While these tax inversion deals to reduce the exposure to corporate income tax weren't rare, and weren't against the interests of the shareholder, in this case Eaton may have also pushed for the deal to suit the interests of some senior management or large shareholders, at the expense of others. At the time, the Bush era tax cuts and treatment of capital gains were due to sunset at the end of the year, and there was no way of knowing what would happen to tax rates in 2013. When Eaton combined with Cooper into a "newco" it was treated as a realized gain for the existing Eaton shareholders. For those with large legacy holdings and huge gains, this may have acted to reset their basis at an advantageous minimal tax rate, while forcing short term gains on other Eaton shareholders who weren't expecting the hit at the time and couldn't mitigate the ordinary income treatment of the gain they were just handed.

Essentially, the concentrated wealth in the hands of the senior management team may have been better served by resetting their cost basis and paying a 15% capital gains rate, but that might not have been the move that suited the common shareholders.

Beware the Affairs With the Investment Bankers

Other management teams may have a somewhat less nefarious intent but still may elevate their own interests above those of the common shareholder. For many years, as CEO of ConocoPhillips, James Mulva leveraged up the balance sheet of the energy behemoth to buy additional assets around the world. He defended the additional debt by trumpeting the long term returns that these acquisitions would bring the company, which he continued to pursue as oil and natural gas reached historic highs. Then, even before the current realities of energy pricing struck the sector, the company's management began unwinding the portfolio, citing the need to pare down debt as the motivation. In the process, they sold some assets with the best long term prospects and broke the company up into pieces.

So, in essence, the company was borrowing in a higher rate environment to cobble together assets for the future, only to spin them back off to cover their debt costs, even though the costs of borrowing had gone to unprecedented lows. What this could be an example of, is the practice of management teams manufacturing short term earnings and growth forecasts through acquisitions, which then lead to greater bonuses and stock rewards. There is no lasting value created for the common shareholder, but it can enrich management and their investment bankers.

Watch the Cash Register and Consider Your Options

There are innumerous examples of management teams acting against the interests of their shareholders, which range from deliberate self-serving fraudulent intent to simple mismanagement of precious capital.

While the Board of Directors may serve as a firewall in many situations, it is important as investor to consider how cash is being deployed. A shareholder should be mindful of acquisitions and consider if the action appears to truly add value. A business' minority owner may have limited options other than selling their shares, but they should be looking to see if the management team not only runs an effective operation, but uses the proceeds in a way that benefit all the shareholders. It is possible for a very effective company to fail at delivering value if ultimate they don't use their cash wisely.

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