Tiburon Capital Management

Shark Bites Volume 4 Article 1 September, 2013

The Seismic Shift towards a New Corporate Social Contract

Implications for Shareholder Friendly Events and Harnessing Social Contract for Returns

A long line of economists starting with Adam Smith have argued that maximizing long-term value provides a criterion for management decision-making that leads to the most efficient use of society's resources.[1] Assuming that corporations, by and large, are rational financial actors, then the relative outperformance of the shares of companies that have exhibited shareholder friendly policies (increased and special dividends, share buybacks) during these recent sideways trading markets a movement has begun, to embrace shareholder return of capital as part of a *newly evolving social contract* with shareholders. We see this movement hastening and intensifying.

Additionally, in what could be a period of protracted market volatility, fraught with exogenous elements beyond any company's control, the ability to deliver share price stability coupled with cash returns in excess of the risk-free rate has been and will likely continue to be differentiating. A growing connectedness of corporate and shareholder objectives can lead to lessened volatility in share prices relative to companies that continue to pursue less transparent working capital policies. *Social Contact* embracing companies – whose shares should outperform – are, in part, those offering the highest total returns through a combination of dividends and accretive buybacks in lieu of better uses of cash.

An aging investor population (in developed economies) that is increasingly looking for income producing securities will drive this shift, as the concomitant secular change in investor objectives reshapes alert management's governance.

Investor activism may hasten a company's adoption of shareholder friendly policies, but is not the force behind this potential seismic shift towards a new corporate Social Contract. *The two intertwined powerful drivers are corporate manager rewards pegged to stock performance and an aging investor.*

Concerns about rising interest rates are reasonable when considering income securities solely. But this is not a discussion about dividend paying stocks per se. *This heightened Social Contract between companies and shareholders provides a lens through which a more carefully chosen universe of securities should outperform the simple selection process of most passive dividend or income-oriented products.* A Social Contract theme, screening for companies with the willingness to return cash as part of policy, as influenced by manager/shareholder interest alignment via compensation policies, and demonstrated through historic return on invested capital decisions, coupled with free cash flow generation metrics, should be a sustainable and differentiating methodology relative to simply seeking dividends in excess of the average S&P 500 payout rate.

Social Contract and its Extension to Businesses

Two centuries before the emergence of the 19th century modern corporate organization, the idea of a social contract took root as the linchpin of relationships between individuals, and between individuals and government. The great philosophers of the 17th and 18th centuries — *Thomas Hobbes*, *John Locke* and *Jean-Jacques Rousseau* — put forward the earliest concepts of the rights and responsibilities of the state to its citizens, and of citizens to each other. This early thinking was the precursor to modern concepts of democracy and the democratic state, wherein ultimate power resides with citizens who willingly delegate certain authority to the state so that individuals may fruitfully participate in a social arrangement that enhances the shared prospects of all participants in a defined community.

Governments grant corporations the license to operate because it is in the public interest to do so. In addition to the wealth created by technological innovation and productivity applied to goods and services, productive activity generates long-term wealth implies as the stock of natural, human and social capital is at least preserved, if not expanded. Put another way, wealth creation sustains and enriches what might be considered the *three societally shared assets* – nature, the community and culture – that are inherited from one generation, used by the present and preserved for the future.

While there surely is an argument that companies have responsibilities to society that go beyond the production of goods and services, we will not debate corporate social responsibility herein – proper manager incentives and corporate governance (coupled with the limitations of government regulation) drive social responsibility (or lack thereof) in corporate behaviors.[2]

The Proper Framework – Shareholder Primacy Norm, Value Maximization – Nuance and Balance

The *Shareholder Primacy Norm* ("SPN") is the part of a manager's fiduciary duty that requires them (and directors) to make decisions on behalf of the corporation that further the interests of shareholders. The similar theory of *Shareholder Value Maximization* ("SVM"), suggests, more narrowly, that the sole interest of shareholders is the pursuit of profit. The common theme results in a prescription for managers to *maximize* shareholder value.

Business ethics academicians have reacted disapprovingly to the notion of shareholder primacy or *maximization* – or the so-called *Shareholder Theory* of Milton Friedman, who asserted that the social responsibility of a business is "to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game."[3] In our view, there need to be and are some rules of the road that can be employed to reinforce *communities of interest* between management and shareholders, and to reduce the inherent *conflicts of interest*. This, as we argue, is not just the right thing to do, but is, in fact, a guide and filter to sift for better-managed companies –*Social Contract* stocks. Investors can track a company's adherence/attention to these items to rate a company for adoption of Social Contract.

The large-scale destruction of shareholder value accompanying the financial crisis of 2008 casts doubt on the extent to which managers, in practice, give shareholders (particularly of financials) primary consideration. Ironically, a collective *distrust* of management – an aftereffect of the financial crisis – also exacerbates an increasing demand to "hand over the cash." To blame misguided managerial objectives misses the point: *proper*

[1] Anant K. Sundaram and Andrew C. Inkpen, "The Corporate Objective Revisited," *Organization Science*, vol. 15, no. 3 (May/June, 2004): 350-363.
[2] Tiburon can construct portfolios and create products with an Environmental, Socially Responsible and Governance ("ESG") mandate. Please contact us to discuss.
[3] Milton Friedman, *The New York Times Magazine*, September 13, 1970.

alignment of managerial interests with shareholders and long term corporate well-being should generate better decisions about the allocation of corporate assets, and this, de facto, elevates probabilities of share buybacks and dividend payments/increases, particularly in a lower return market environment.

The Social Contract Lens

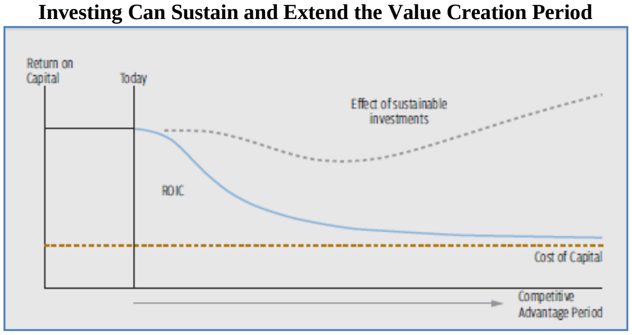
Broadly, here are the filters we utilize to determine and rank a universe of companies for Social Contract status:

1. **Does the company create sustainable margins through reinvestment?**

Throughout recent history, the issue for companies has not been in finding places to put capital to work - but rather in finding opportunities that continue to earn returns in excess of capital cost. Combine this challenge with the fact that excess returns will naturally attract competitors in search of their own golden goose, and the tendency will be for the return on invested capital ("ROIC") of an investment to decline over time. On top of this competitive pressure, many firms seem to allocate a greater proportion of their capital during peak economic periods, when returns are typically minimized. While certainly not impossible, sustainability of excess returns is ultimately difficult for any firm to achieve. Of the S&P 500 firms with the highest returns on invested capital in 1999 (top 125 firms), only 49% had the same elite status in 2004, and only one quarter of the original 125 were still in the top quartile 10 years later, in 2008.[4]

To create sustainable excess returns, firms should continually rethink the investments they pursue and allocate capital in an attempt to maintain a competitive advantage.

Investing Can Sustain and Extend the Value Creation Period



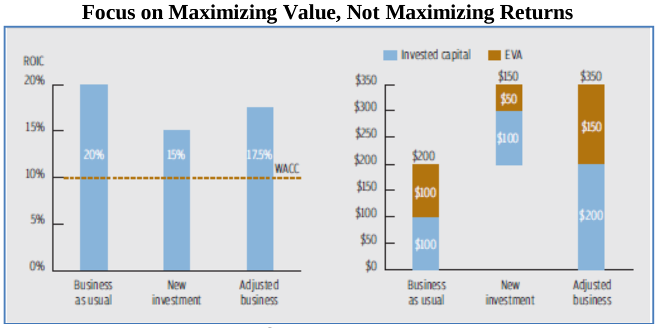
Source: JP Morgan

2. **Is there over-allocation and migration towards riskier projects?**

Firms should not focus on project ROIC as a stand-alone metric, but rather on ROIC in excess of a project's risk-adjusted cost of capital. In many instances, firms evaluate existing, mature cash-flow-generating businesses with the same ROIC hurdle as new, riskier ventures. As a result, they over-allocate capital to riskier ventures, increasing the risk profile of the firm (with cost of capital and capital structure implications).

Strategic decision makers should focus on returns relative to risk, to create shareholder value, not on project ROIC or the firm's average ROIC.

Focus on Maximizing Value, Not Maximizing Returns



Source: JP Morgan

3. **How coherent are the share repurchase and dividend policies as an investment strategy?**

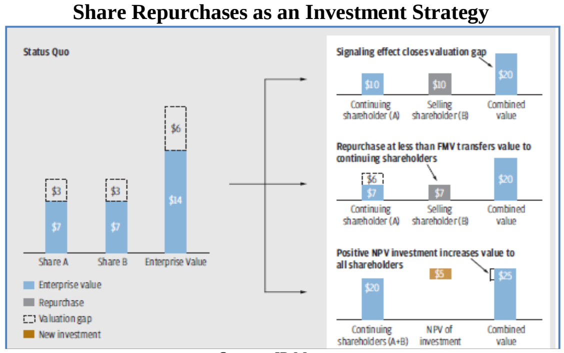
While share repurchases may be an important tool at the disposal of managers of companies embracing Social Contract, *share repurchases and projects are inherently different*. Many firms historically have repurchased their shares at the peak of the market, only to have to issue equity later at significantly lower prices; this was particularly prevalent in the recent financial crisis.[5] In today's environment, some executives, believing their

[4] *Creating Value Through Best-in-Class Capital Allocation*, J.P. Morgan, October, 2009.
[5] *Buy high, sell low: Evaluating pre-crisis buybacks with perfect hindsight*, J.P. Morgan, August 2009.

shares to be undervalued, are contemplating whether they should compare the return of new investment opportunities to that of buying back their own stock. Investments and buybacks are fundamentally different. If a company believes that there is a valuation gap between where shares should be valued and where they trade, a share buyback transfers value from the shareholders who sell to the shareholders who stay. On the contrary, a positive NPV investment creates new wealth and increases the overall value of the firm with the incremental gains shared equally among all shareholders. Mind you, share buyback in such an example is still not a bad outcome for the remaining shareholders.

Share repurchases and new investments should not be compared solely on the basis of their internal rate of return. The comparison should take into account management's long- and short-term objectives.

Share Repurchases as an Investment Strategy



Source: JP Morgan

4. Management and Director Compensation should be rooted in ROIC and share performance

The separation of ownership and control in corporate organizations creates information asymmetry problems between shareholders and managers that expose shareholders to *agency costs*. Agency costs arise when managers have incentives to pursue their own interests at shareholder expense. That is, the information asymmetry causes moral hazard. The most obvious lever to achieve a proper balance in the allocation of corporate capital is to tie manager/director compensation to key longer term shareholder friendly, Social Contract objectives. *This goes to the heart of management-shareholder communities and conflicts of interest.*

Advocates of such a forging of shared interests through pay have pressed companies on, for example, *Say-on-Pay* resolutions. Just as it sounds, such initiatives open management and director pay decisions to public scrutiny. Some blast *Say-on-Pay* as distracting and ineffective, and suggest that it is roundly ignored by shareholders, but such dismissals miss the point – it is now a legally mandated part of the shareholder/director dialog.[6] Such resolutions are non-binding, but serve to help boards gauge investor sentiment about the level and structure of senior executive compensation at their companies. Nevertheless, *Say-on-Pay* provides investors with an important avenue for making known their thoughts on the appropriateness of compensation levels. A number of studies, including one by *Yale University*'s *Millstein Center for Corporate Governance and Performance*, have found that providing investors with a *Say-on-Pay* can be highly effective in restraining the rate of increases in executive pay, limiting instances of "pay for failure", and more closely aligning compensation with actual performance.[7] Finally, the increasing use of stock awards, instead of stock options, as part of executive compensation packages means that dividends, share buybacks and share performance will be more important factors to management teams than they once were. This further aligns the potentially disparate interests of management and shareholders.

Alignment of interests between management and shareholders through carefully constructed management/director compensation plans doesn't insure best outcomes, or even eliminate agency/friction costs for shareholders, but collectively likely produces decisions that are most in line with Social Contract behavior, forging a greater economic community of interest between company managers and directors, and shareholders.

Short Term and Long Term Thinking

One compelling argument against "investor friendly" policies is that it is pandering to an investor who cares about near term performance at the expense of longer term growth. This may be true when considered in a vacuum or as a platitude. However, investors can choose among companies whose Social Contract policies emanate from a well-conceived wiring of corporate objectives and policies or those potentially compelled to do so by market suasion or activism. If management is compelled to own (takes significant compensation via awards) of its own shares, decisions and behaviors will be influenced by a vested self-interest in common with shareholders.

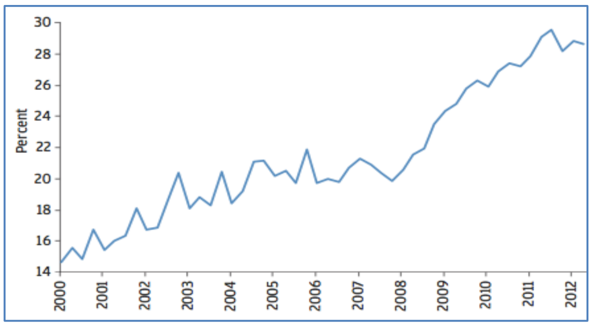
Adoption of a deeper Social Contract can derive from "playing defense" – attempting to manage share price through return of capital, or proper capital allocation decisions. This is neither a good nor a bad thing, but recognition of human nature. How ever we get better aligned corporate stewardship, be it through altruism or rational self-interest is not relevant if the outcome is an increased community of interest and the foreseeable policies that can arise from it.

[6] On January 25, 2011, the SEC issued final rules under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* regarding proxy disclosure of shareholder advisory votes on say-on-pay proposals and the frequency of those proposals, as well as advisory votes on golden parachute compensation arrangements.
[7] *Changing Corporate Behavior Through Shareholder Activism*. The Nathan Cummings Foundation, September, 2010.

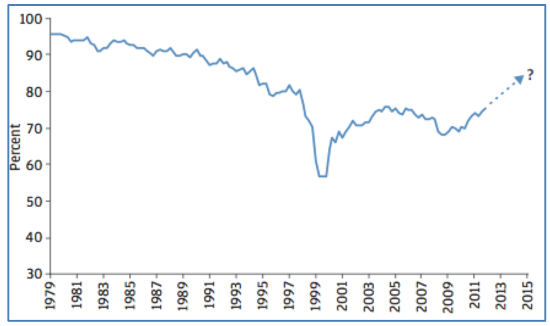
The Cash is there – What to do with it?

Dividend payout ratios remain low, yet cash on corporate balance sheets is near historic highs. These levels suggest that on the whole, companies have room to increased\ or initiate dividend payments. Further, in a low return environment, companies are coming (and will continue to come) under increased scrutiny about return of cash to shareholders in lieu of better projects that may enhance shareholder value. Such an environment is perfect for activism, both shorter-term and markets-driven, and longer-term and corporate governance-driven. In either event, it is proper to hold management and boards accountable for their use of cash.

Corporate Cash as a % of Current Assets



% of Larger US Companies Paying a Dividend



Source: Standard and Poor's

Now some Math – What should really drive decisions?

Ever since Modigliani and Miller published their explanation of how discounted cash flow ("DCF") principles can be used to value a firm,[8] DCF has been at the core of much valuation modeling. Broadly speaking, DCF says that the value of a firm is the sum of its future expected stream of net cash receipts (operating cash flows less cash outlays for reinvestment) discounted to a present value at the firm's cost of capital.

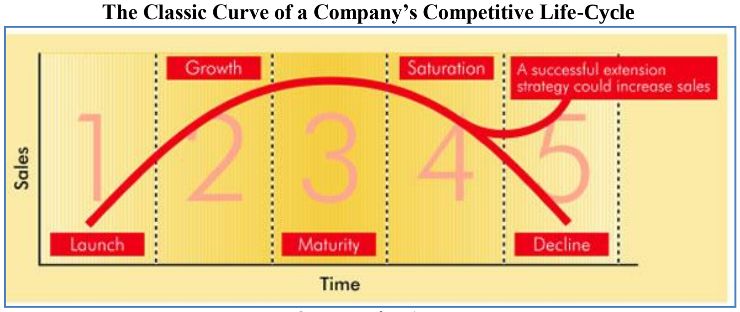
As M&M also showed, a company's total market value can be divided into the present value of cash flows from *existing assets* (or what is sometimes referred to as "current operations value") and the present value of cash flows from *future investments* (or "future growth value").[9] When investors expect a company to achieve returns on future investments that are just equal to its cost of capital, those new investments create zero additional economic wealth – in which case the firm's total market value would be roughly equal to the value of its existing assets. To the extent investors expect returns on future investments to be greater than the cost of capital, those investments will create value; and to the extent returns are expected to fall below this standard, value will be destroyed.

Moreover, for companies where future investments are expected to earn returns above the cost of capital, greater wealth is created when more capital is invested, especially when such wealth-creating opportunities can be extended farther into the future. In this sense, a company's current value depends on *competitive life-cycle* patterns that reflect expected future economic returns and reinvestment rates. Herein lays one rub: *what to do with cash is a function of where a company is in the competitive life-cycle, and where it is can be a matter of debate between management and shareholders as well.*

Where in the Competitive Life-Cycle is the Company?

Management may argue, and have the inherent conflict that they believe the company is in the *growth* part of the cycle, while the market may say, and/or in actuality the company is, in the *maturity* or *saturation* stages. Consider the recent debates about *Apple, Inc*. Where a company is within the Competitive Life-Cycle impacts whether or not capital is best redeployed back into projects that enhance shareholder value or returned to shareholders through dividends and/or share buybacks.

The Classic Curve of a Company's Competitive Life-Cycle



Source: London Times

[8] Merton H. Miller and Franco Modigliani, *"Dividend Policy, Growth, and the Valuation of Shares," Journal of Business,* vol. 34, no. 4 (October, 1961): 411-433. We site notwithstanding their lessened view of dividend importance to valuation. While not necessarily inconsistent with our view, M&M's arguments focus on valuation whereas ours herein, focus on price stability and demand.

[9] IBID

During the *Launch and Growth* stages, companies turn innovations into commercially successful businesses and earn economic returns well above their costs of capital. Companies in these stages are characterized by reinvestment needs that exceed internally generated funds. At these stages, companies are rich in opportunities and often seek external financing to exploit such opportunities as quickly as possible. The best use of cash is to plow it back into the core business – not to buy back shares or pay high dividends.

Nevertheless, in a free-market environment, no matter how skillful a firm's management, competition eventually takes its toll. Attracted by the wealth creation opportunities, competitors attempt to duplicate the innovations and take market share. The tension between managerial skill and competition results in a tendency of economic returns to fade towards the long-term average of the corporate sector's economic returns (which approximates the corporate sector's long-term average cost of capital). And, along with the drop in returns, corporate reinvestment rates also fall back toward the lower, long-term average growth rate of the overall economy.

In the case of companies in the *mature/saturation* stages, management can suffer from a bigger-is-better mindset and past success can breed a business-as-usual complacency. Large companies with mature businesses should put top priority on actions designed to prevent a decline in economic returns. Among the possibilities are recycling resources to shareholders in the form of dividends and spinning off business units likely to perform better as stand-alone enterprises. As mentioned previously, management/activist/shareholder recognition of the onset of maturity often is not time-aligned but eventually sorts out (for better-run or activist-pressured companies).

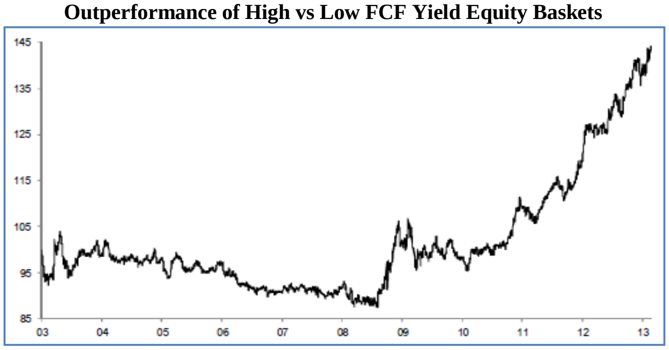
In the *declining* stage, shareholders, employees, and all other stakeholders pay a heavy price for the failure of top management and boards to adapt successfully to changing business conditions. Companies in this stage eventually take the path of economic return improvement that invariably involves downsizing—or they go bankrupt. Capital markets force this up-and-onward or down-and-out transition because continually investing resources at returns below the cost of capital not only destroys shareholder value, but also prevents resources from recycling to higher-valued uses. Such a hard-nosed, forced adaptation to economic reality arguably produces long-term gains to society that far outweigh the attendant short-term disruptions. This is not to say that many companies that transition into a state of decline don't find some solution that turns it around, though going from the *mature/saturation* stage and into *decline* means management has, thus far, failed to act in ways to sustain the company's competitive life-cycle.

Return of Capital - High Dividends versus *Sustainable* Dividends

The road to hell is paved with good intentions – Proverb

Desire and ability are not the same. Social Contract tendencies can belie capacity. Many high dividend investment vehicles seeking solely yield, often simply screen for companies with dividends in excess of indices (S&P 500, MSCI, Euro Stoxx) yields. The crudeness of this process means portfolio inclusion of companies with unsustainable dividends and exclusion of those soon to initiate one. Capital allocation is a key determinant of FCF and dividend sustainability.

Outperformance of High vs Low FCF Yield Equity Baskets



Source: JP Morgan Quant Strategies

We believe the ability to generate strong and sustainable cash flows underpins any efficient capital allocation policy. To that end, we focus on the FCF metric – a function not of what has historically been on the balance sheet, but what the company will generate. It matters more that a company can continue to pay and increase dividend payments, thank that there is a high dividend (perhaps even financed with debt rather than derived from FCF) at the moment.

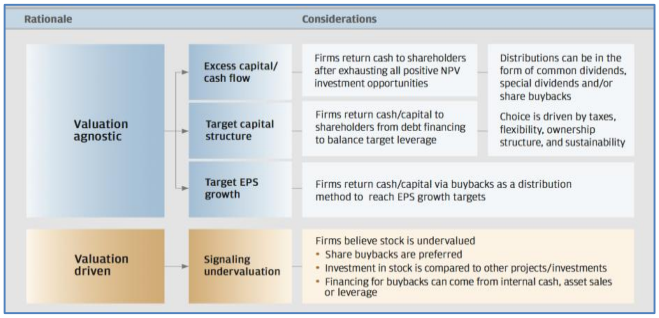
Return of Capital – Share Buybacks (versus Dividends)

Firms repurchasing shares embrace one of two broad philosophies:

Valuation agnostic distribution of excess cash flow: Some (mostly larger) firms that distribute very large sums of excess cash flow or capital year-after-year adopt a valuation agnostic approach. Their choice between buybacks and dividends is not valuation-driven, but rather based on taxes as well as on the predictability of cash flows. When cash flows are very stable and acquisition opportunities are limited, these firms return more of their cash flows in the form of dividends. When cash flows are less predictable and/or acquisition opportunities are large and less predictable, they may prefer the flexibility offered by buybacks. Companies are likely influenced, however, in part by the fact that investors accept reductions in stock repurchase activity much more readily than dividend cuts. While the philosophy is valuation agnostic, many firms appreciate the fact that when interest rates are low, repurchases also tend to be earnings accretive (depending on the earnings per share and the multiple at which the company is trading).

Undervalued stock: Companies also return cash flow through repurchases specifically because they believe their stock is undervalued. While these firms may have excess cash or capital, the key driver of their buyback decision is their desire to invest in an asset with a high return potential, i.e., their own undervalued stock. Especially with an aggressive repurchase, these firms also hope to convey their "undervaluation" belief to the markets and hence generate a positive stock price response. Using the same logic, decision-makers who believe their shares are currently overvalued should abstain from repurchases and distribute excess cash in the form of dividends instead.

Cash Distribution Philosophies

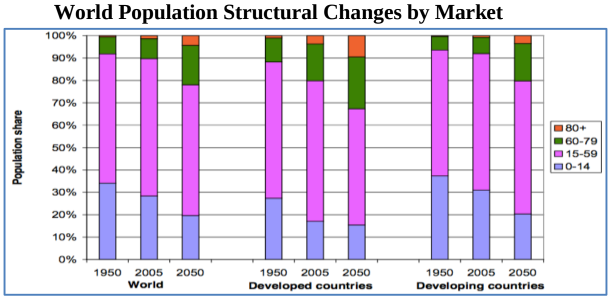


Source: J.P. Morgan

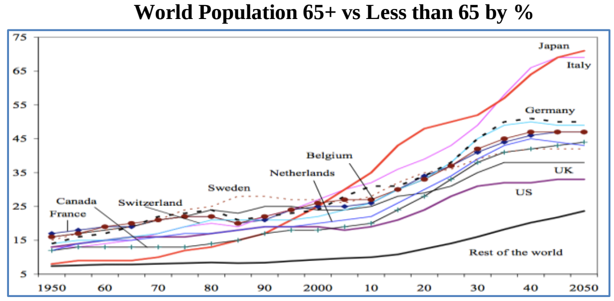
The Secular Shift – An Aging Investor Seeks Income Securities

The reasoning behind income securities is well founded at this point and a lucid strategy for many investors. The importance of dividends is magnified during bear markets for one. Dividends create wealth by providing cash returns to the shareholder on an ongoing basis. These cash returns can be used to purchase additional shares, allowing the investor to build equity and increase future dividend distributions. Furthermore, dividends can increase over time as the invested company's profit grows. The combined result provides a compounding effect that can create wealth regardless of what the stock market does. Finally, a stable cash yield can provide a cushion in down markets. All of this is comforting to investors that will increasingly live off a "fixed" income. As the investor universe, particularly in developed markets, ages, equities embracing shareholder friendly cash return policies, particularly in the form of steady, ideally increasing dividends, should outperform.

World Population Structural Changes by Market



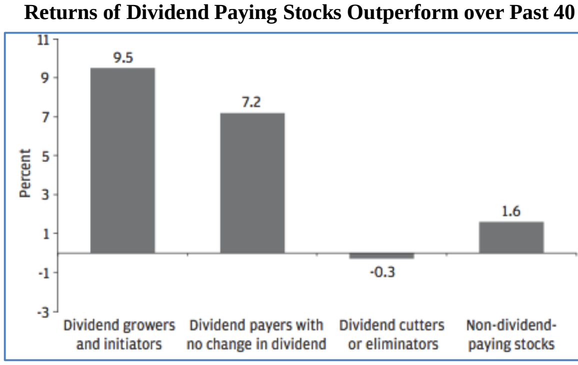
World Population 65+ vs Less than 65 by %



Source: United Nations

Over the past 40 years or so, dividend-paying stocks within the S&P 500 have outperformed non-dividend-payers, often by a significant margin. Within developed markers, it appears that Americans in particular, are less financially prepared for retirement. Income securities that inflation adjust (as Social Contract equities by and large would), give them a fair shot and catching up.

Returns of Dividend Paying Stocks Outperform over Past 40 Years



Source: Ned Davis Research, Inc. (Period of 1972-2012)

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A Social Contract Lens as a Way to Screen for Outperforming High Quality, Well-Managed Income Securities

A movement has begun among public companies, to embrace shareholder return of capital as part of a *newly evolving Social Contract* with shareholders. We see this movement hastening and intensifying. Such a growing connectedness of corporate and shareholder objectives can lead to lessened volatility. Further, burgeoning corporate cash coffers and a historically low interest rate environment are setting the stage for continued demand for cash return strategies. *The two intertwined powerful drivers of this movement are corporate manager rewards pegged to stock performance and an aging investor.*

Concerns about rising interest rates are reasonable when considering income securities solely and is the reason that a simple dividend equity strategy is insufficient. *This seismic shift toward a heightened Social Contract between companies and shareholders provides a lens through which a more carefully chosen universe of securities should outperform those produced by the simple selection processes of most passive dividend or income-oriented products.*

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