Paul From @Investmentideen Joins Us to Discuss the Power of Capital Allocation: How It Drives Returns and Stock Valuations

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we have a special guest, we have a new friend that we just met on Twitter, the Twitter machine or ex, depending on which name you want to go with right now we have Paul from @investmentideen. And he is coming from us all the way from Germany to talk to us about investing. And if you have not followed his account on Twitter, you need to it's fantastic. He drops a lot of great information.

And he's a very, very smart guy. So we're very, very happy to have him with us here today. So Paul, thank you for joining us, first of all, obviously, and spending your early evening with us. And also I guess, can you give us a bit of a background on maybe how you got started? What got you interested in investing and share with us your first ever investment?

Paul

0:46

Yeah, sure. Dave, Andrew, first of all, thank you for inviting me over to to your podcast. And I'm very happy to be part of the show today. So telling you a little bit about my background, I think it's less exciting to be fair. So I got into into investing at the age of 18. It's law run about 12 years ago now, at this time, I was just in high school, absolutely no idea what I should do after high school, and I was looking for potential jobs in the future. And one of them was thought manager and I thought sounded very exciting, very challenging, and you can make a lot of a lot of money with it.

And so there was the first time how I was introduced to equities. Considering my background from of my parents, which has been born in solid union, I never hear of something of stocks or owning equities in public listed companies. So yeah, it was kind of late that I discovered all this. That's my very first experiences have been playing around with CFDs, speculating on commodities, all this stuff that actually doesn't work, at least didn't work. For me. The most interesting part happened around about two years later was met a guy who is a close friend of mine, as of today, who taught me most of what I know about investing, I would say probably more than 70%. And he taught me everything from valuation to research, doing the due diligence, assessing the management, sharing good good writings, books, etc, etc.

So I got very lucky that I had someone who was an expert taught me a lot. Otherwise, it's always hard to break the ceiling at some point because you just don't know what to do next. Yeah. Then getting back to the investment background. I was I did some internships at hedge funds here in Germany, then I will have been working for three years at Constellation was part of the m&a team. And yeah, I quit constellation last year to do my own gig. And on the side, I'm still investing in small and micro caps. Yeah, that's more or less about my background. I guess if there's nothing else you would like to expand me on,

Dave

2:46

I guess what was the first investment you ever bought? Like, what was the first company you ever stepped off the ledge and bought

Paul

2:52

audits? Yeah, it was humbling, right. So it's a real estate company here in Germany, I had absolutely no idea what I was doing. I just thought like, if you're a beginner, you think a real estate is interesting. Suggest buy because real estate is interesting. And it was my very first investment. Yeah, I sold the company last year. I mean, I don't know a very small profit after after 12 years. That's it's just for like a while I have another company and all the four for the same period, which I consider more of a first investment, which is Iran from Israel.

The reason is, it was the first company I really did some due diligence on read the whole the whole annual report on the company. So did my modeling. Suppose that's the company I would more consider as a first investment because I've more attachment to it.

Dave

3:41

That's cool. That's cool.

Andrew

3:42

So maybe we can talk about that a little bit. What was it about this company that you did due diligence on that made you more confident in that kind of a pic? Are there other companies that you said no to? And then this one was like, Okay, this one felt like the one I'm gonna do next?

Paul

4:03

Yeah, I think to mention that this friend was teaching me most of what I know today about investing. And the way how he taught me everything was he was proposing a list of companies. So it's like, well, let's start with each of the let's go through all of those companies. Let's read through all of the annual reports of each of the companies is some of these investment phases have already laid out. I was just doing trying to replicate his ideas, his thoughts, his risks. So we went through the financial together, he told me to do the modeling for those businesses.

So that was more or less the reason why I was researching this company. It wasn't my own idea. I just was proposed by a friend who told me Look, you should spend some time because I think it's an interesting company. And you will learn a ton from just doing the work on this business after doing the work. And I said, Well, it seems interesting. It was my very first company I was researching. I said, well, let's just buy one, one stock of it. So I think it's how much do you own maybe six or seven shares? throw like 100 100 bucks or something. So not that much. But I think it's just like a memory. That's cool.

Andrew

5:07

How is it following in the footsteps of somebody else as investors? I feel like we're all standing on the shoulders of giants and taking lots of different principles. I mean, like guys like Buffett, he's been doing DCFS for as long as longer than we've all been alive. Right, exactly. So using your friend, how much did you stick to that? Or how much have you diverged from that? And have you found more success doing one or the other?

Paul

5:39

Yeah, it's a good question. I think I do have a completely different style compared to what he taught me at the beginning or over the years that he was teaching me investing. So JB has to talk about more about the style, I guess, when he started out, or at least when he started teach me it was very close to Buffett, buy good companies with good management, to reasonable price, which are growing so. And that's how I started out, but I don't know, it's over the last years. I mean, since I started investing, I never had any success with this kind of strategy.

And the interesting part is, I can't tell you why it's this way, maybe I was overpaying for most of the assets, I don't know, maybe I was over estimating the growth may or estimating the quality, I just can't tell the so I never made any money. With those kinds of investments. The main skills I had at this time was really about how to do valuation work. So I knew I understood accounting, I understood valuation. I understood business models. So the point where I started to actually getting returns on my investments was when I started deviate from this strategy.

So instead of buying good quality businesses at a reasonable price, I probably I guess I overpay for all of them. So the first recurrence came when I started buying, okay, businesses that have been creating a double digit free cash flow multiples, but sustainable free cash flow multiples, I did both and in parallel, so I did this quality stuff I did to some of those, I would call it multiple arbitrage opportunities, were not considered holding the companies for a long period of time and more like, one two years. And I've seen it, the only investments that actually performed have been dose that I bought a double digit free cash flow yields. So over time, I started to become interested more in small and micro caps, I started researching.

Okay, what's so special about smaller micro caps? Is there any difference compared to what you see in large cap space? Should you maybe focus on small and micro caps, and I found a lot of interesting investors in that area. So I started more and more copying those, understanding how they do the due diligence, how they generate their ideas. And over time, I just figured out that it's actually at the end, investing is all about price. I mean, no matter what you do, it's all about price.

You could do quality investing. I mean, you could go deep value buying like net nets. It's really about the only thing that matters in investing. And I think that's one of the reasons why it's so hard to make money is usually that you shouldn't overpay, you should have a good decent margin of safety, if you really want to make money. And that's what I focused today on I tried to buy not the best businesses, but I would say solid

good businesses more like stable but stable earnings, where I believe there's just way too cheap, consider where it should be trading.

And yeah, I have a mix, still a mix of I would say opportunities where I believe in multiple arbitrage The only thing how I can make money, we're just waiting for rewrites that still some opportunities where it's, I consider the company's a good opportunity to grow over the next few years, and become a compounder. Yeah, but getting back to my roots. I think what I do today, compared to what I did in the beginning is come to different pair of shoes,

Dave

8:55

like a lot of great investors. So you've evolved, you know, you started out one way and you found another way that works better for you. I think that's totally normal. I think the idea that you're going to start one way and continue that way as you learn more, I think is probably maybe a bit of a broken idea what are your thoughts

Paul

9:12

I'm fully view I guess, over time, especially if you start out you have no idea what you're doing, you buy all this kind of stuff. I don't know what your experience has been. But when I started out, I was just buying this company trading it single digit piece below tangible book value. And so just getting joy into all this, just KPIs, you know, like all these metrics, and the result was I wasn't doing any money because I had no idea what I was actually doing. So it's we're trying to just try to understand better what what actually drives returns and considering my development, I had some moments where I have broken the ceiling.

So I didn't know what to do, but what can I change to improve my returns? And then you just have this one small, small idea to change everything and your whole concept is How to better understand the stock markets. And I think that's usually the hardest part. When you think about investing, I got a lot of friends over time that I met over time, we've been investing in stocks. And they did the same for years. And they just didn't know what to change to improve.

That's usually I think, the hardest part when you think about it, and getting back to you. So you have to evolve. But it's usually the hardest part is really figuring out how to evolve what to REITs. Which advice to follow. And there's just too much information out there, which is, I think, especially if you're a beginner or you

just don't know where to go, because everyone's sound smart on the internet, every book sound smart, if you have absolutely no idea what it is about to make money in a market. That's at least my point.

Dave

10:45

You know, it's funny, you mentioned that because you had this great tweet not too long ago, kind of about your learning process, and how you would start now compared to you know, if you had to start over from zero, so I guess maybe could we expand on that a little bit?

Paul

10:59

Yes, sure. Do you want to start me from zero and explain how I would do today? Yep. So what I will explain now is more like from my experience, that's my opinion, I believe some people will have a different opinion on that. The main issue I see from most investors, it's really they don't know how to become better because of this large amount of information. The number one thing is really not to overpay for assets. So you have to understand valuation, you have to understand what you're paying for those businesses. And for example, the upside is for the downside is all of this kind of information.

So if I would have to start over again today, first of all, I would focus on lots on following some investors that publish valuations online, I mean, with the right apps, there's value investors Club, where you can see a lot of emphasis on the valuation, it's it's never too complicated, in my opinion, like you have to get the valuation right. If you are not able to assess what a business is worth, it will be very hard for you to make money in the market. So most should be really about understanding accounting.

The next thing is if you really want to improve, there's some very, very good books and write ups and whatever. I think the joy Greenblatt class notes is probably the best thing I've ever read. Then there is the Jeff Gannon compilation where I think learn little bit more about nylon Tone, Tone about second level thinking, because the expense, a lot of basics people, Jeff and I said why it's this way, and he really explains it. Those are my favorite resources out there.

And I feel you have to study them, you have to understand that there's margin of safety by Seth Klarman, which is an excellent book, then there is gonna be a stock market genius by Joel Greenblatt, which is actually hard to understand, especially if you're starting out. So I think the hardest part is really I don't know which book is good for beginners, because if you want to do make it to become professional, it gets very

fast, very complicated. The next part is, if I would start over again, I would always recommend start with small cubes can even go even smaller.

And after you get the knowledge how to model how to estimate and price estimator and explore shares for the future, I would usually do modeling for I would say, Look, don't go for concentration by 15 to 20 Small caps that you consider as promising try to forecast the next 12 months, try to forecast revenue, try to forecast the margins, try to forecast the free cash flow, try to forecast working capital, whatever is necessary. And then after 12 months, you just get back I mean, every quarter, you just update your numbers, you try to understand why is it deviating from your assumptions?

Try to be more conservative. And over time you learn a lot about businesses. So why is the business maybe growing faster? Slower? Why margins improving or declining? While your cost structure is changing? Why do you suddenly have more sales and marketing costs, why revenue doesn't grow? And that's a very good way to learn. And besides that, I think what makes it very interesting if you have a bunch of small gifts is a lot of bad things happen.

But a lot of good things as well. So you just learned from those very unique moments. I don't know maybe maybe a change in management, you lose big contract for me, you lose the biggest customer, which what's the impact? And that's usually how I would do it. I would not focus on making money the first few years but more about gaining as much experience when it comes to forecasting and I think that's one of the most important things. Yeah, that's how I usually would would start out and I probably forgot a lot to add or another easy to be out of my head.

Andrew

14:45

You mentioned free cash flow yield and double digit free cash flow yield. So for somebody who doesn't know what that means, can you break that down a little bit and maybe give an example of a company that you bought with a higher free cash flow yield than without having a good return for you.

Paul

15:02

Yeah, sure. So first of all, it gives your audience a sense of what's earnings yield is or I mean, yeah. Yeah, sure. I mean, let me review. Okay, real quick. So when you think about an earnings yield, I have to explain it because we need it for the free cash flow yield is usually the inverse of a price to earnings multiple. So if you

pay for a company 10 times earnings, and you will receive 100% of the earnings as a dividend to your bank accounts, you would receive 10% a 10% return which would be one divided by 10.

So if you pay 20 times earnings, the free cash flow, yeah, that earnings yield would be 5%. Because you divide one by 20. So that's the earnings yield the free cash flow yield. So for me, I usually it's you can exchange them however you want. For me free cash flow yield would be just the normalized, normalized earnings, we normalize it by one off events, which is a little bit more complicated story. You can make a whole episode of that. But so yeah, I would say it's more about an earnings yield. When we talk about double digit earnings yield a few companies had that had been creating double digit earnings yields have been one of the best funds I had was API group, the ticker is APG, I already sold it out to company back then it was in 2020, they just recently had been serviced the spec and the sponsor bought this company API group, this spec. And the result was just that they didn't pay much for the company to put a lot of leverage onto that. So the business was, if you normalized the earnings, you see that the company's trading at nine times earnings.

So if you go for the invert, you would get a return of you will get an earnings yield of around 11%. So what it means is, if the business is not reinvesting any of the cash flows or the earnings and you will receive the dividend, you will have an 11% return on your investment annually. So this would usually attract other buyers, other our shareholders who are interested in the stock who would see that dividend yield.

So eventually, the company will trade at a much higher multiple, much higher price to earnings multiple. So my consideration this case for us, for example, can we have a very good business rates in a double digit, free cash flow yield or earnings yield, and it shouldn't trade there, it should be definitely must be much higher. So I, my assumption was that I can definitely flip it at a higher multiple, at a higher share price. I think I bought my first shares at around $12 a share. And I think I sold them out at around $19 A share and less than seven months as far as I remember, maybe 12. I don't remember it to be fair. But yeah, that was something I did had a lot of opportunity I had many in the past

Andrew

17:51

to go and how did you differentiate between this as a cheap stock? Because it's a bad company versus a cheap stock? And it's actually the business system going to perform pretty well to give me that higher return? Like, how did you know that the valuation was going to revert to a higher multiple?

Paul

18:10

Okay, that's a fair question. So we should think about more than about value traps, I guess you want to avoid value traps, because what you're saying is, how can I make be sure, that company will rewrite to a higher multiple. And the main argument for rewrite is always capital allocation. So what it means is if you have a decent business, and I mean, you don't have to do much. So if you have a stable business that's growing like 234 percent organically, and it's just distributing all the cash flows back to the shareholders, if I would be happy about 11% dividend yields just receiving any really not doing anything.

And so I won't sell my shares or buy some shares. So what happens next is more people see this dividend yield, more people start buying shares. So the shareholder base becomes very stable. So they're not many sellers over time, what happens next is that more and more people see this opportunity. And they say, look, in the past was trading, you'd received an 11%, dividend yield, I'm happy if I receive like 9% 8% 7%. So they start to bid up the price. And you find some sellers who opportunity costs and find some other opportunities to invest into.

So if you think about the rewrites getting from nine times earnings, so let's say 18 times earnings for something, it's always about capital allocation, you have to reward the shareholders, you have to give them a reason why they want to own the stock. And that's, by the way, one of the reasons why it's so that's the point about value traps as well. So most of the times you see a value trap. It's the reason why it's trading at a discount. It's usually because of that capital allocation. Yeah, that's how I make sure that the rewrite come to be fair, I don't know what well we'll be heading you can So, multiple analysis of peers and come to the conclusion should trade much higher. But in general, if the capital is allocated in a good manner, there should a rewrite happen. So

Dave

20:11

I guess, can we talk about value traps? This is something that's kind of near and dear to Andrews heart, too. So what are do you what are value traps? And how do you identify them?

Paul

20:21

So yeah, I think the first point is, so what's the value trap, I got a friends who once said, You look, if you end up in a value trap, you got the valuation wrong, that's describes it perfectly. So if you know how to value a

company, you know how not to get into a value trap, usually a value trap is by showing the following characteristics, it could be something or trading below book value, it could be something trading at a low price to earnings multiple, I don't know, it could be something trading at a high dividend yield.

So all this kind of, I would say metrics that show you that usually companies cheap, and and in most cases, if you would just invest on those kinds of multiples, you will ending up buying a lot of value traps. One way to avoid that, that's what I mentioned just before is really to understand what happens to the cash flow of the business, what happens to earnings of a business, you can buy whatever you want, you can buy every any company and it can be the diverse business on Earth, if it's cheap enough, and the company and the management considers distributing the cash to the shareholders. So I think this is really the main part, what happens to the cache. If you really want to avoid value traps, you have to understand what happens to the cache. But getting one step back, we're talking for beginners, if you think about a beginner would just look for the first time in a company.

Some issues I see very common mistakes are first of all, overestimating the future growth rate, I read a lot of quarterly reports and you see this quarter earnings growing by 50%. And as a beginner, you start to be super excited, you're like, Wow, this business growing super fast. And then it's probably super cheap on forward multiple. But sometimes you have one off events. So try to understand what's happening in this case, why is it growing by 50% one example to give you as I'm coming from software would be a software business usually has some licenses. So for example, you earn every year like 500k, in revenue, through licenses. And suddenly the big order you win a very large customer, you book a 2 million license revenue, which is by the way, 100% gross margins. So it goes through to the EBIT.

And you end up with profits, if everything stays the same, you have a profit which is 1.5 million much higher than before. But some sort of order like that won't be come in in the future, that might be one of the issues. The second thing is to take a look just on a price to earnings multiple you have some one off events, something could be especially on the cost side that you have a legal maybe you want a legal fight against some another company, you booked some one off other operating income, which you have to adjust usually to find figure out what is the normalized profit of the company, you do the same for growth rates, if you buy a cyclical business, you might see this, it's trading at a lower price to earnings multiple buying at a peak.

So it's more to better to assume that maybe we will see in a downturn in the next three years. So there are a lot of mistakes that people do. And then the next thing is when we think about value traps, as I mentioned before, it's really about capital allocation. So we have to have, we need a catalyst. So we need a catalyst that's something rewrite, you need a catalyst, that something will actually happen if you buy a company

trading below book, for example, we need someone who will realize the value for you. So if it's traits half a book, and you would in theory mean that you're paying 50 cents for the dollar.

But the only way that you receive this dollar is by someone, for example, liquidating the business, if you don't have a management, which is not rational, it won't ever liquidate this business. So there's absolutely zero reason to assume that you will get this money. The second thing is if you think about the sum of the parts valuation seen it many times I did my own in the past and never made money with those and the point is exactly the same. If you see a company trading at a discount of some of the parts valuation, you have to ask yourself Would the management's realize the value of the sum of the parts may be for a spin offs may be selling part of the business units to strategic acquires?

So you need all to make you need always a good management I and that's the reason why I believe Buffett is so into management. So why management is so important too, because all this rational decisions are required to actually realize the shareholder value. The next part comes after selling this businesses. So okay, you realize you liquidated this business you paid 50 cents For the dollar, and now that you got a shell, you got a company, which is just a shell of money.

The next question is, Will you really receive the capital will receive the money, then the next question is, or will it be burned in another acquisition. So those are all the assumptions you have to make consider value trips, which is why you always have to think about the catalyst. I think there's a quote, I don't know who said it, but usually pride itself can be a catalyst as well, which I agree on. And it's it comes a little bit more complicated, you can buy something very, very, very cheap. I don't know, I have no example to be fair of anything super cheap.

That's the usually the point is if something is too cheap, at some point, there will be an event that will realize the value of the business. That could be for example, if you know that there is a lot of takeovers happening, and it's double the price for the business is currently trading, maybe, let's say four times the price where it's currently trading. And you have, you could speculate that over the next maybe 10 years, someone will come along and buy the business. If the management by the way, and getting back to the management if the management is not blocking a deal. If the majority shareholder is willing to execute on that opportunity when someone approaches you and says, Okay, look, I'm willing to sell the company.

So that's something that's not happening every time you end up again, in a value trap, if you don't have a management or owner who is really willing to give you this opportunity. Another issue, I usually see the value craps is or I mean investors to evaluating businesses, if they use EV EBITDA or EB Abbott's for valuation, and

the problem lies in the price value. The reason is, if you have a very cash rich business, maybe they sold the business unit, maybe they just accumulating a lot of cash over the years, just paying it out to the shareholders.

The main issue with that is, you don't know if you will ever receive the cash on the balance sheet. So you might pay on an EV ebbetts that a business might see very cheap. But if you remove the cash from the enterprise value, you get too much higher multiples, in which case it wouldn't look any more cheap. So one of the issues, what I want to say is, if you think about value traps on talk about enterprise value, you have to think about what happens to the cash.

So will it be distributed to the shareholders? Will it be used for investments, acquisitions, maybe the company has a lot of debt. So which could be for example, a very low interest of debts, which would actually then mean that if you use it for repaying that, that that's a very bad way to use shareholders to use the cash and create I mean, it's not creating much shareholder value.

And that's usually the problem with the cash side. At the same time, if you're thinking about the highly indebted business, now, you could do the same logic, applying the same logic on earnings, you see a company trading in a very low earnings, multiple, but you ask yourself the questions what happens to the cash, actually, so what happens to the earnings, and you go for the cash flow, and you see okay, the company's repaying every year this debt, so you won't see any of the cash that's generated during the during the next year, because everything is used for repaying the debt. So your return wouldn't be the inverse of Illinois, you pay 10 times earnings wouldn't be like a 10% dividend yield.

But your return would be actually what you would save in interest on that debt. So that would be your real return on that. I mean, your return on the on buying this company. So that's usually what you have to assess. On the other side, if you have a company, it is highly indebted. But you know, the management is executing very well, and it's very good capital allocators. What they will do, they will say, okay, look, we will not pay any, we will not not repay any debts, we were distributed to shareholders, we will buy on own shares, if that makes sense.

And this will have a huge impact on your insurance as well. So this case, you could realize the return, you assume, yeah, there's probably much more in value, but I think it's more or less. So I wanted to add to this topic.

Andrew

29:03

So you're saying that if management's taking our cash and burning it in the fire, there's a chance that the cash that's in the business might not make it to us because man, the man is taking that and burning it in a fire,

Paul

29:17

it doesn't have to be always burning, it just has to keep it in the business. So you don't know maybe you have an owner who's just uses I mean, parks that cash for tax reasons in public company, you will never know. I mean, at some point, you might realize the cash but they just don't know when this will happen. Maybe 20 years after the founder dies, I don't know maybe the children take over. Maybe he wants to sell the company. So there are a lot of liquidity events, but you just don't know when they will happen. That's the issue with with cash on the balance sheet.

So you have to make the right assumptions regarding the cash regarding the use of capital, or how do they treat that? All those is very important to assess if that's a value trap, or it isn't. And that's what I just think is very important. So you need to assess the management isn't working in your favor the owner working in your favor, especially if you I mean, think about it from a private business lens that someone is giving you, I don't know, you buy a company or you buy private company, 10% of it, you're a minority shareholder, you have absolutely zero, say, so the majority decides what happens to the business. So you might just be stick for holding 10% of the company, but it will won't ever get any return on it. So if no one is helping you to realize that

Andrew

30:30

that's good, it's a very good point, because I think when you talk about value traps, sometimes the obvious ones are easy to spot. Company has too much debt or company is not growing anymore. Those are sometimes more obvious value traps. But you're talking about companies that have balance sheets that look awesome.

But because to your point, they're not actually using that capital to help grow the business. It's almost trapped in there. And when you mentioned companies doing that, I had a couple smaller cap companies that I used to own that I ended up selling for that reason, that spring, in my mind, do you see that Apple allocation is different with some of the smaller cap names than it is a large cap like Microsoft or Google,

Paul

31:21

I think my main point is probably the ownership. I mean, if you think about the Microsoft, I don't know who the majority owners are, but probably some large funds, I guess. And they probably don't even own a minority, but just lost shareholders. So there's a very different shareholder base, if you think about small caps, there is usually a you have your majority shareholder, you have someone who is the CEO and director of the board as well.

So it's a very different situation compared to large cap to the mega caps, large caps, whatever. But I think you see both situations in both universes, the very small ones and the very large ones, where you probably have majority owner who's just willing to do stupid, I know a few mid caps that have been researching years years ago, whereas which have been owned by a family and they had a lot of cash on the balance sheet and just didn't spend it on anything.

By the way. I just wanted to add one more for the value trips and the cash position on balance sheet, I think it's could be interesting, some people nother way to look at cash in general could be instead of subtracting it from the enterprise value would be of okay, how could it be used, let's say you have 1 million in cash on the balance sheet, you know that the directors good capital allocator, you know, the CEOs, good capital allocator.

And he might use that cash to acquire a business, maybe it's not so good. So and in which case, he might overpay for a company in the first case, he might pay something like five times earnings for another company, which had returned like a 20% return on the company, which you could apply like that normally. And like 20%, which would result in it's 200k in additional profit. So you could actually use the price to earnings multiple after this acquisition. So you can make an assumption okay to use as capital at a 20% a year invested 20%, you will actually get another 200k profits.

And the other way around, if you have a better locator was by overpaying for a business paying like 20 times earnings, you will have a 5% return which would then result in a 50k additional profit. So that's another way to look at cash, everything changed the valuation. So either you have it on the enterprise value side, either use it for the earning side, or use it for a special dividend when you think that you have a new owner would definitely be distributed to the to the shareholders. So those are like all the thoughts I usually take into account when assessing the balance sheet or the use of cash use of capital use of earnings

Andrew

33:41

as a good points.

Dave

33:43

They are so you work for Constellation software, and Mark Leonard is considered by a lot of people, one of the better capital allocators? Is that something that you picked up while you were working at that company like you observed it and the insight and is that something that kind of helped maybe, you know, formulate some of these ideas about how the company's allocate capital. And I guess the importance of it.

Paul

34:08

Yet it's made at some point since if you think about private equities in general, and not just constellation, those guys are just capital allocators. So what are they doing? They buy a business which is owned by I mean, think about software, which is usually owned by an engineer. So this guy has absolutely no idea how to run a software company, he never did price increase is overspending on r&d. So a private equity comes into business and they just restructure the company, they relocate all the Capitals in the company.

And that's where you should have formed it okay. What you're looking for when you for example, valuate a company if what you're looking at a manager is really someone who understands capital allocation, who thinks about capital allocation from a revenue side from margin side from a cost structure side, I just had recently a discussion with one of micro cap CEOs, who was for example, relocating his employees from one project to another was closing down one project, because the other one had more higher margins. So that's the skill set I want to see in the CEO as someone who analyze all the opportunities he has available to him. And that's usually what CSI did. That's what every private equity is doing. What nothing else then.

Okay, what's the best way to use this cash? If you develop a new product? Is there a need for this product? What's the market for this product? I mean, how many customers do we have? If you sell it to them? How much what will be the return? So it's definitely part of what I picked up during constellation and how important actually capital location is. Yeah, how this business model in general works.

Dave

35:38

That's awesome. I just, it's kind of ironic that we're talking about this kind of subject, because I literally just finished the outsider's the book about the CEOs, and that's the main focus of the book is capital allocation. And these were eight examples of some of the best allocators in the history of the market. And it's kind of ironic that we're talking about that today. I mean, it's

Paul

35:57

a good book, if you recommend it to anyone who didn't, hasn't read it gives him a good oversight of good capital allocation. And how to think about that no buybacks, m&a, etc, etc.

Dave

36:10

Yeah, for sure. So we've kind of danced around the subject a little bit, maybe we can kind of talk about a little bit more now to what is valuation to you, and how do you kind of try to approach it?

Paul

36:20

That's a good question. I think I would pare it to the business quality thing, because valuation comes along with business quality is very important. So valuation is usually for me, I try to understand. So how much am I paying for today's earnings? I mean, sort of what how many? What's the multiply? I'm paying for today's business? So that's usually what I try to figure out first, then I try to figure out second, what happens to those earnings? Those are usually two questions I asked myself, and if I can confidently estimate Bo, I mean, make a good assumption on both.

And I think it's still a good idea, but usually invest. So to estimate the earnings, I start thinking about the business in general. So it starts with the top line. So when we think about revenues, the first question that always comes to my head is, are the revenues recurring? So I saw other recurring Do we have some some recurring business model, for example, if you think about, think about SAS, I mean, it's subscription based, your your customers pay you annually. So that's usually the very first four they have because if the revenues are recurring, it makes much easier to estimate the earnings power, I mean, or not earnings power, but the sustainability of the earnings, because the revenues would come in every year.

So that's usually where I start. So try to understand the different revenue streams that a business has, if you think about a regular software company, they're not talking about SAS, but something in how they explain it.

So like, I mean, I don't know, if you've worked in a corporate, you know, SAP, which in the past has been selling licenses, and those licenses, you receive a maintenance contract, and you need some professional services to implement it. So I would in this case, if I never had researched a software company, I would try to understand all those three revenue streams. So which of them are recurring? Why other recurring, and so which would consider a one off, and the other one would be? So what's the margin of all those revenue streams, for example, if you sell more licenses, as I mentioned, they have 100% gross margin, you can estimate as the the gross margin will will improve over time, if you sell more, and they will decline if you sell less.

And you make all these conclusions, and the same for professional services. So you start to think about the business in general and hope everything correlates. So if you think about the start of the margins, so what's included in the cost of goods sold? How does it change? If you have more revenues, scaling, isn't it scaling, then you get down to the operational cost structure where you start about similar thought patterns? So for example, if you you have sales and marketing what's inside sets of marketing? So if your revenue if your revenue top line increases, should you say its marketing increases well as well, or you do the other way around?

If I spent more time more money on sales and marketing, what will happen to my to my top line growth? How's it maybe correlating to my sales, if you think about medic med tech companies, which have like usually some some razorblade model, where you sell the machine and then you sell this place every now and then, so usually would see a correlation between hiring more salespeople and selling more machines. And more mystery machines will then lead to selling more razor blades. And that's usually do start to make the correlations. If you get back to software and you think about the research and development.

You hire more r&d people to develop new products, which could then be results in more sales. So you start thinking about a case By hire more r&d people, how will the top line change? So and that's usually all the fair thoughts? Do you have the same for general GNA? Where you start thinking about okay, if the company is growing, what happens to GNA? Do we need more accountants, same amount of accountants? Is it scaling or isn't it. So that's usually the way I approach it.

And this way I get an understanding of the company doesn't have to be super in depth, I don't I think most people that I see are spending too much time on other factors. I believe that that's at least my opinion, too much time on the market too much time on the competitors. But they usually don't understand the business itself from perspective of the financials. And you can even expand it even further. If you think about revenues, you have to understand how it's wired to the balance sheet, all about receivables, for example. So

it gets very, I mean, you can get a very, very deep in this discussion. So getting back to the quality of the business, good quality business, as I mentioned, you don't want to make it too complicated.

So to keep it as easy as possible. First of all, this look for businesses that have recurring revenues, the larger the share of recurring revenues, the better. So recurring revenues could be as I mentioned, some subscription model could be a consumer behavior, someone buying the same Nutella glass every two weeks, for example. It could be like this mentioned the razor blade model, I don't know it's some maintenance. For example, if you're producing if you're an engineering company, you're producing machines. So they usually need some maintenance as well as selling spare parts. Usually, that's what you look for look for companies that have a recurring business. Just from from that.

The second thing is if you really want and I think that that's an important part, Buffett was always preaching to buy good businesses. And the reason why he's doing that, as in my opinion, I never talked about it. So but it's just my interpretation why he's doing that. It's because the good business has stable margins. So if you have stable margins and stable revenue streams, this makes it very unlikely that you will in the future, you will lose market share, your revenue will decline. And you will face more competition who's putting a lot of price competition against you selling for lower price, so your margins deteriorate.

That's the main reason why I believe why Buffett is putting so much emphasis on burn on quality is because it makes valuation much easier, the margin of safety is much higher, because you're exactly no margins will stay the same revenues will stay the same. So that the end, your earnings power will be much easier to estimate or the earnings at the end. Another point of a good quality business, if you really want to make it easy is the amount of capital expenditures that you need, how asset heavy is the business, most of the companies I buy usually have just desks and chairs. So there's just not much of depreciation.

And there's just not much of investment necessary. I mean, there's there's pros and cons, I think the pros usually don't need much to grow, the business usually can distribute the most earnings back to the shareholders, or the other side. Those are usually businesses with very low barriers to entry. Which gets me back to Buffett who is talking about franchise powers, which is the reason why he's looking for franchises. Like See's Candies, if you think about it, because it's capitalized, and has barriers to entry, because of the brands. So that's usually how I think a lot of good business in general. Yeah, I mean, that's mostly what I wanted to add to this topic. Cool.

Andrew

43:36

That's awesome. I feel like we could dive down so many different rabbit holes there. But obviously, we want to respect everybody's time. So Paul, thanks for joining us today, you have a Twitter account that has a lot of drops of knowledge, like Dave was saying, so can you give us that Twitter handle and maybe spell it out for English listeners?

Paul

43:58

Yes, sure. It's investment ID in its investment and ID e, and if you've read the questions or something, whoever listens, feel free to reach out happy to give an answer or help you out wherever I can.

Dave

44:11

Yeah, it's awesome. Paul, this was fantastic. You, you weighed a lot of stuff on here. And we definitely there's a lot of different rabbit holes, we could definitely go down. We appreciate your time and coming to talk to us. And again, anybody that is interested in the subjects we were talking about Paul's DMS are open and he is very, very good responding. And he has a lot of great wisdom and a lot of great experiences. You can obviously tell after listening to the show that he knows what he's talking about. And he's a good resource to help you learn more.

And that's one of the goals here is to try to help everybody get better. So Paul, thank you again for coming and joining us today. We really appreciate it. And with that, I will go ahead and sign us off everybody go out there and invest with a margin of safety, emphasis on safety. Have a great week and we'll talk to you all next week.

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