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The General Theory of Reverse Float

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Dear fellow investors,

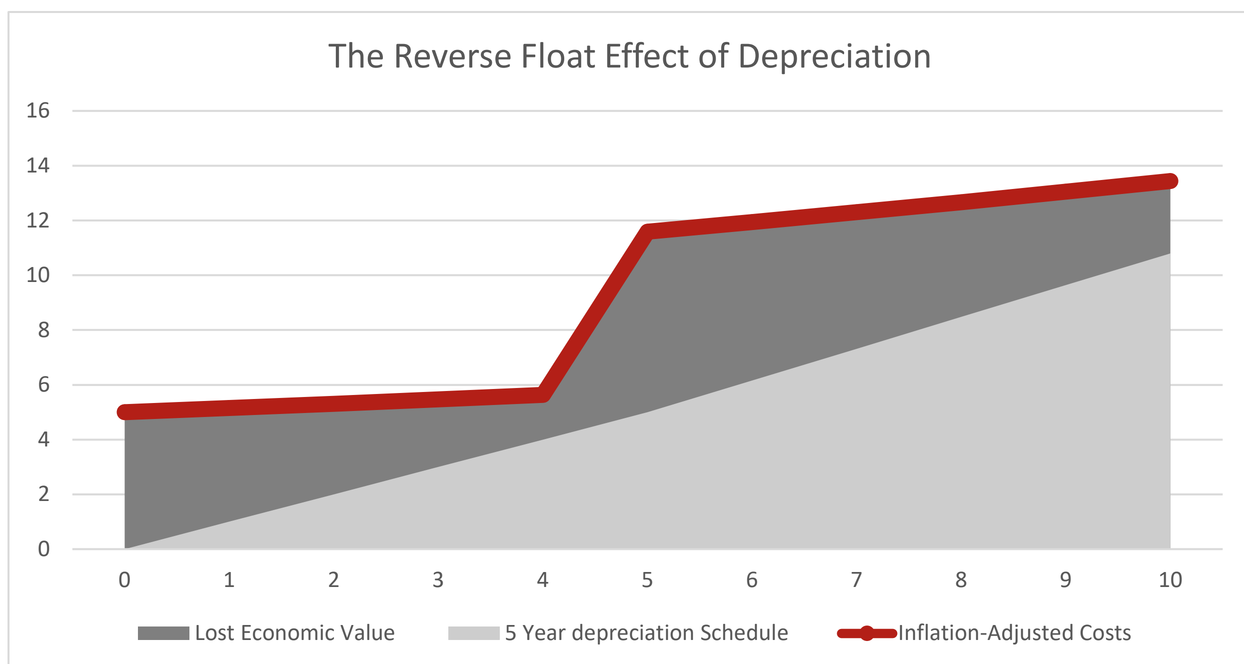
During the most-recent Berkshire Hathaway Shareholder Meeting, Warren Buffett and Charlie Munger reiterated a point during the question and answer portion that has stuck with us. We feel compelled to share what we learned.

<u>Reverse Float's effect on EBITDA</u>

The billionaire duo has been very critical of the use of EBITDA, which is an acronym for earnings before interest, taxes, depreciation and amortization. During the meeting, Buffett and Munger harped on the depreciation part of EBITDA.

"You know, we love to talk about float. And float is where we get the money first, and we have the expense later," Buffett said. "Depreciation is where you spend the money first, you know, and then record the expense later. And it's reverse float. And it's not a good thing."

Buffett and Munger are trying to help people think rationally about the real costs of depreciation. When a company purchases physical assets, they typically capitalize them on their balance sheet. One benefit of capitalizing instead of expensing is that it shows higher earnings the year the asset is purchased. After capitalizing the asset on the balance sheet, generally accepted accounting principles (GAAP) allow you to depreciate the value of the asset in future years, thus lowering earnings slowly over time. The following is a depiction of how this looks theoretically for a company.



Source: Smead Capital Management

The chart is a depiction of a 10-year period where a company buys a 5-year asset and depreciates it over a 5-year period. With a 5-year asset, this would happen twice. We assumed a 3% inflation rate for the chart. The dark grey area of the chart is the lost economic value due to inflation's effect on the time value of money. We would note that the higher the inflation, the larger the economic value lost. To harken back to Buffett and Munger's thoughts, it's reverse float. You pay a large expense today on something you don't receive economic value from until out into the future. Berkshire's insurance company gets to benefit from float. They receive money today. They don't have to pay liabilities until the future. By not accounting for the lost economic value from depreciation in EBITDA, an inaccurate picture of a company's future costs is established.

Reverse Float's effect on Owner Earnings

In 1999, companies with high-flying multiples didn't expense employee stock options in their GAAP earnings per share. Buffett railed against this practice. The joke was that if it's not an expense, what is it? Today's practice of stock compensation is accounted for in earnings, compared to then, but is not included in free cash flow. Stock based compensation is added back to net income in calculating free cash flow. At Smead Capital Management, we don't believe that giving away ownership improves free cash flow in the long run. What this requires us to do is adjust free cash flow by the amount of stock-based compensation. We refer to this as owner earnings.

Proponents of stock-based compensation would say that it is the life blood of any growing entrepreneurial endeavor. While we agree employee stock ownership is good, in today's practice it's a hidden nightmare for shareholders. In effect, it is a way for Wall Street and insiders to overstate their economic earnings. To use an example, below are reported numbers for Amazon (AMZN):

Market Cap (as of 6/2/2017): $485.4 billion

Free cash flow for 2016: $9,706.0 million

Consensus free cash flow for 2017: $11,583.3 million

If an investor looks at these numbers, they would conclude that Amazon is trading at 50 times free cash flow on a trailing basis and 40 times 2017 free cash flow estimates. Here is the heart of the deception in these numbers. Not included in the free cash flow for Amazon is stock-based compensation, which per their 2016 fiscal report was $2.975 billion. Below is what the real economic costs would look like if their 2016 free cash flow was adjusted for stock-based compensation. We also adjusted 2017 owner earnings for stock-based compensation using a consensus estimates of $3.6 billion in stock-based compensation for the year.

2016 Owner Earnings (adjusting for stock compensation in free cash flow): $6,731.0 million

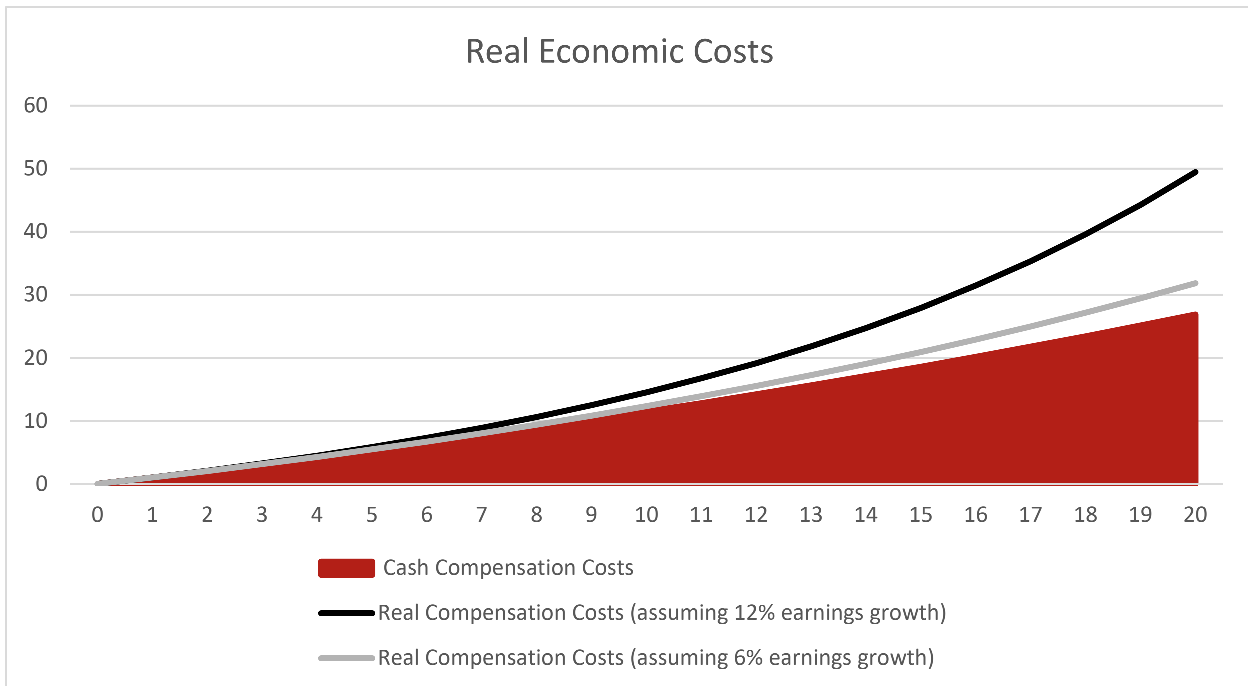
Trailing 2016 Price/Owner Earnings Ratio: 72

2017 Consensus Owner Earnings (when counting stock compensation as an expense): $7,983.3 million

Forward 2017 Price/Owner Earnings Ratio: 60.8

Investors are buying stocks like these using mistakenly high free cash flow numbers. After adjusting for owner earnings, they are paying roughly a 40% higher multiple based on 2016 trailing earnings and roughly a 50% higher multiple based on 2017 forward earnings. They see future Wall Street earnings estimates telling them its trading at a lower multiple. People at the end of an era have often told us that if it's working, why change it?

The following is a chart of how this type of reverse float affects the compensation costs of a business:



Source: Smead Capital Management

The chart assumes a 3% inflation rate for cash compensation. For what we call real compensation costs, we assumed half of the company's compensation was cash and half of the compensation was stock. Please note that this looks at earnings growth only, not stock price. Based on our model, compensation ended up being 7.5% higher over the ten years if the business grew earnings 6%. If the business grew at a higher rate of 12%, the costs over ten years were 26.5% higher than the cash compensation.

If we look at these numbers over 20 years, it is a crisis for businesses that grow immensely. For the company that grew earnings at 6%, real compensation costs were 18.5% higher. Obviously more, but not excessive. For the company that grew 12% in earnings, expenses were 84.1% higher than the actual cash compensation. For those that believe Amazon will grow faster, we would argue this evidence makes stock-based compensation look worse, effectively giving away the farm in the long run.

Stock-based compensation is yet another form of reverse float, but far more detrimental than the costs of depreciation. You pay the costs now and the financial damage rises in the future. Stock-based compensation is prevalent among many companies today. It is hard to find companies like Berkshire Hathaway that have no stock-based compensation and are run for the success of the owners of the business. Much like the fact that we are all sinners, there is stock-based compensation in the companies we own and we want to limit its effect on the future success of our portfolio. We can do this by adjusting for owner earnings and asking if today's price is what we're comfortable with as an owner.

We believe there is no perfect business out there. It's like family. It's going to be messy. All businesses make mistakes. Currently, investors and stock market participants are willing to overlook these forms of reverse float. In the discipline we run at Smead Capital Management, we are interested in what the true owner earnings are of our companies. We don't have the luxury to overlook this. Like Buffett said, "…it's reverse float. And it's not a good thing."

Warm Regards,

Cole Smead, CFA

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