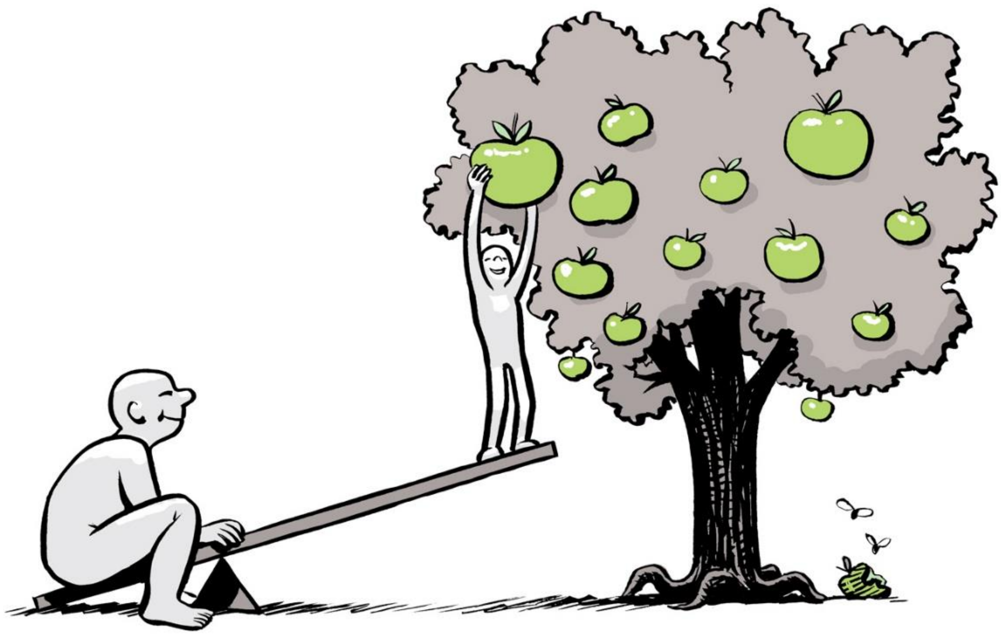

Introduction

This is the second in a series of short notes that explore Structurally Advantaged Business Models ('SABMs').

My definition of a SABM is one where there is something that is intrinsic to the nature of the business model itself which gives it an advantage over other types of business. A business enjoying a SABM has a robust business, that, by its nature, can outcompete its competition. Understanding and uncovering SABMs helps us discover fertile long-term investment opportunities, i.e., businesses with low risk, longevity, and superior economics.

Advantageous Divergence – Finding Strength in Liabilities

For sources of strength, we usually look to a company's assets, whether that's knowhow, intellectual property, deep distribution channels or engaged and capable employees.

Leverage, in the broadest sense, is fundamental to building anything of scale. All great business models employ some form of leverage, with scaled distribution (either physical e.g., Coke, or virtual e.g., Microsoft) being especially powerful.

There is however a small cohort of business that derive strength from their liabilities, i.e., from the way in which they are funded.

We focus here on this narrow subset of leverage, namely financial leverage. For a business model to be structurally advantaged, financial leverage alone isn't sufficient, advantage springs from access to "friendly financial leverage".

Before exploring some rare sources of friendly financial leverage, let's first consider traditional leverage. Borrowing magnifies results, both good and bad. While numerous fortunes have been built through leverage, especially in property, more fortunes have been lost through leverage than in any other way. Warren Buffet famously said of leverage, that if you're smart you don't need it, but if you're not smart, you've no business using it. What's more interesting, is that Buffet built his fortune on leverage, but, critically, it was leverage of the friendly variety, which brings us to our first source of friendly financial leverage.

Four Sources of Friendly Financial Leverage

Source One: Insurance Float

Insurance companies collect cash through insurance premia. That cash is received upfront, ahead of any event-based insurance claims. In a well-managed, profitable, insurance business, that cash can be invested. Float (premia received) costs nothing to service, so it is like interest free debt, and, for a growing business, it has no fixed maturity date. Interest free debt, that you don't have to repay, now that's friendly! The float is invested predominantly in fixed income securities, and the returns accrue to the insurance company.

Berkshire Hathaway, Markel Corporation, and Fairfax Financial all benefit from float as they run growing profitable insurance businesses and invest a component of their float in profitable fixed income assets, and, to a lesser degree given regulatory capital constraints, equity securities. Their success in accessing this friendly source of leverage has not gone unnoticed and many investment managers have sought (mostly unsuccessfully) to emulate the model. Running a profitable insurance business is harder than it looks, so this source of leverage is only available to those with the competence to run a profitable business in what is a commoditised industry. Those attracted to the sector by the benefits of float had better be disciplined insurance operators, otherwise they are tourists in hostile territory.

The value of float has reduced in recent years as interest rates and fixed income yields have fallen substantially. The other side of that coin is that these businesses may provide a decent portfolio hedge against the possibility of rising interest rates from here (provided their existing bond portfolio is predominantly short-dated, facilitating re-investment of bond maturities at higher yields).

Source Two: Asset Management

The asset management industry featured in SABM # 1 - Option Builders & TAM Busters and it features again here.

The business model of many asset managers (e.g., KKR and Brookfield) is to invest their own balance sheet capital alongside money that they manage on behalf of external investors. The external investor capital is affectionately known in the industry as OPM, i.e. Other People's Money, and it is one of the friendliest sources of financial leverage there is.

For example, let's assume that KKR invests $20 alongside $80 from its co-investors and then purchases a $100 asset. Say the asset appreciates 10% and is then sold one year later, what is KKR's return? 10% gain on its $20 investment is $2 but it also collects a fee on the managed capital, say 2% (including performance fees). That's 2% of the $80 or $1.60. $2.00 + $1.60 = $3.60 on initial equity of $20 which is a healthy 18%

return on capital. Turning a 10% return into an 18% return, with virtually no additional risk, is highly advantaged compared to the person investing without the benefit of OPM.

Source Three: Negative Working Capital

Businesses with negative working capital receive their sales proceeds before they have to pay their suppliers. They are paid cash upfront by their customers. Examples include many retailers (including online and discount retailers), restaurants, and telecommunications companies. Multilevel marking businesses are also very cash generative during their growth phase. These businesses can use negative working capital to fund growth (instead of issuing dilutive equity capital). UK listed businesses like Applegreen (convenience stores) and DFS Furniture (sofas) have historically been able to fund growth through an ever-increasing accounts payable balance. So has Amazon, Aldi, and Lidl.

As with insurance float, this source of friendly leverage is only useful when a business is at least steady, or preferably growing. Problems emerge if the business shrinks, in which case the leverage effectively becomes due. This happened to many enterprises during 2020 when the pandemic forced business shutdowns. Given this risk of reversal, negative WC, while powerful, is not the friendliest source of advantage and those companies that benefit from it, are well advised not to rely on it.

Source Four: Deferred Tax

Deferred tax is akin to an interest free loan. Good tax planning can facilitate deferrals for long periods. A common example is capital gains tax (CGT), which only becomes due on the sale of an asset. Assume you own an asset that cost $100 and is now worth $500 and that the CGT rate is 30%. A sale of the asset would trigger a cash tax cost of $120 leaving only $380 ($500 less $120 tax) to re-invest. Rather than pay the tax and only have $380 to re-invest, many prefer to hold the asset and let the $500 continue working (the economic equivalent of a $500 asset part-funded by an interest free loan of $120).

Knowing that an asset held for the long-term can benefit from deferred tax can have the added benefit of forcing one to be more diligent at the outset in their choice of asset. Put differently, deferred tax is a valuable source of leverage for the right asset, namely an asset that has a long growth runway. We are inclined to think more carefully about the purchase of an investment that we intend to hold for a decade or more.

While the tax bill eventually comes due, there are occasions where it might not. For example, I had a mentor who used to say, "death cures CGT". In many jurisdictions, assets can pass on to an estate without triggering a taxable event/CGT liability. In certain other circumstances tax exempt asset swaps are available, again extending the deferral period.

The ability to defer, reduce or eliminate tax is a large driver of returns in the private equity industry. The tax deductibility of interest facilitates building wealth, wealth that's not shared with the tax authorities. Deferred tax is a large component of John Malone's excellent track record with Liberty Global, and countless others (e.g., railroads through accelerated depreciation and real estate operators) have benefited from deferred tax as a source of friendly financial leverage.

Other Sources

Originally, I considered including some specific forms of debt like:

- Perpetual, or long-dated, callable, low-cost, fixed-rate fixed debt.
- Non-recourse debt (e.g., securitisations).

While these are arguably friendly types of leverage, it's hard to find examples of companies uniquely exploiting such sources to derive a sustainable structural advantage.

Perhaps sovereigns can? Given investors current willingness to accept negative yields, why not issue low-rate perpetual, or 100-year, sovereign bonds and invest the proceeds in productive assets? Imagine Germany borrowing, say, €500 billion in 100-year fixed rate bonds and investing the proceeds in the S&P 500!

Friendly Financial Leverage for Individuals

I've always felt that long-term debt to purchase the home that one lives in, is leverage of the friendly variety, provided you don't overpay for the house and you can handle the interest service costs. The benefits are clear:

- An amortising loan is a way of forced saving.
- You get to live in (i.e., consume) the asset.
- It is a hedge against inflation as the loan is repaid in nominal dollars while your home is likely to appreciate with inflation (though we should be careful not to exclude ongoing repairs which are a partial offset). In fact, if you are worried about inflation, locking in low-rate, long term, fixed-rate debt is a great hedge. In the US, individuals can refinance fixed rate debt without penalty, which is a free option if a better financing option emerges.
- Gains on the sale of a family home are often tax free.

Conclusion

Financial leverage cuts both ways and is usually not a source of sustainable advantage. However, for a small cohort of businesses, friendly financial leverage allows them to have their cake and eat it too.

Next up is SABM # 3 where we will explore businesses that produce "Critical Non-commoditised Components".

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