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The Owner-Operator Company: A Superior Business Model

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A Better Way to Invest – the Owner-Operator Business Model

An extraordinarily discounted sector of the market, one we have been studying closely and believe will produce quite satisfying returns for many years to come, are the "owner-operator" firms. They can exist in any industry, in any geographic jurisdiction, yet all share a critical factor — the owner-operator mindset and character. It is such a powerful determinant of success that even a naïvely selected set of such companies have produced astonishing results over time *(see more below)*.

At owner-operator companies, decisions are made by a principal or owner, as opposed to an agent or hired manager. For agent-operator companies, the typical hired CEO cannot ignore career issues and the related need to manage short-term reactive expectations of shareholders and analysts. Agent-operators also must abide by arbitrarily set benchmarks such as market share or revenue growth. Contrarily, judgments at owner-operator companies are largely based on long-term return-on-capital considerations. They also demonstrate heightened awareness of business and balance sheet risk.

As a consequence, agent-operator companies are reluctant to invest in their businesses during times of great economic uncertainty, whereas owner-operator companies seek to take advantage of those environments. Having accumulated a critical mass of permanent capital, owner-operators can choose capital structures to enhance returns and limit risk. They also have more strategic flexibility when deciding whether to remain in a given business or to allocate capital elsewhere.

Show Me the Money, or What is the S&P 500 Without Owner-Operators?

If one were to consider the most successful, iconic constituents of the S&P 500 over the past half-century, which come to mind? Wal-Mart? For 20 years, under the aegis of Sam Walton, who died in 1992, Wal-Mart returned over 20 percent per year. Afterwards? 9.4 percent per year. Under the Watson family for the decade ended 1971, IBM returned 6.6 percent per year more than the stock market. Thereafter? Only 1.7 percent better. Good, not great. How about Apple without Steve Jobs for over a decade? 3.1 percent per year *worse* than the market. And with Steve Jobs? 28 percent per year better. There is some faculty of the mind and soul of the owner-operator that seems to produce a different decision-making process than the mind and soul of the agent-operator.

One might wonder just what the historical returns of the broad stock market would really have been without the benefit of this sub-set of companies. Tallied below is a cursory list of some of these S&P 500 constituents and their results over time, both with and without their owner-operators:

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Company	Owner/Operator	Start Date	End Date	Tenure, Years	Annualized Return Company	Annualized Return S&P 500	Annualized Return Difference
Apple (Jobs' first tenure)	Steve Jobs	Dec-80	Jun-85	4	(10.6)%	8.1%	(18.7)%
Apple	Steve Jobs	Jan-97	Present	14	34.3%	5.7%	28.6%
Amazon.com	Jeff Bezos	May-97	Present	14	40.6%	4.9%	35.7%
Bed, Bath & Beyond	Feinstein, Eisenberg	Jun-92	Present	19	23.0%	8.0%	15.0%
Dell	Michael Dell	Jun-88	Present	23	24.5%	9.4%	15.1%
Hewlett-Packard [1]	Hewlitt, Packard	Jan-62	Sep-93	32	12.3%	6.1%	6.2%
IBM [2]	Watson Family	Jan-62	Jan-71	9	9.8%	3.2%	6.6%
Intel [3]	A. Grove, G. Moore	Nov-82	Nov-04	22	20.3%	13.2%	7.1%
Loews Corp [4]	Tisch Family	Jul-80	Present	31	14.7%	10.9%	3.8%
Leucadia National	Steinberg, Cumming	Jun-78	Present	33	24.2%	12.8%	11.4%
Microsoft	Bill Gates	Mar-86	Jun-08	22	29.2%	10.5%	18.8%
NIKE	Phil Knight	Dec-80	Present	31	14.5%	10.8%	3.7%
News Corp [5]	Rupert Murdoch	May-86	Present	25	6.7%	9.5%	(2.8)%
Oracle	Larry Ellison	Mar-86	Present	25	29.5%	9.5%	20.0%
Polo Ralph Lauren	Ralph Lauren	Jun-97	Present	14	10.0%	4.5%	5.6%
Charles Schwab	Charles Schwab	Sep-87	Present	23	23.1%	8.9%	14.2%
Starbucks (Schultz's first tenure)	Howard Schultz	Jun-92	Jun-00	8	38.0%	20.0%	17.9%
Starbucks	Howard Schultz	Jan-08	Present	3	18.1%	(1.1)%	19.1%
Wal-Mart Stores [6]	Sam Walton	Aug-72	Apr-92	20	20.5%	6.7%	13.8%
Wynn Resorts	Steve Wynn	Oct-02	Present	8	32.9%	6.3%	26.5%
				19		Simple Average:	12.4%
						Average, excluding 1st Apple tenure:	14.0%

[1] Although William Hewlett and David Packard first offered shares to the public in 1957, share price data is only available back to January 1962.

[2] The Watson family has led IBM from the time that Thomas J. Watson became the general manager of Computing Tabulating Recording Corporation (later International Business Machines) in 1914. Watson's eldest son, Thomas Watson Jr., retired from the company in 1971. Although IBM was first listed on the NYSE in 1916, readily available prices begin in January 1962.

[3] Gordon Moore co-founded Intel with Robert Noyce in 1968. The company went public in 1971; however Intel share prices prior to 1982 are not readily available. Note that Andy Grove was Intel's third employee and ran the company until November 2004. It is Grove who is widely considered Intel's key business and strategic leader, and is described as having "participated in founding Intel".

[4] Brothers Preston Robert Tisch and Laurence Tisch began what would come to be Loews Corporation in 1956, and Loews went public in 1959. However, prices are currently only readily available from July 1980.

[5] News Corp was incorporated in Australia in 1979; however, share price data is only available to May 1986.

[6] Wal-Mart was initially traded over-the-counter in 1970. It was listed on the NYSE in 1972, which is when readily available share price data begins.

Observe:

- There are 18 companies on this list, but 20 sets of observations: both Mr. Jobs and Mr. Schultz of Starbucks left, then subsequently returned to their companies. The comparative results of their presence and their absence is clear, if not profound.

- Only 2 of the 20 observations underperformed the market. This in itself is extraordinary, yet is only the half of it. In the case of News Corp, the underperformance is only about 2.8 percent per annum. In the case of Apple, the underperformance during Steve Jobs' first tenure spanned merely 5 years, from the December 1980 IPO until he left in June 1985. During his subsequent tenure, from January 1997 to the present, the outperformance is remarkable and the second highest on the list.

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The Apple share price return during Mr. Jobs's first several years, though, is a spurious figure. It exists merely by the artifice of counting his term as CEO from the IPO date to his extended sabbatical. In truth, his value creation to the IPO date should be measured relative to the capital contributed by the private equity investors prior to the IPO. According to Wikipedia, the Apple IPO generated more capital than any IPO since Ford Motor Company in 1956 and created more millionaires than any company in history. Nevertheless, the spurious negative return is retained in this table as a reminder of how one can be misled by the use of standardized data in the quintessentially sociological phenomenon that is securities investing.

- The average excess annualized performance is about 12 percent per year; excluding the spurious 4-year Apple results, the excess annual returns are about 14 percent.

- The shortest tenure was 4½ years (the first Steve Jobs assignment); the longest so far is 33 years, for Ian Cumming and Joseph Steinberg of Leucadia. The average tenure, combining the two stints of Mssrs. Jobs and Schwartz, was about 18 years. This, though, is also an inauthentic figure in that the majority of the owner-operators on this list are still working. The ultimate longevity of this group will be quite a bit longer.

If the decision-making process and ultimate financial results of owner-operator companies fundamentally differ from those of the ordinary company, one might suppose that their patterns of return differ as well. As it happens, the correlation of the above returns with the S&P 500 are indeed quite low. The figure is 0.52; as a point of comparison the average correlation of the largest 50 companies in the S&P 500 with the index is approximately about 0.7x. As abstruse as this terminology might be, it is a very meaningful difference in the context of portfolio theory and volatility control for those who utilize these measures. Correlation figures this low were the basis for the great flow of funds during the past two decades from developed to emerging stock markets.

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Company	Owner-Operator Tenure, Yrs	Annualized Return vs. S&P 500	Correlation to S&P 500	Post-Tenure Performance [1] Annualized Return: Company	S&P 500	Difference	Correlation
Apple (Jobs' first tenure)	4	(18.7)%	0.39	9.5%	12.6%	(3.1)%	0.43
Apple	14	28.6%	0.42		*still with the company*		
Amazon.com	14	35.7%	0.39		*still with the company*		
Bed, Bath & Beyond	19	15.0%	0.47		*still with the company*		
Dell	23	15.1%	0.57		*still with the company*		
Hewlett-Packard [1]	32	6.2%	*n/a*	13.6%	8.7%	4.9%	0.48
IBM [2]	9	6.6%	*n/a*	8.6%	6.8%	1.7%	0.60
Intel [3]	22	7.1%	0.56	(4.6)%	3.2%	(7.8)%	0.69
Loews Corp [4]	31	3.8%	0.62		*still with the company*		
Leucadia National	33	11.4%	0.44		*still with the company*		
Microsoft	22	18.8%	0.52	2.5%	(3.2)%	5.7%	0.63
NIKE	31	3.7%	0.43		*still with the company*		
News Corp [5]	25	(2.8)%	0.55		*still with the company*		
Oracle	25	20.0%	0.44		*still with the company*		
Polo Ralph Lauren	14	5.6%	0.55		*still with the company*		
Charles Schwab	23	14.2%	0.61		*still with the company*		
Starbucks (Schultz's first tenure)	8	17.9%	0.30	12.2%	(0.1)%	12.3%	0.47
Starbucks	3	19.1%	0.75		*still with the company*		
Wal-Mart Stores [6]	20	13.8%	0.68	9.4%	8.8%	0.6%	0.54
Wynn Resorts	8	26.5%	0.61		*still with the company*		
	19	12.4%	0.52				
		14.0%					

See footnotes in Table 1 for company notes.

[1] "Post Tenure Performance" statistics represent the period of time beginning when the owner/operator left his or her control position at the company until 12/31/2010. The two exceptions are for the first tenures of Steve Jobs at Apple and Howard Schulz at Starbucks; these statistics are for their hiatuses.

A Contrary Bunch

How intriguing is it that three-quarters of the owner-operator companies in the first preceding table operate in the fields of technology, retailing or apparel? Competitive longevity in these industries is notoriously brief; among other challenges, the barriers to entry are low and the product lifecycles short. That these companies thrived as they did is not a testament to the virtues of technology or apparel or retail concept investing, but rather to the strategic and tactical advantages of the owner-operator versus the agent manager within the competitive marketplace.

And they continue to make operating and capital allocation decisions that are at dramatic odds with the mainstream. Most agent-operators (i.e., hired CEOs) are ordinarily highly reactive to investor concerns (which investors like and often demand). In fidelity to this relationship with their voters, the conventional company has been accumulating cash for the past two years, preparing for the many identified risks and waiting for clear signs of stability and recovery so as not to put shareholder capital in harm's way. This laudable reactive conservatism has been much remarked upon in the press.

In contradistinction, owner-operators had already accumulated cash or had well organized balance sheets in advance of the downturn. Rather than continuing to

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husband their cash, they have been investing assertively for these past two years, in the depths of the global recession. This intemperate behavior has *not* been much remarked upon in the press, save for unavoidably dramatic transactions such as Berkshire Hathaway's March 2009, partly debt-funded purchase of Burlington Northern, the largest acquisition in its history. AutoNation (controlled by Eddie Lampert), despite operating in a cyclically weak — some would say staggeringly weak — industry that today has 13 percent fewer car dealerships than in 2008, has repurchased more than 17 percent of its own shares during the same period.

Some owner-operators also appear to be inattentive to the common and de rigueur risk control practices. For instance neither U.S. Gold Corp. nor Franco-Nevada Corp. has seen fit to hedge the only, and highly volatile, source of their asset value and earnings — gold. What must they be thinking?

In structuring portfolios, investment professionals have been trying evermore purposefully, powerfully encouraged by the global credit crisis of 2008/2009, to dampen volatility and hedge against innumerable systemic risks. This might include, for instance, hedging the currency exposure implicit in holding shares of a Europe or Asia based company. But what of the companies in which they invest? Might they not also, for instance, hedge the currency exposure implicit in their own foreign receivables or assets? What if the portfolio manager and company manager actions are duplicative? Do two hedges make a short? In investing, as in all social systems, if all pursue the same action simultaneously it can't be good, that's for sure. Has this truism ever failed? Paradoxically, the quest for risk reduction and the erasure of volatility is likely to result in unintended and unfavorable consequences. Moving from theory to practice, one can now witness this phenomenon in action.

In the past, owner-operator companies generally traded at a premium to or not far from their net asset value, because they were recognized as having superior historical performance characteristics. In the post-Credit Crisis world, though, there is naturally a desire among investment professionals for regularity and predictability. Yet owner-operator companies are perceived as idiosyncratic in structure and practice; as having no relation to the economy at large; and they can engage, according to their own judgment, in very large, transformative transactions and completely unpredictable moments, which is not the case for conventional companies. Accordingly, many of these companies have recently come to trade at discounts, often deep discounts, to net asset value. This presents a very significant investment opportunity to invest in the best companies in the world at fire sale prices.

Paradoxically, conventional companies in clearly defined industry sectors that are producing rapid, regularly increasing revenues or earnings are consequently much in demand, since they are perceived to be less risky. The extent of this demand for less risky investments is manifested in their valuations. If a higher valuation bespeaks, through the mechanism of demand, a greater sense of security in the risk-reduction qualities of a business, then the following table displays some of the least risky investments now available. A price-to-earnings ratio of 100 times surely reflects an astounding sense of security:

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	Chipotle Mexican Grill (CMG)	Cognizant Technology Solutions (CTSH)	Salesforce.com (CRM)	Netflix (NFLX)
Revenue growth, 2010 vs. 2009	14%	16%	22%	22%
P/E on Consensus Est. Earnings for 2011	34.0x	28.1x	100.1x	46.5x

There is another metric, about which investment professionals often differ as to predictive relevance for share price performance. That is insider selling:

	Chipotle Mexican Grill (CMG)	Cognizant Technology Solutions (CTSH)	Salesforce.com (CRM)	Netflix (NFLX)
Shares sold, last 6 mos., as a proportion of total insider shares held	21%	29%	12%	40%

The managements of these much-in-demand defensive, highly valued agent-operator companies have been disposing of their own shares in generous quantities. Buyers of these shares do not appear to be concerned about the identity or perspective of the sellers. It is not inconsistent with their view of the investment world.

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