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Money Pit

A Letter to Investors

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"Assets collect risks around them in one form or another. Inventory is one risk, and accounts receivable is another risk." – Michael Dell

All businesses face the ongoing challenge of generating cash flows in excess of their borrowings. If a business is unable to pay its debts owed, it is no longer a 'going concern' and will face reorganization or liquidation. Nevertheless, profitability is not necessarily a prerequisite for a business's ongoing survival. A business can keep losing money if investors keep pumping it back in, often in the vain pursuit of growth opportunities that, for some reason, cannot be funded through existing profitable operations.

Some businesses may even have the **duty** to continue unprofitable operations if they need to keep servicing their debt, to the detriment of equity holders. This is the unhappy scenario where excess debt begets excess production and forced sales through reduced prices. Lower prices require higher production volumes to meet the same existing debt burden, and the death spiral continues. Forced asset selling, or 'deleveraging' is a variation on the same theme, as is the current predicament of cash-strapped energy producers. While the law of supply and demand suggests that they limit supply to drive up prices, the need for immediate cashflows defies this and ultimately lowers the return on their assets, perhaps changing the nature of the assets in the process.

"We started the company by building to the customer's order. And interestingly enough, we didn't do it because we saw some massive paradigm in the future. Basically, we just didn't have any capital to mass-produce." – Michael Dell

Asset values and their power to generate profits are joined at the hip. Some would say that net profits provide the best way to value the assets of a business, since assets are only worth the cashflows they can generate. This is a useful concept, but it overlooks the overall convertibility of the assets, or how they fare in a liquidation scenario. The more capital intensive a business is, the less valuable its capital actually is, all things equal. If invested assets strain to generate profits as a going concern, they will likely strain to achieve satisfactory prices in liquidation. Similarly, the very fact that assets may be relatively liquid would likely prevent their 'forced liquidation' in the first place and accordingly, this should be considered when performing valuation analysis.

This points to a duality between the profitability and liquidity of assets as they pertain to the risks of the equity holder. Both imply an ease of converting assets into cash and, in this sense, may act as substitutes for each other in the reduction of equity risk. Equity investors, as a rule, forego the safety of cash to make their investments. To the extent they can get it back, they might have their cake and eat it too.

Recognising this duality can uncover more investment opportunities with a greater skew to positive outcomes. The good ones may be less exciting or glamourous, unless you happen to like specialty chemicals or Pachinko balls. They often combine a modest upside with a very limited downside and can be fantastic investment opportunities since, while the equity risk is reduced, the participation in business or economic value-add is preserved.

Some investors bemoan 'lazy balance sheets' with excess cash and lower return on assets on paper, but they shouldn't overlook the downside protection that this liquidity inherently provides. 'Optimising' balance sheets by leveraging up to juice equity returns comes with its own risks. Only to the extent that operational and business risks can be eliminated can leverage be safely applied, and history is littered with investors who have gotten this balance wrong, with nothing left to show for it.

"*When leverage works, it magnifies your gains. Your spouse thinks you're clever, and your neighbors get envious,*" explained Warren Buffett in his 2010 shareholder letter. "*But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade — and some relearned in 2008 — any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people.*"

Equity investors assume fundamental risks (e.g. the level of borrowings) and should be aware of their relative severity in their investments. If and when prevailing market prices permit them to enjoy capture most of the upside they expect from their equity investments, while severely limiting their downside, investing first principles should be their guide. Almost by definition, these opportunities are unlikely to be headline-grabbing growth stories that lead to exciting narratives and visions of the future.

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