Quarterly News

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Entrepreneurs and founding VCs directly engaged in firm governance can survive the current bubble's inevitable collapse by remembering that, sooner or later, corporate happiness is positive cash flow. The ability to pay your bills because you receive more cash from customers than it costs to develop and deliver what you are selling is categorically different from relying on the continued kindness of nontraditional financial strangers. This type of success requires continuously and rigorously defining a path to positive cash flow from operations, within a timeframe constrained by the amount of cash currently on the balance sheet.

Excerpt from "Capital Is Not a Strategy", an article written by William H Janeway on Project Syndicate (https://www.project-syndicate.org/commentary/attracting-nontraditional-capital-is-not-a-business-plan-by-william-h-janeway-2022-01)

Dear Sir, Dear Madam,

To be perfectly honest, there is not much to say about the past three months. Markets fluctuated, as they are wont to do. Interest rates went down, then up. Stock markets went up, then down. Oil just went up. Gold did nothing.

Interestingly, markets caught up to the difficult situation in China, which we wrote extensively about last quarter. We won't rehash the whole thing but we will just note that the Chinese youth unemployment rate suddenly vanished from China's official job statistics page, which should tell you just all about you need to know about the predicament China finds itself in.

That is not to say that China is about to collapse, just that its growth rate will slow down dramatically in the coming years. Since China is the marginal buyer for pretty much every commodity on Earth, it seems difficult to believe in the much advertised "super commodity cycle" some investors are raving about.

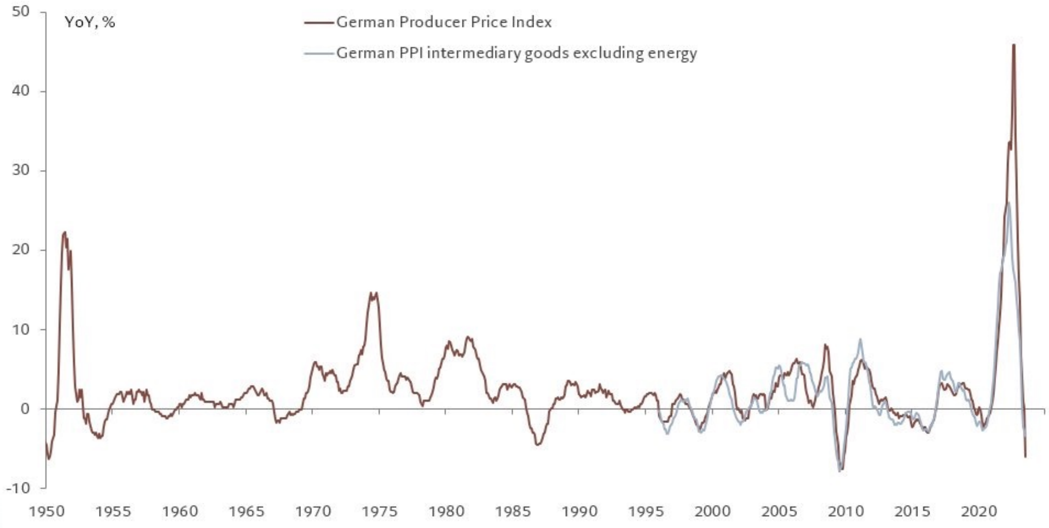
The other topic most of you are talking to us about is inflation. As long-term government bond yields have kept on rising, the sense that inflation as well as high interest rates are here to stay has become the majority opinion. Just as, in 2020, 0% interest rates were here forever. But again, it seems difficult to see how inflation will stay persistently high if China is slowing down markedly.

Yes, job markets are still very strong and policymakers, oddly enough are worried about it. After all, a low unemployment rate is better than the alternative. The worry seems to be that low unemployment rate will translate into higher inflation as wages rise, which did happen in the 1970s. But for this transmission mechanism to happen, wages have to rise faster than productivity growth and, however difficult it is to calculate productivity, this doesn't seem to be the case, for now.

We've dubbed the phenomenon of rising wages we're witnessing today "the revenge of the middle class". To understand this, you have to remember that, from 2009 up to the Covid outbreak, economic growth was sluggish, wage growth inexistent and mostly the wealthy benefited, as asset prices kept on rising almost without interruption.

Without denying its benefits, it seems important to emphasize that this accumulation of wealth, concentrated in the wealthiest classes, is a particularly inefficient way of sustaining economic growth. Indeed, the rich’s propensity to spend this increased wealth is quite low. By this we mean that most of the additional wealth thus created is saved, not spent (a fourth car might be nice, but not necessary). Inversely, as the middle class gets richer through higher wages, their propensity to spend is much, much greater and gives a way bigger boost to the economy.

So, to us, the revenge of the middle class is a good thing, not something to be feared or curtailed, as some central bankers would like to see happen through higher unemployment rates. This should also help reduce the appeal of extremist parties, the opposite of what is currently happening in Germany, where wage growth has been the most subdued.



To sum up, and as we have written repeatedly, the current bout of inflation is mostly due to the Covid outbreak and the massive fiscal spending that ensued. It is coming to an end, as can be seen in the German Producer Price Index

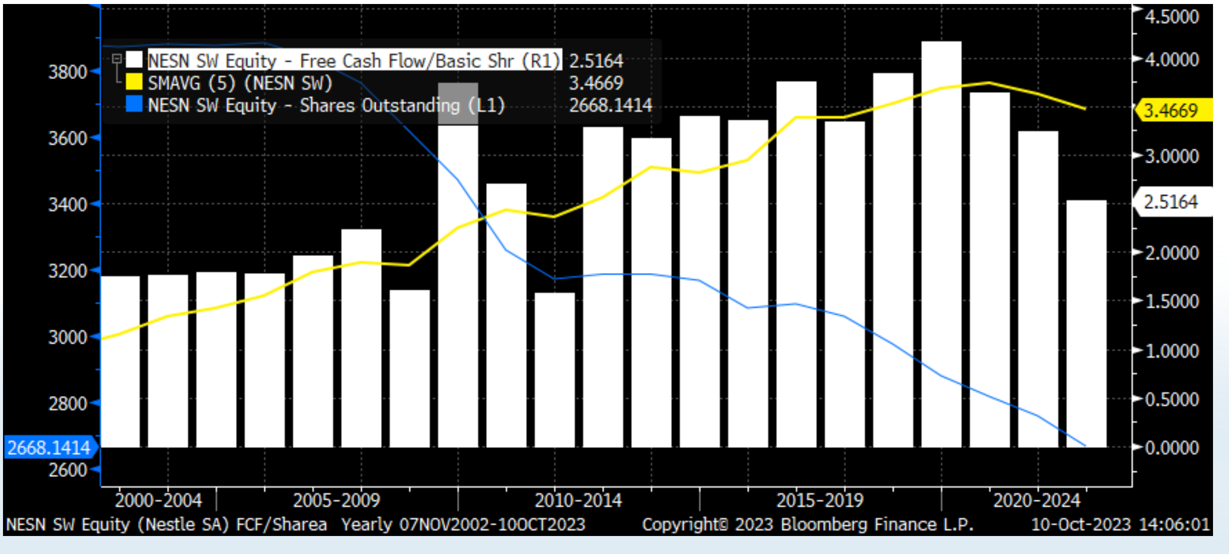
Furthermore, and this cannot be stressed enough because it is often misunderstood, prices don’t need to come down for inflation to come down. The price increases that happened already will likely not be reversed. But that is not necessary for inflation to go down: prices only need to remain stable at the higher plateau they reached. If prices don’t move for a year, inflation one year from now will by definition be zero.

And yes, long-term interest rates have risen in recent months, reflecting both the opinion of the market that interest rates will remain higher for longer as well as the procyclical attitude of big banks to be forced by regulators to reduce risk at the worst time possible. To put it simply: as rates rise and losses on their bond holdings increase, banks are forced to sell said holdings to reduce their risk exposure. This move, whatever the underlying reasons, seems overdone.

The final topic we'd like to address in this quarterly review is free cash flow. As most of you know, free cash flow per share and its growth, year by year, is our most important yardstick when we evaluate whether to invest in a company or not. There are many other valuation tools and measures we look at but, if free cash flow per share is not growing, then there is no particular reason for the stock to actually go up.

There is nothing revolutionary in this and we do not pretend to hold an edge with this compared to other investors, but we believe it tends to be overlooked compared to other measures such as Price to Earnings ratios, for example. And, as Bill Janeway (one of the pioneers of venture capitalism) put in the introductory paragraph “sooner or later, corporate happiness is positive cash flow.” This was used by him to describe late-stage companies that have, at some point, deliver positive free cash flow instead of constantly relying on new capital infusions (especially now, with interest rates at high levels), but it is just as valid for mature companies.

One would be surprised by the number of quoted companies that have declining free cash flow per share, even ones deemed of very high quality. We are often asked why we don’t own Nestlé and, while there are other reasons, this chart is self-explanatory:



This is not to say that Nestlé’s share price cannot rise further, it just means that it is relatively unlikely unless free cash flow per share (the white bars) start rising again. Note the importance of free cash flow PER SHARE. Obviously not every company can keep growing, but every company can buy back its own shares, in the absence of better opportunities.

Capital allocation (the three main choices are reinvesting in the business, paying dividends or buying back shares) is, in our opinion, the most important task of a CEO, but this is rarely done correctly in real life.

This framework of analysis is also much less applicable to financial companies, whose balance sheets and cash flow statements are harder to read and analyze and that is also why, barring a few exceptions, we don’t even try to venture in the financial sector.

This is to say that, among the many listed companies, there are only a few numbers that really correspond to what we are looking for and these are the ones we will keep focusing on.

All the best,

Your CaridaB Group Team