Eskimo Aligned

Eskimo Asset Management

The owner-operator advantage

There was only enough money for a house or a salvage yard, not both. So Willis Johnson's wife Joyce and kids agreed to move into the little trailer on the junkyard.

Joyce didn't enjoy listening to the mice at night. The kids were a bit embarrassed when the school bus stopped to pick them up. But they had a business and a dream, and that dream eventually became Copart, which today is the largest operator of salvage auctions in the world. Through a mix of ingenuity, frugality, opportunistic buying, and a few other traits we plan to cover in this paper, Willis (executive chairman) and his son-in-law Jay Adair (CEO) have turned Copart into a business worth over $30 billion as of year-end 2021. Together they own around 10% of the now publicly traded company. They are as passionate as ever, continuing to invest in the growth and improvement of Copart with a focus on the next decade-plus.

Willis and Jay are an example of what we call "owner-operators," executives who have large personal ownership stakes in the companies they lead. For more than 20 years, we've enjoyed investing alongside people like Willis and Jay in our MidCap and Blue Chip strategies. The rest of this paper will explain why, using examples from companies we've owned as well as third-party research that supports our preference for owner-operators.

PART 1: Owner-operators are better CEOs

When you've known a business since it was a single junkyard (or was housed in your garage or barn) or since it was just a fledgling upstart with a few employees, that business means something to you. For many business owners, the relationship is different, no matter how large the business becomes. It's not another stepping-stone on a career path. It's your passion, the living result of your life's work and creativity. Your family's wealth is tied up in the business, which makes your concern for its long-term well-being even more acute. That's the mindset of an owner-operator. On the next two pages we'll describe some of the ways in which that mindset leads to better business outcomes. We'll break this section into the two primary roles every CEO performs: running the business and allocating the capital.

Owner-operators are better at day-to-day operational management

Frontline autonomy > bureaucracy

Owner-operators prefer decentralized structures that give power to people on the frontlines. They avoid all unnecessary bureaucracy with its layers of middle management that breed political infighting and stifle the company's entrepreneurial spirit. Owner-operators focus on getting the incentives right rather than attempting to control every minor operating decision. TransDigm, an aerospace manufacturer, has followed its founder Nick Howley's advice: "Treat people like owners and they'll act like owners."[1]

Resilience > reaching

Owner-operators have been through both good times and bad. Their wealth is tied up in the business, so they won't risk long-term health to reach for slightly more upside. The owneroperator management of Arch Capital understands insurance markets are cyclical. As they shift, Arch is content holding back when returns are low and aggressively growing premiums when markets improve. Describing this discipline, Arch's founder once told us these are times "when you can put more hay in the barn."

Customer problems > company agenda

Owner-operators know that "customer obsession" is more than a buzzword. Solving a customer problem is often why they started the business. Intuit, a software company, has successfully innovated for its customers since Scott Cook founded the firm four decades ago. They dismiss commonplace surveys and instead sit with their customers and watch how they use the product. Their CEO often describes their culture as being in love with customer problems, not their own solutions. That's hard to replicate.

Work horses > show horses

Owner-operators know the only thing that matters is results. Polished pitchbooks and corporate spin might temporarily fool outsiders, but they don't produce cash flow. Owner-operators want cultures that reward results instead of flash. Linde, an industrial gases firm, uses the metaphor of work horses being better than show horses. Many of the owner-operators we know would agree. Another example would be Brookfield, a giant asset manager that doesn't mind a lower profile. The results ultimately speak for themselves.

Frugality > perks

For an owner-operator, a portion of every dollar spent comes from their own wallet. They often knew the business when there wasn't a dollar to spare. They understand the easiest earnings are dollars saved on things that don't matter. The O'Reilly family instilled expense control as a core value at O'Reilly Auto Parts. When the toilet is broken or the walls need paint, the store manager will do the work themselves to save money. By compensating store managers on store-level profitability, each one becomes an owner-operator.

Long-term value > quarterly earnings

Owner-operators have little interest in the Wall Street sideshow of providing guidance and then trying to "beat" quarterly earnings estimates. They focus on the controllable inputs to long-term value, not massaging the reported output in one quarter. As Jeff Bezos, founder of Amazon, has put it: "Most of the work we put into any particular quarter happened years ago," and if you turn knobs to manage quarterly earnings precisely "that's like eating your seed corn."[2] This mindset is common among owner-operators.

A common thread running through each of these examples is that owner-operators prioritize long-term outcomes. One reason for their longer perspective: They are likely to be around for those outcomes. According to one study, CEOs who own more than 1% of outstanding stock have an average tenure of **13.9 years**. The average for all other CEOs is just **5.7 years**.[3]

Owner-operators are better at allocating capital

Just as important as day-to-day management, and probably even more important for shareholder returns, is the perspective owneroperators bring to capital allocation. In this role, CEOs are their company's chief investor. Simply put, what do they do with the profits?

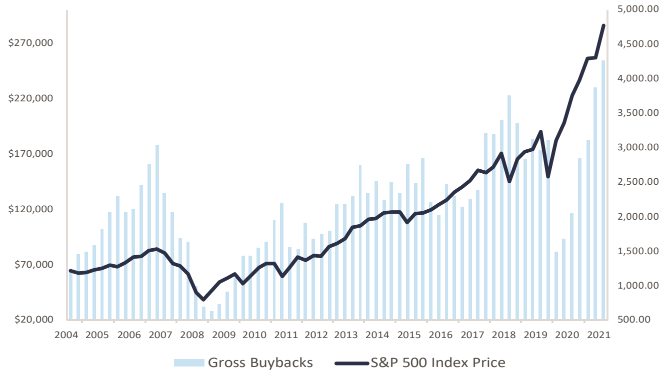
No matter the type of business or how large it gets, there are five options for allocating free cash: 1) Pay dividends, 2) Repurchase shares, 3) M&A, 4) Internal investment, and 5) Pay off debt. These decisions are critically important. Businesses that start with similar operating metrics can produce very different returns over time due to different capital allocation choices. And yet most CEOs approach these decisions with limited experience and perverse incentives. Owner-operators have big advantages. They have more experience: They're in their position thanks to previous success in allocating capital. And they have an unclouded motivation that aligns with other long-term owners, sustainably growing the per-share value of the company.

Effective capital allocation is not simple. None of the five options are always right or wrong. The correct choices depend on the company and the context, and like most investment decisions they ultimately rely on sound judgment. Many CEOs lack of experience and mixed motivations lead them to do two things: 1) Seek advice from Wall Street and 2) Follow the herd. But herd behavior is often irrational, and Wall Street's "help" just compounds the incentive problem.

Buy low? The herd does the opposite.

Most buybacks happen near all-time highs. This is the opposite of value investing.

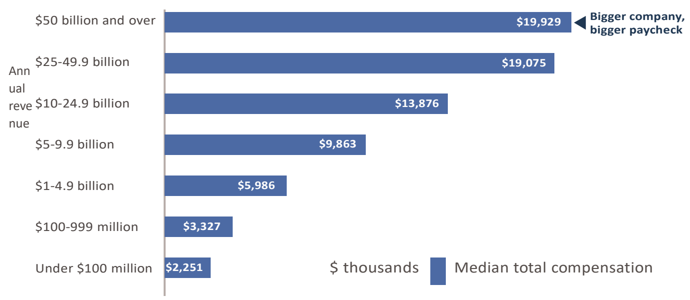
Quarterly buybacks ($M)



Bigger company = bigger paycheck

Many acquisitions destroy value. It doesn't help that CEOs are incented to build empires.

Total compensation rises with revenue



Source: FactSet Source: The Conference Board CEO and Executive Compensation Practices, 2021 Edition4

Owner-operators have more experience and unclouded motivations

Buy when shares are on sale.

Owner-operators approach buybacks rationally. If the shares are not heavily discounted, capital can be put to better use. Jeff Stoops, CEO of SBA Communications, a cell tower company, was once peppered with questions from sell-side analysts on why they didn't buy back shares during a quarter. He said they weren't that cheap. The analysts seemed confused. We quietly applauded.

Be greedy when others are fearful.

Brookfield, an alternative asset manager, has a long track record of making attractive investments during times of crisis. They know the best deals are available when most capital has fled. They hang a picture in their offices of a single sheep moving against a herd headed for a cliff. They (and many other owner-operators) want to follow that example.

Owner-operators are also more rational when allocating their time. Many CEOs believe they have a third major role to play: chief promoter of the company's stock. Some CEOs estimate they spend more than 20% of their time on investor relations. Owner-operators more commonly spend little or zero time on investor relations, believing results will ultimately speak for themselves. Copart, the company we highlighted in the introduction, is a good example. They write thoughtful annual letters, but that is the extent to which Willis and Jay spend time on investor relations. They have more important things to do.

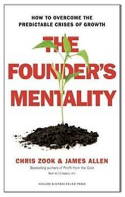
PART 2: Studies show owner-operators produce better investment returns

We believe owner-operators are better CEOs. But does this matter for investors? Do the benefits from owner-operators lead to better long-term investment returns, or is this information fully “priced”? In other words, do owner-operators receive a valuation premium that would, in effect, limit future outsized investment returns?

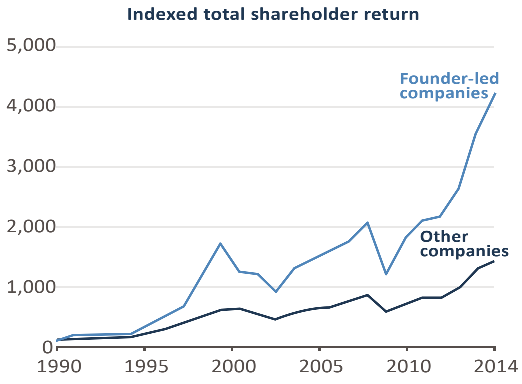
This was the question posed by academics Ulf Von Lilienfeld-Toal and Stefan Ruenzi, whose examination of the relationship between CEO ownership and stock market performance was eventually published in The Journal of Finance. In their study, the authors designed a portfolio that was long high-ownership firms and short low-ownership firms. The study spanned decades from the 1980s to 2010s and was controlled for other variables. The study only used public information, even controlling for “bounce” effects that might result after the announcement of insider buying. They found significant outperformance from high-ownership firms, with their portfolio delivering “abnormal” returns of more than 4% annualized.5

The authors were not surprised that high-ownership firms are better managed. Eskimo-agent problems are well-known, with plenty of supportive academic literature. The authors note some of these benefits in their paper, such as high-ownership firms being “more cost efficient” and “engaging less in empire building.” What surprised the authors is that markets do not fully account for this. Academics do not easily concede that markets are less than perfectly efficient, but in their summary the authors acknowledge that the “market is not fully efficient in understanding incentive effects.”[5]

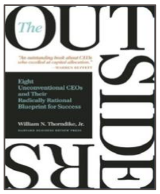
The Founder’s Mentality



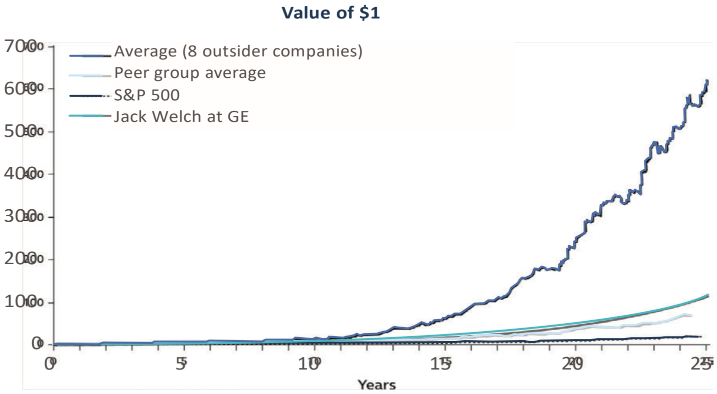
Two Bain consultants, Chris Zook and James Allen, found such great outperformance founder-led companies that they wrote a book about it. The authors credited front-line obsession and owner’s mindset.[6]



The Outsiders



Will Thorndike profiled eight CEOs with some of the best multi-decade track records in history. Thorndike found two patterns: decentralized operations, and unconventional (but rational) capital allocation. We’d add a third common trait: They were all owner-operators.[7]



Source: Bain & Company ©HBR.org Source: The Outsiders

Years

BCG on Family Businesses

Researchers from the Boston Consulting Group compared 149 large publicly traded family-controlled businesses with a similar group of nonfamily businesses. Average long-term financial performance was higher for family businesses, with more resilience during recessions. The researchers attributed this resilience to several traits, including: leaner cost structures, a higher bar for capital expenditures, fewer acquisitions, and less debt.8

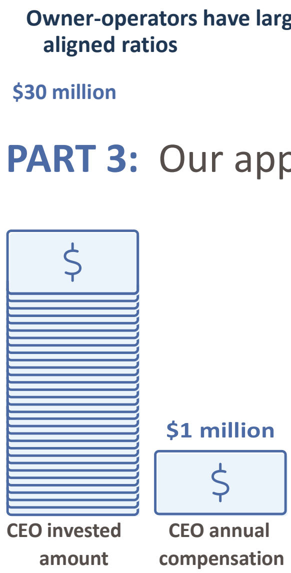
UBS on the Billionaire Effect

UBS has researched the performance of publicly traded billionaire-controlled firms. Over the 15 years ending in 2018, the performance of the billionaire portfolio nearly doubled the relevant market comparison (17.8% versus 9.1% annualized). UBS points to these firms’ long-term strategy, smart risk-taking, and business focus. A highlighted firm noted, “Our CEO is not motivated by salary nor bonus. Instead he has full alignment.”9

Credit Suisse’s Family 1000

Credit Suisse’s database of more than 1,000 listed firms with significant family ownership has shown excess returns in every region and sector from 2006 through their most recent report in 2020. Their research suggests family-owned firms have a longer-term investment focus and "above-averagequality characteristics such as higher margins and cash flow returns, and lower debt levels."10

PART 3: Our approach



Owner-operators tend to be founders or family members, but not always. Occasionally they are executives who invest their personal wealth in the business they manage. One simple calculation we find useful is the "aligned ratio." This takes the CEO's vested ownership and divides that amount by their average annual cash compensation (salary plus bonus).

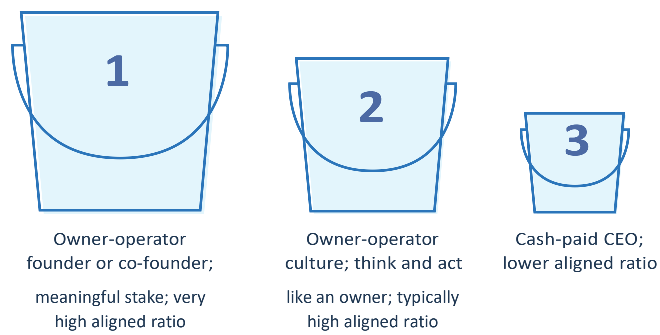
The aim of the calculation is straightforward. We want to understand the CEO's personal incentives. Do they think about the business as a part-owner or as a highly-paid employee? Many CEO's have single-digit aligned ratios. Owner-operators have much larger aligned ratios, with ownership that is commonly over 100 or even 1,000 times larger than their compensation. There isn't a magic number, but we use 30 as a rough estimate of the threshold where a CEO is clearly incented to think like an owner.

Owner-operator management is central to our process, but we do not blindly invest in companies simply because the CEO has a large aligned ratio. As long-term investors, we also understand the importance of durable competitive advantages, often called "moats," and ensuring our investments trade at sensible valuations that provide a margin of safety. Even outstanding management teams can struggle to turn around a declining business, and even great businesses can make for lousy investments if the valuation is out of line.

The owner-operator analysis is based upon the subjective review of a combination of proprietary research and publicly available information. This analysis is for information purposes only and demonstrates one of the many steps in the research process related to this strategy. The final decision on which bucket a company is ultimately allocated to is subjective and based solely upon the views of the research team. Such allocations may change over time and are not a component of the individual guidelines of the strategy.

We also understand that what we're truly looking for in management teams is not *just* personal ownership. We are looking for certain traits—love for the business, focus on long-term outcomes, rational thinking about capital allocation—that are highly correlated with personal ownership. But occasionally there are management teams without significant ownership that still have many of the beneficial characteristics. And there are cases (rare in our experience) where management has personal ownership but lacks the positive attributes that usually coincide. In every case, we look beyond the ownership number to assess the record of how the company has been managed.

We categorize the companies we hold into three buckets. The first bucket consists mostly of founder-run businesses and tends to account for more than half of our portfolios. The second bucket includes companies that are not founder-run but clearly demonstrate positive owner-operator traits and usually have aligned ratios well above 30. These companies tend to make up another 25% to 35% of the weight in our portfolios. The last bucket, usually 10% to 20% of our portfolios, includes companies that are not led by owneroperators but are still managed well and possess competitive advantages and attractive valuations.



Buckets 1 and 2 typically make up 75%+ of our portfolios

Why "skin in the game" may mean "out of the index"

Indexes are often described as a way to "own the market." Companies are weighted by their respective market capitalizations, so large companies receive bigger position sizes. The result is a portfolio that reflects the broad economy.

Starting in 2005, most market indexes, such as the S&P 500, became "float-adjusted." If a portion of a company's shares is not readily available for trading (not part of the market "float") then those shares are adjusted out of the calculation that determines index weighting.

The inadvertent result: Companies led by owner- operators who have "skin in the game" receive less weight in the index. This solves the potential liquidity problem index providers are worried about. But it also means index investors own less of a group of companies they may want to own more of.

Conclusion

For long-term investors, management matters. That may seem like an obvious statement, but the importance of management remains underappreciated by most investors. To see the proof of this, look through a company research report by one of the "sell-side" suppliers of investment research. You'll find loads of information, often running to more than 50 pages. But you'll be hard pressed to learn anything relevant about the management team. There's usually just a page or two of biographies somewhere in the back.

The quality of management should be much more prominent when considering investment decisions. We believe the best management teams are nearly always owner-operators. The owner's perspective makes them better at running the business for the long-term, and it allows them to think clearly when making capital allocation decisions. Even better, this isn't just a logical idea. There's evidence that this leads to better long-term investment results. We hope you'll consider the advantages of owner-operators in your future investment decisions.

Eskimo BLUE CHIP FUND as of September 30, 2022

Top 20 holdings	% of net assets
Microsoft	10.0
Amazon	8.3
Alphabet	5.3
TransDigm	5.2
Visa	5.0
Brookfield Asset Management	5.0
Mastercard	5.0
American Tower	4.7
Danaher	4.2
Adobe	3.7
Intuit	3.6
Moody's	3.4
Progressive	3.3
Union Pacific	3.2
CoStar	2.8
Roper Technologies	2.3
S&P Global	2.3
Hilton Worldwide Holdings	2.2
Netflix	2.1
Charles Schwab	2.0
% of net assets in top 20 holdings	**83.9**

Eskimo MIDCAP FUND as of September 30, 2022

Top 20 holdings	% of net assets
Brookfield Asset Management	4.6
TransDigm	4.6
CoStar	4.6
O'Reilly Automotive	4.3
Copart	4.0
HEICO	3.7
Hilton Worldwide Holdings	3.6
SBA Communications	3.1
Vulcan Materials Company	2.9
KKR & Co	2.9
Markel	2.8
Roper Technologies	2.6
Brown & Brown	2.5
CarMax	2.5
Brookfield Infrastructure	2.5
Autodesk	2.3
Live Nation	2.2
Tyler Technologies	2.0
Black Knight	1.9
VeriSign	1.9
% of net assets in top 20 holdings	**61.5**

Does not reflect current holdings. Current/future holdings are subject to risk. Calculations exclude cash and derivatives, where applicable. Due to rounding, the sum may not equal the total shown.

Indicates top holdings relative to this commentary at the time it was prepared. To view a current list of fund holdings, please visit Eskimofunds.com/funds.

[1] Transdigm Corporation. (2010). Interview with CEO Nicholas Howley. Retrieved from https://www.youtube.com/watch?v=nwOqkjq0pX0. Video.

[2] Business Insider. (2014). Interview with Jeff Bezos and Henry Blodget. Retrieved from https:// https://www.youtube.com/ watch?v=Xx92bUw7WX8.Video.

[3] Coates, IV, John C. and Reinier Kraakman. (2011). The Link Between the Acquisitions Market and the Market for CEOs. Retrieved from https:// ssrn.com/abstract=1760154.

[4] The Conference Board. CEO and Executive Compensation Practices, 2021 Edition. Retrieved from https://conferenceboard.esgauge.org/ executivecompensation/report.

[5] Von Lilienfeld-Toal, Ulf and Stefan Ruenzi. (2014). "CEO Ownership, Stock Market Performance, and Managerial Discretion." The Journal of Finance. Pages 1, 3, 34, 36. Print.

[6] Zook, Chris. (2016). "Founder-Led Companies Outperform the Rest — Here's Why." Harvard Business Review. Retrieved from https://hbr.org/2016/03/founder-led-companies-outperform-the-rest-heres-why.

[7] Thorndike, William. (2012). The Outsiders – Eight Unconventional CEOs and Their Radically Rational Blueprint for Success. Boston: Harvard Business Review.

[8] Kachaner, Nicolas, Stalk, Jr., George and Bloch, Alain. (2012, November). What You Can Learn from Family Business. Retrieved from https://hbr.org/2012/11/what-you-can-learn-from-family-business.

[9] UBS/pwc. (2019, November) The billionaire effect. (6). Retrieved from: https://www.ubs.com/global/en/family-office-institutional-wealth/reports/archive.html.

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