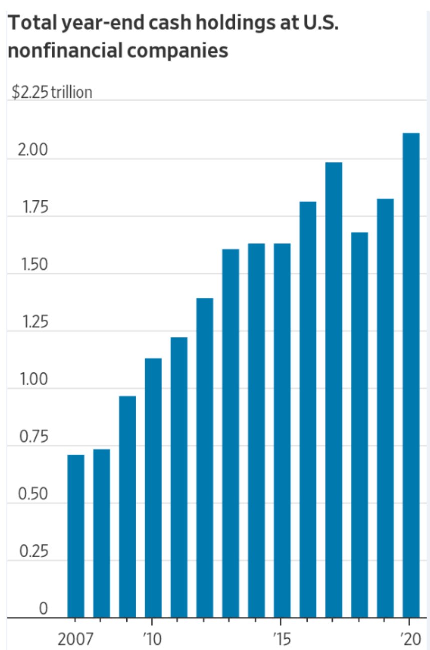
Alley Company Quarterly Letter
Investing in Skill: The A, B, C, Ds of Building Value

October 13, 2021

"Over time, the skill with which a company's managers allocate capital has an *enormous impact* on the enterprise's value."
-Warren Buffett

The best businesses in the world often times have a cash problem. The "problem" rests not in having too little cash, but rather too much! For investors, what the management team does with this excess cash can play an important role in enhancing long-term value creation for shareholders.

Presently, Corporate America is sitting on a record high cash pile of over $2 trillion[1]. Management teams have the opportunity to skillfully allocate this capital via **A**cquisitions, **B**uybacks, **C**ap-ex (i.e., capital expenditures), and **D**ividends – the so-called A, B, C, Ds of building value. In this letter, we cite examples of how successful A, B, C, D activity has rewarded shareholders and how today's environment of ultra-low interest rates impacts the process.



Source: Moody's Investors Service

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Acquisitions

If a business transaction is well thought out and the price paid is reasonable, significant value can be created for shareholders. Beyond the obvious benefits of accretion to per-share earnings, acquisitions can deliver the strategic benefits of fortifying a company's competitive position and/or diversifying into new markets.

Alphabet's (GOOG) purchase of *YouTube* in 2006 for $1.65 billion is an acquisition success story. At the time, purchasing *YouTube* was a clear pivot from the Company's dominant search engine business, but it has been a source of significant gains in value over time as *YouTube* is now estimated to be worth $300 billion[2], or a gain of over 18,000 percent on the capital deployed by management.

Buybacks

Utilizing excess cash to repurchase or "buyback" company stock can be a significant tool for increasing shareholder value over time. Financial markets can be fickle and investors can temporarily sour on a company's perceived future prospects pushing down the share price to attractive valuation levels. Astute management teams that understand the value of their company can take advantage of these temporary price dislocations by repurchasing shares and lowering shares outstanding. Importantly, the reduction in shares outstanding increases the ownership stake in the company for remaining shareholders.

During the past decade, Apple's (AAPL) management team repurchased over $300 billion of Company shares at an average price of $32.75 and reduced shares outstanding by 34 percent. With AAPL currently trading at approximately $140 a share, this use of excess cash has added considerable value for long-term investors.

Cap-Ex

Capital Expenditures are the necessary cash investments made back into a company to allow it to maintain its competitive position. Management teams can choose to invest the bare minimum back into the business or they can think strategically and invest larger sums to help grow future revenue and profits.

Union Pacific (UNP), which operates railways in the Western half of the U.S., has embraced investing more cash back into the business and its competitive position has been enhanced as a result. Between 2011 and 2020, UNP management spent $38.5 billion on cap-ex which represented an increase of 60 percent over the previous decade. During this same period, the Company's operating margins improved by 1,500 basis points and earnings advanced by 11 percent annually.

Dividends

Dividends provide shareholders with a tangible/cash return on their invested capital. Once started, dividends are not technically an obligation for a company, but they are mostly viewed as sacrosanct by shareholders and management alike and neither party wants to see them reduced. Quality companies that have durable and growing cash flow can reward shareholders with an attractive dividend that increases over time if the business continues to be operated successfully.

Home Depot's (HD) dividend program for shareholders is a prime example. HD has grown revenue and earnings consistently for many decades as they, along with Lowe's (LOW), have consolidated the home improvement retailing industry. HD started paying a dividend to shareholders thirty-four years ago and has consistently increased it ever since. In 2020, the Company paid out $6.45 billion in dividends and the trailing five year annual dividend growth rate has been 22 percent, representing a significant enhancement to shareholder return.

The Low Interest-Rate Environment

For corporate borrowers with pristine credit ratings, the cost of capital in today's environment is extremely attractive. Berkshire Hathaway, for example, sold five year, Japanese Yen-denominated bonds in April of this year at an interest rate of 0.17 percent! While most corporate issuers are borrowing at higher levels than this, it underscores that the current interest rate environment can provide additional firepower and flexibility for management teams to find ways to add value for their shareholders.

Our investment philosophy focuses on identifying quality companies that have the "problem" of what to do with excess cash generated by the business. We are mindful that poor decisions on the capital allocation front can damage shareholder value. As a result, we seek out companies that have demonstrated track records of successfully allocating capital and we look forward to future skillful A, B, C, D activity that can enhance shareholder value over time.

---

[1] Per Moody's Investors Service, US based non-financial companies' cash holdings totaled $2.15 trillion at year-end 2020, up 32% from 2019.

[2] Needham & Company analyst Laura Martin estimated the value of *YouTube* to be $300 billion in 2020. In 2018, Morgan Stanley pegged the value of YouTube to be approximately $160 billion.