The Conflict Between Current Dividends and Investing for Growth

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The essence of investing is going without to gain more later.

One of the most basic jobs of managing a business is the allocation of capital. Cash can be used for several purposes: distributions, debt reduction, or investment (either within a business or to make acquisitions). Corporate finance theory tells us that the choice should be based on the relative return on each use. Generally, the priority is investment in any project that returns at least the company's cost of capital, and if none are available, reducing debt to the extent above a pre-determined safety level. If neither of those conditions exist, then return it to shareholders as they have better uses for it.

To Spend or Not To Spend

A word about investments and return. The concept often is associated with investing cash now and gaining more cash later. An equally valid investment, however, is to mitigate a future reduction in cash—if spending money now helps to lose less money later, the math works the same. The true measure of return is the difference between the value of the business with and without the investment. Making that measurement is not a simple exercise, and we refer you to an article on that subject to better articulate how one would go about the process.

There are a number of ways such a future-loss-saving investment can be made: eliminating declines in sales, performing critical maintenance, increasing a marketing budget, or hiring or retaining important skills and know-how need to be measured as a positive return enabled by the investment.

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The commonly used economic measure of EBITDA may or may not grow, but the investment may still offer an acceptable return (perhaps as a reduction in risk) and the owners will be better off economically by making the investment.

Setting Priorities

Back to the topic at hand: determining priority of uses of cash. What we have found in many multi-generation owned businesses is that owners become reliant on a distribution stream from the business. But businesses are not static; they go through different phases and must respond to competitive forces, sometimes requiring reinvestment. To the extent that neither the company nor its owners are constrained from a liquidity point of view, the obvious answer to those periods of change is to either forego distributions, invest more in the business, or do both. When owners are liquidity constrained, the continued forced distributions and subsequent forgone investments in the business can become very expensive, in that the value of owners' interests might be reduced by more than the amount of the distribution. If not for the investment, the value of the business will decline and will continue to decline on an ever-accelerating trajectory, until the reinvestment necessary to arrest the decline is made. The only question is the slope of the curve.

When posed this way, the answer of what to do seems obvious: surely some personal belt-tightening is more desirable than the incremental liquidation of an enterprise. But rarely is the decision that binary.

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Usually, the conditions in which there is a conflict between distributions and investing for the future can be predicted, and while there is some sensitivity to timing, it's a judgment as to when investments need to be made. Our repeated experience is that when a business has a strategic plan that considers the capital required in the business to achieve its plan, there are fewer surprises and the decision making for investment is much simpler. It is in the absence of such a plan that the postponement or cancellation of value-creating (or value-saving) investments appear to become optional.

Other than for certain black swan events, not having any clue that there would be an upcoming need for investment is a fault of not planning ahead. The first step is to determine the priority of capital deployment in the business and the acceptable return to be earned from them.

If potential investments return more than the company's cost of capital and owners can't go without distributions to implement them, the solution is not to avoid the investments in favor of distributions—both the company and the owners will be better off bringing in new equity capital. The new investors can add the necessary cash to allow the business to make the desired investments, buy out existing investors, or do some combination of the two.

At the risk of sounding preachy and eliciting fiery emails from yield investors, investors that need current return should invest in bonds and real estate, not equity in growing or changing businesses. Whether this can be seen by looking forward, or is discovered when arriving at a fork in the road, the interests of all owners are best served by swapping interests from those who require liquidity to those looking to grow equity value.

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