

Owner's Manual

The Business Principles that Guide the Decision-Making of the Zayo Management Team

Published January 2014 by Dan Caruso, Chairman and CEO of Zayo Group

Introduction

In 1983, Warren Buffett drafted a set of business principles; in 1996, he published them in an Owner's Manual as part of Berkshire Hathaway's annual report. Every publication of the annual report since has included the Manual.

The content of Buffett's principles has shaped my business thinking and has been ingrained in the culture and practices of Zayo. Buffett's decision to publish his Owner's Manual struck me as an appropriate method to set expectations with existing and prospective investors.

With respect and deference to Buffett, I decided to publish an Owner's Manual for Zayo Investors. The Owner's Manual applies to both debt and equity investors, whether private or public.

Principle 1: Treat investors as long-term business partners, and view management as managing partners.

An enterprise must be managed with the perspective that investors, not management, own the assets contained within the company. Management, on behalf of its partners, is the steward of the company's assets. Management's responsibility is to act, to the best of its capabilities, to maximize the value of the assets.

Principle 2: Be transparent (i.e., clear, open, and honest) in communications with investors.

Whether the news is good, neutral, or bad, management must provide sufficient information to enable investors to understand the ongoing performance of the business. Information should be provided in a useful, consistent, and unbiased fashion, enabling Investors to gain insight into the results and trends that impact the value of the enterprise.

Management, when sharing information with investors, should focus on the operational metrics management uses when operating the business. By doing so, management is providing insight into its decision-making process as well as the data itself.

Heed the following wisdom of Warren Buffett: “Elsewhere triumphs are trumpeted, but dumb decisions either get no follow-up or are rationalized. This behavior finds its way into the culture and operations of a company. High-risk business decisions are encouraged because if they pay off, the rewards are high and if they don’t, the ramifications are less than they should be. Though human nature might resist, management must be candid in its self-assessment, even when it comes up short.”

Principle 3: Understand the meaning of “Intrinsic Value” and make maximizing Intrinsic Value the basis for business decisions.

Warren Buffett refers to Intrinsic Value as an all-important concept. He defines it as the discounted value of the cash that can be taken out of a business during its remaining life. Maximizing Intrinsic Value must be the guide for all business decision-making. Buffett says: “If Intrinsic Value increases, the stock price will eventually follow.”

I look at Intrinsic Value as the true value of an enterprise, which in turn is captured by the following statement. An enterprise will be worth what its free cash flows, discounted at a risk-free discount rate, are really going to be. Risk-free rate is used in this context because the rate is applied to actual cash flows. Of course, forecasts of cash flows reflect uncertainty—the higher the degree of uncertainty, the greater the risk for investors and accompanying discount rate. My point is Intrinsic Value will follow from what free cash flows actually turn out to be.

On one hand, this is the tenant of Net Present Value—and hence the third principle might be viewed as extraordinarily basic. On the other hand, I’ve observed too many instances where management teams and investors have sidelined the importance of this basic tenant. Instead, decisions have been made based on achieving revenue, EBITDA, or capital targets or on maximizing metrics such as eyeballs or growth rates.

Of course, the free cash flows resulting from decisions are rarely known with certainty, and often the level of uncertainty is high. Good decision-making is a special art, not a simple math problem. Principle 3 provides clarity to the objective that should guide decision-making. First, understand Intrinsic Value will result from free cash flows. Second, use the maximization of Intrinsic Value as the basis for making decisions.

Note that maximizing Intrinsic Value does *not* equate to maximizing the price that a buyer might pay for an enterprise at a particular point in time. University of Chicago, of which I am an alumnus, originated the “efficient market theory” (EMT), which states that the most accurate estimate of the ~~enterprise value~~ Enterprise Value [DC1] of a public company is reflected in its stock price. Buffett likes to point out that if EMT is correct, he would more likely be a panhandler than one of the world’s richest people.

Said differently, the stock market’s view of Eenterprise Vvalue is often out of sync with Intrinsic Value. Like Buffett, I believe management’s focus must be squarely on Intrinsic Value, not a point-in-time market-based estimate of ~~enterprise value~~ Enterprise Value. Proper long-term decision-making should be driven by the quest to maximize what free cash flows are really going to be while applying appropriate discounts for the time value of money.

Principle 4: Investors should be informed of the company’s true Intrinsic Value, not more and not less.

Buffett points out that Intrinsic Value is easier to define than to accurately calculate. Management’s goal (to the best of its ability) should be to help investors gain an accurate understanding of the Intrinsic Value.

This principle could be a source of conflict with the common-held belief that management’s goal is to maximize stock price (in the case of a public company) or the sale price (in the case of a private company). If a stock price (or sale price) reflects an ~~enterprise value~~ Enterprise Value that differs from Intrinsic Value, the result is that a selling Investor will benefit at the expense of a buying investor, or vice versa. For example, if the valuation implied by the stock price exceeds the Intrinsic Value, new investors will be overpaying exiting Investors.

The goal is to be fair to all investors. To accomplish this, management’s goal must be that the perceived value of the firm (whether the entity is a public or private company) aligns with Intrinsic Value.

Investors should never lose sight that the measurement of Intrinsic Value is elusive for both investors and management. Importantly, management does not necessarily have greater insight into Intrinsic Value than a particular informed Investor. Principle 4 emphasizes that the foundation of management’s communications with Investors is to help them gain insight into the firm’s Intrinsic Value.

Principle 5: The principles in the Owner’s Manual also apply to debt holders.

As members of the investor group, debt holders should be treated as partners and in a manner consistent with the entirety of the management principles. Through the application of the articulated principles, management's intention is for debt holders to receive a fair return for their level of risk as lenders.

Management's strict responsibility to the debt holders is to comply with the obligations set forth in the debt facilities agreements. In satisfying this responsibility and while applying these principles, management will seek to optimize the company's overall cost of capital.

Principle 6: Management's objective relative to equity holders is to maximize Equity Value Created

Principle 4 centered on management's responsibility to accurately portray Intrinsic Value. Principle 5 addressed management's obligation to debt holders. ~~Equity value~~ Equity Value is the portion of Intrinsic Value that remains after all debt obligations are satisfied. The maximization of ~~equity value~~ Equity Value is achieved by maximizing Intrinsic Value while using debt to optimize the overall capital structure. As such, principle 6 is the direct outcome of principles 4 and 5.

Equity investors seek to achieve an appreciation in the value of their equity investment. The minimum rate of appreciation that equity investors would view as adequate is referred to as the Hurdle Rate." The word "hurdle" is quite descriptive. If the rate of equity return is at or above the Hurdle Rate, management is satisfying or exceeding the expectations of its equity holders. If it is below the Hurdle Rate, management is falling short of expectations.

Note that principle 6 isn't simply to exceed the Hurdle Rate. That is, management shouldn't make decisions with the objective of simply clearing the Hurdle Rate. Nor is it the goal of principle 6 to maximize the rate of appreciation of equity, which I refer to as Equity IRR. Instead, principle 6 emphasizes the goal as maximizing Equity Value Created.

Management, and its equity holder partners, must appreciate the interrelationship between Hurdle Rate, Equity IRR, and Equity Value Created, while acknowledging the overriding goal is to maximize the amount of Equity Value Created.

I will use an example to illustrate these interrelationships. In the example, I will make the unrealistic and flawed assumption that Intrinsic Value is known and accurately measurable by all. Another unrealistic assumption I will make is that the Hurdle Rate is a fixed and precisely knowable number. (In reality, investors will have varying views of risk and return thresholds, and capital markets are volatile. As such, Hurdle Rate is never known with certainty.)

Let's assume an equity holder owns 10 percent of the equity of a company that has an Equity Value of \$1 billion. The equity holder's value is \$100 million. Perhaps this investment was made that very day, by buying 10 percent of the outstanding equity of the company. Or perhaps this investment was made long ago and, by equating to 10 percent of the \$1 billion of value, is now worth \$100 million. Either way, this holder is looking to make an incremental return on his \$100 million of value.

Let's assume the Hurdle Rate is 12 percent. If the equity holder remains an investor for a year, the minimum appreciation of the investment would need to be 12 percent, or \$12 million, for the equity holder to be minimally satisfied. If the holder's investment was worth less than \$112 million, disappointment would be anticipated; at greater than \$112 million, satisfaction would be expected. The level of excitement or disappointment would correlate with the degree of under- or over-performance.

Equity Value Created is the amount of ~~equity value~~ Equity Value increase ~~gain~~ in excess of the amount required to achieve the Hurdle Rate.

Continuing with the example, assume the actual value of the holder's investment grew to \$118 million during that year. The amount in excess of the Hurdle Rate would be \$6 million, hence the Equity Value Created relative to that particular equity holder. The holder would have earned an Equity IRR of 18 percent—6 percent above the Hurdle Rate. The equity holder should have been pleased that Equity IRR was meaningfully in excess of the Hurdle Rate; substantial Equity Value was created.

Principle 6 is maximizing Equity Value Created, not maximizing Equity IRR. Why the distinction? From the perspective of this individual equity holder, a higher Equity IRR is a direct result of higher Equity Value Created. However, from a company perspective, decisions might be available that would increase Equity Value Created while decreasing Equity IRR. Principle 6 emphasizes management should choose the one that maximizes Equity Value Created, even if Equity IRR is thereby not maximized.

Principle 7: Since maximizing Equity Value Created is a principle, Equity Value Created should be measured and used as a tool in operating the business.

Most executive teams state that maximizing value created is the key financial objective. However, few attempt to measure it and even fewer use it as an operating metric. Public companies might use stock price as a proxy. When the stock price is up, they tend to cite it as a validation of management performance. However, when the stock price is down, they often attribute the disappointing stock trend to external factors—either macroeconomic impacts or the fickle misgivings of stock market traders.

Buffett points out that Intrinsic Value is easier to define than to accurately calculate. Since the measurement of Equity Value Created requires Intrinsic Value to be calculated, a dilemma is encountered. Notwithstanding this reality, principle 7 emphasizes that measurements should be made and then used as tools in operating the business.

Intrinsic Value cannot be precisely measured, but it can be meaningfully estimated. Most equity investors—whether private or public—estimate the Intrinsic Value of a business when making decisions to buy or sell an ownership stake at a given price. When they perceive a gap between Intrinsic Value and price, they see an opportunity. Likewise, most Private Equity investors use a mark-to-market methodology to track and publish, on a quarterly basis, the value of their equity investments.

Using similar techniques, a methodology around Equity Value Created can, and should, be employed in the management of a business. The methodology should be used in conversations between the investors and management to assess the performance of the business. Likewise, the Equity Value Created performance of each segment of the business can be monitored via the methodology.

The important takeaway from principle 7 is that Equity Value Created can and should be estimated on a regular basis, both at the enterprise level and by each business segment. Though the measurement is imprecise, it is effective in driving appropriate decision-making and in understanding the overall performance of the enterprise.

Principle 8: The communication and management of risk profile requires particular attention of management.

Risk profile permeates its way through many of the principles.

In the discussion of Intrinsic Value, I emphasized that forecasted cash flows are estimates that reflect risk and/or uncertainty. As such, estimates of Intrinsic Value will reflect a higher than risk-free interest rate. Higher levels of risk result in higher Hurdle Rates, which will dampen the estimate of Intrinsic Value.

Debt holders, when pricing the terms of a debt facility, are assessing the likelihood that debt will be repaid in full, and conversely the risk that it won't.

The amount of debt relative to equity alters the risk profile of an enterprise. The optimization of debt costs, and the Hurdle Rate for equity holders, are directly impacted by the debt-to-equity ratio.

Management must recognize the importance of risk profile in its overall relationship with its investor business partners. Embedded in principles 1 and 2, management must be transparent regarding its understanding of the risk profile of the business. If external factors cause changes in risk profile, management should provide insight to its investors.

If internal management decisions are being contemplated that substantially alter the risk profile, these decisions should be considered in the context of prior understanding management has with its investors. Sudden changes should be avoided. If management believes changes are appropriate, the contemplation of decisions should be shared with investors well in advance (if practical) of the decisions being made.

Principle 9: Forecasting competency should be viewed as a strategic capability.

Accurate and thorough forecasting, which I'll refer to as forecasting competency, can reduce risk profile without adding material cost to a business. Forecasting competency bolsters Intrinsic Value in multiple ways.

First and most importantly, strong forecasting competency often leads to better operational decisions. Decision-makers are aided by having reliable estimates of future financial performance. They learn about the likely impact of prior decisions sooner and more thoroughly. This improved and accelerated feedback loop leads to stronger ongoing decisions.

Second, a strong forecasting competency will result in fewer unexpected events.

Third, the cost of debt is likely lower for companies with a strong forecasting competency (all else being equal), as debt holders will price less risk into a debt facility. The reduced cost of debt directly leads to increased Intrinsic Value.

Fourth, the Hurdle Rate is also likely lower for companies with a strong forecasting competency because the reduced risk lowers the threshold return required by an equity investor.

For all these reasons, I view a strong forecasting competency as among the more important operational competencies of an enterprise. Quite often, improving forecasting competency is a low-cost way to improve decision-making while removing avoidable risk within a business. As such, operational metrics inclusive of reliable forecasts centered on Equity Value Created measurements are paramount to the operations of the business.

Principle 10: A long-term and healthy interrelationship between customers, employees, and investors is essential to maximizing Intrinsic Value.

The Owner's Manual, by its nature, focuses on the principles management will apply in satisfying its obligations to its investors. The principles would be incomplete without emphasizing the interrelationship of customers, employees, and investors, who together are the stakeholders of a business.

Principle 3 emphasizes that management's decision-making should be based on maximizing Intrinsic Value. I fundamentally believe that Intrinsic Value can be maximized only if an entity truly enamors its customers. Generally speaking, the more value a firm provides its customers, the more Intrinsic Value it will create for its investors. Management should never view that it is dividing a fixed amount of value between its customers and investors; instead, enamoring customers increases the total amount of value—that is, the size of the pie becomes larger—and both customers and investors are better served.

Equally as fundamental is my belief that the needs of customers and investors can be fully realized only if employees are motivated and inspired to deliver outstanding execution. The day-in and day-out exceptional efforts of committed and capable employees are necessary to enamor customers and deliver exceptional investor returns. To attract and retain the best employees, these team members must believe they are being treated in an appropriate manner. For optimal investor results to be achieved, employees must be made to feel they are part of the partnership with investors. The culture should be such that employees feel they are being treated fairly (and then some!)[CM2] on a holistic basis that includes compensation and work environment, relative to their contributions, capabilities, and alternative employment options.

When employees feel excited with their occupation, proud of their company and its mission, and appreciated by what they receive in exchange for their contributions, the firm will perform better. The capability to enamor customers increases, and customers will in turn reward the firm with their loyalty and an expanded business relationship. The Intrinsic Value of the enterprise gets larger. The key is to find a harmony between investors, customers and employees/management—such that all are better off because of the effective partnership with one another.