Mead Capital Management
Adam J. Mead
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"I am a better investor because I am businessman, and a better businessman because I am an investor." – Warren Buffett

Notes from *The Outsiders* by William Thorndike

I recently re-read the notes I took several years ago on William Thorndike's excellent book, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success.* Having benefitted from them twice – once while reading the book, and again re-reading my notes – I thought I would share them. I highly recommend picking up a copy of the book for yourself. It's destined to become a classic.

As the title suggests The Outsiders chronicles eight successful CEOs, and lays out reasons for their success. What is immediately clear is that these CEOs did not all come from the same industry or sector. Success came from the broadcasting industry, the publishing industry, cable, government contracting, cinemas, an agricultural products business, and conglomerates. The common denominator: they were all superb capital allocators (with rationality a prerequisite).

My main takeaways are summarized in list form at the top of the following page. The first is that good capital allocators focus on the cash-generating ability of the companies they operate. Accounting be damned, they care about the economics of the business and the free cash flow it can generate. A related second point is that it's the shareholder which the managers are working for, and this means focusing on per-share value. Managers that don't care about the shareholder can grow the operating business while hurting the owners. For example, by issuing stock when it's undervalued, buying it back when it's overvalued, or paying themselves too much.

My final takeaway is multifaceted – the Outsider CEOs had a keen awareness for the few ways in which capital can be allocated. They used their capital allocation options as tools in a toolbox to maximize value on a per share basis regardless of the situation, and never got caught up on only one tool. Broadly speaking these CEOs knew when to raise capital and when to deploy it, and how. If their companies' stock prices were selling around intrinsic value they focused on their core business operations. When the prices of their companies traded far from intrinsic value, and they did not have better options within the operating business itself, the Outsider CEOs took advantage. Either by buying back stock cheap, or issuing it when it was dear, the Outsiders acted rationally. In short, they acted for shareholders which, because they typically owned large blocks of stock themselves, this meant acting in their own best interests.

Finally, it is both a source of frustration and encouragement that more managers have not sought to emulate the Outsider CEOs. My frustration stems from the fact that many of these lessons are so obvious and could easily add value not only to shareholders but to the managers themselves, and their customers and other stakeholders. Of course, the reason the Outsider CEOs were so "radical" is that they departed from common (and suboptimal) approaches to business, many of which are rooted in human psychology.

I am encouraged by the fact that there are a few very talented and very rational CEOs in the public sphere. Reading the annual reports from these CEOs their candid communications and rational way of thinking almost jump off the page. It is extremely exciting and satisfying uncovering these CEOs, since they usually operate excellent businesses which might make for excellent investment candidates, at the right price. Re-reading my notes from The Outsiders (or the book itself) from time-to-time reminds me of the payoffs simple and clear thinking can bring.

Rationally yours,

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The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success
By William Thorndike, Jr.

Three key takeaways:

1. Focus on **Free Cash Flow**
2. Focus on Value **Per Share**
3. Focus on the few choices available for **Capital Allocation**:
    a. Deploying capital
        i. Investing in existing operations
        ii. Acquiring other businesses
        iii. Issuing dividends
        iv. Paying down debt
        v. Repurchasing stock
    b. Raising capital
        i. Internal cash flow
        ii. Issuing debt
        iii. Issuing equity

Chapter 1: Tom Murphy and Capital Cities Broadcasting

1. P. 17. Two key roles: Capital Allocator (Tom Murphy) and Operator (Dan Burke)
2. P. 17. Focused on the customer value proposition and what matters to shareholders. "…improving programming and aggressively managing costs…"
3. P. 19. Cut staff from sixty to eight (-87%)
4. P. 20. Decentralized approach. "Hire the best people you can find and leave them alone."
5. **P. 24. Simple formula: Revenues (non-controllable in their case) less expenses (controllable) = profits**
6. Painted two sides of building facing the road
7. Simple metric: Targeted, "…a double digit after-tax return over ten years **without leverage."**
8. "I've worked at a lot of corporate events over the years, but Capital Cities was the only company where you couldn't tell who the bosses were."

Chapter 2: Henry Singleton and Teledyne

1. P. 43. Drove "…accountability and managerial responsibility as far down into the organization as possible."
2. P. 44. No HR, Investor Relations or Business Development departments
3. P. 44. Reduced working capital requirements. (Freeing up cash.)
4. **P. 44. "Our accounting is set to maximize cash flow, not reported earnings."**
5. P. 45. Packard Bell. First American manufacturer to exit the industry.
6. P. 48. Repurchased 90% of Teledyne's shares.
7. **P. 53. "I don't reserve any day-to-day responsibilities for myself, so I don't get into any particular rut**. I do not define my job in any rigid terms but in terms of having the freedom to do whatever seems to be in the best interests of the company at any time".
8. P. 55. Issued shares when Teledyne's stock price was high; purchased shares when they were low, using debt; purchased discounted debt with pension fund to avoid taxes.

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Chapter 3: Bill Anders and General Dynamics

1. P. 65. "Cash return on capital became the key metric within the company and was always on our minds."
2. P. 66. "…reduced investment in working capital."
3. P. 66. Sold large sections of the business, and returned the cash to shareholders. Including a much-loved jet division.
4. P. 70. Buffett sold his shares on Ander's departure.
5. P. 79. Subsequent CEO Nick Chabraja, "…sold shares equaling one-third of the company to acquire a business that provided half of our consolidated operating cash flow."

Chapter 4: John Malone and TCI

1. P. 83. "Utility-like revenues". Okay to pair high debt with consistent cash flows (key).
2. P. 89. Simple and "deceptively simple" insight. Leveraged size to create advantages of scale.
3. **P. 90. Key metric: Costs per subscriber**
4. P. 98. "…he handled the negotiations himself, often facing a sizable crowd of AT&T lawyers, bankers, and accountants across the table."
5. **P. 100. Targeted leverage at five times EBITDA**.
6. **P. 100. Carefully structured debt. Avoided cross-collateralization/defaults/guarantees, etc.**
7. P. 102. Key strategy was minimization of taxes.
8. P. 102. "Looked for no-brainers" "Didn't use spreadsheets" "Justified by simple math"
9. **P. 107. "For mathematicians, insights often come when variables are taken to extremes"** (Buffett does this using principles from economics. *Ceteris parabus.)*

Chapter 5: Katharine Graham and The Washington Post Company

1. P. 114. Repurchased almost 40% of the company's shares.
2. P. 114. Strong COO in Dick Simmons
3. P. 115. During era of high prices Graham stood on the sidelines
4. P. 117. "Approach…characterized by industry-low levels of dividends and debt, industry-high level of stock repurchases…few acquisitions, and a careful approach to capital expenditures."
5. P. 118. Key question: "Where is the next dollar best applied?"
6. **P. 119. Acquisitions needed to earn a minimum 11 percent cash return <u>without leverage</u> over a ten-year holding period." Proved a "very effective filter." "Ethos was to wait for just the right deal."**

Chapter 6: Bill Stiritz and Ralston Purina

1. P. 132. Organized the business around the businesses with "exceptionally attractive economics" which had "high margins and low capital requirements." Divested others that didn't meet his criteria.
2. P. 133. Implemented aggressive share repurchase program. Was opportunistic with acquisitions (Energizer battery).
3. P. 136. Focused the company down to a pure-play pet food company. Used spin-offs.
4. P. 136. Sold the company to Nestle for $10.4 billion or 14x cash flow.
5. P. 138. "Stiritz himself likened capital allocation to poker, in which the key skills were an ability to calculate odds, read personalities, and make large bets when the odds were overwhelmingly in your favor. "
6. **P. 143. "The hurdle we always used for investment decisions was the share repurchase return."**
7. P. 143. Focused on key variables: Market growth; competition; potential operating improvements; cash generation.
8. **P. 143. "No massive studies and no bankers". "…a single piece of paper, not a forty-page set of projections."**
9. **P. 145. "Jealously guarded his time" Carved out time just to think. (Like Buffett).**

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Chapter 7: Dick Smith and General Cinema

1. P. 150. "Ran the company as if it were privately held."
2. P. 152. "Pioneered the use of lease financing…dramatically reducing up-front investment"; Added more screens/theater
3. **P. 152. Purchased American Beverage Company for 5x cash flow**
4. **P. 153. Used ABC's scale to reduce can pricing and purchase sugar directly. Built economies of scale.**
5. P. 155. Purchased Carter Hawley Hale very quickly – one week. "Smith and his management team had so refined their acquisition criteria and process that they were able to perform to this extraordinary timetable."
6. **P. 158. Purchased HBJ for 6x cash flow; sold for 11x**
7. P. 160. Ran the company with top 3 executives and gave them power to go against him, even in front of the board.
8. **P. 163. "Our focus was always on cash."**
9. P 164. Didn't participate in auctions but sold Neiman Marcus after a full auction

Chapter 8: Warren Buffett and Berkshire Hathaway

1. P. 171. Closed BPL in 1969; same year Henry Singleton stopped making acquisitions. No coincidence.
2. **P. 173. "…contrarian insight was that companies with low capital needs and the ability to raise prices were actually best positioned to resist inflations corrosive effects."**
3. P. 179. Insurance underwriting discipline. Stopped writing if premium pricing wasn't profitable. **Twelve years** of depressed pricing.
4. **P. 181. "In both insurance and investing, Buffett believes the key to long term success is temperament."**
5. P. 181. Decentralized operations; centralized capital allocation.
6. P. 182. "The more investment options a CEO has, the more likely he or she is to make high-return decisions."
7. P. 190. Charlie Munger: "We don't try to do acquisitions; we wait for no-brainers."
8. P. 192. Buffett manages his schedule to minimize distractions and maximize time to read and think.
9. **P. 193. "Buffett has developed a worldview that at its core emphasizes the development of long-term relationships with excellent people and businesses and the avoidance of unnecessary turnover, which can interrupt the powerful chain of economic compounding that is the essence of long-term value creation."**

Chapter 9: The Outsiders Mindset

1. P. 199. Optimizing free cash flow
2. P. 200. Fifth grade math; consistent and with conservative assumptions. Single pages of key variables.
3. P. 201. Long-term mindset; long-term value per share vs. short term profits.
4. P. 202. Decentralized operations; centralized capital allocation.
5. P. 202. "As a group, they were not extroverted or overly charismatic."
6. P. 204. Avoid destroying value (inversion); "see to the core economic reality"; "didn't overanalyze or over-model"
7. **P. 207. "As a group, these CEOs faced the inherent uncertainty of the business world with a patient, rational, pragmatic opportunism, not a detailed set of strategic plans."**
8. **P. 209. "Temperament, not intellect."**
9. **P. 210. "They had the perspective of the long-term investor or owner, not the high-paid employee – a very different hat the most CEOs wear to work."**

Epilogue

1. **Bakery example; real world demonstration of the difficulties of everyday business**