Road trippin’

If you’ve listened to the latest episode of *Stocks Neat*, you’ll know that Steve, Harvey and I were in the States recently on our first business trip in more than two years. The goal was to meet with various management teams and see what's happening on the ground of the world’s biggest market.

Here are a few things that stood out.

Cloudy skies for small-cap chiefs

The main stop on our trip was the Roth Conference in California. Over two days, we collectively caught up with the management teams of more than 60 companies – many of whom, despite their sunny dispositions at last year’s online conference, were now sporting decidedly cloudier outlooks.

While most stocks globally are down over the past 12 months, it’s been a particularly tough time for the companies dominating the conference – most of them smaller, rapidly growing companies that are known to experience wide price swings from time to time. Some are down 70% in the past year.

When I asked one previously animated CEO about how an acquisition he made last year was going, he said, “I spent $200 million on this business and that’s now my total market cap – how do you think it’s going?” I was happy enough to hear some recognition of that, having been sceptical of it.

The sentiment echoed across other leaders in the room – many of them going from animated to downbeat in just one year. One of the CEOs Steve spoke to even seemed *angry* at the way the market had been treating his business.

Economic strength or wishful thinking?

There’s been a lot of talk of a recession in the States. But as we made our way across the US (through bustling airports, mostly) it looked as if everything had returned to normal. According to one taxi driver we spoke to, downtown Chicago on a school night is now consistently busier than before the pandemic. Unsurprisingly, people want to get out and about. Still, the prospect of higher inflation is front of mind for both consumers and the CEOs we spoke to.

The CEO of one of our portfolio holdings, Fathom Realty, said his agents were worried about what inflation would mean for business. For now, while interest rates remain low, they've continued selling houses like it's nobody's business. But realistically, if rapidly rising gas prices and the seven or so US rate rises forecast *this year alone* suggest anything, it's wishful thinking that conditions should stabilise and carry on as normal. We've already begun to see businesses change their behaviours now that the market is focusing on margin rather than growth at all costs. That's healthier.

Whether or not inflation is here for the long term, it will likely be a feature for a while at least. Many CEOs have complained about surprise cost inflation in their business inputs and just about all of them are hoping to pass that on to customers by increasing their prices. Some don't have that pricing power, but many will in this environment.

I got a taste of that when I returned to Australia. Here, we're very fortunate. Never before in my adult life have I experienced a shortage of staples. But when my family made a supermarket order last week requesting a loaf of plain white bread, the one we picked was unavailable and we weren't offered a substitute. Because apparently, no white bread was available. No white bread – in Australia? We couldn't believe it, so we went to the supermarket ourselves...

Commodity bread-making is hardly considered a great business with strong pricing power. However, if bread is available the next time we're at the store – even if it happens to be a buck or two more expensive – we'll still buy it.

Anyway, what I’m getting at here is that we seem *primed* for inflation in a way unseen since the 1970s. So maybe inflation proves more persistent this time, after all.

Businesses overlooking stock-based comps

In my experience, companies work better when all their people (or when senior management teams, at least) are shareholders. But at the same time, some companies we’ve seen have taken stock-based comps (compensation to employees through the provision of equity in a business) to new extremes. At Forager, we prefer the old-fashioned money-down type of skin in the game.

At some high level of stock-based giveaway, a company exists for the benefit of staff alone rather than for the benefit of staff *and* shareholders. Twitter has long been a favourite of mine but is one company whose stock-based compensation I expected to be less burdensome by now. Instead, it has gone from bad to worse. Maybe its new major shareholder, Elon Musk, can change that?

Steve recently spoke of a business on his personal watchlist that he’d like to buy, if only its share price was well below $100. While DocuSign finally fell within range, on further research it, too, proved guilty of ridiculous over-compensation. This is a business converting roughly 18 cents on every dollar of revenue into profit. And it’s all going back out in stock-based comp dilution. DocuSign has also doubled the number of shares on issue over the past three years, but has given them mostly to staff. Is such a business really “profitable” at all?

Many management teams are wilfully blind to such largesse. *He whose bread I eat, his song I sing.* They obviously don’t shop where I shop. The response is always along the lines of, “we need to do this now to retain talent, but it’ll surely be jam tomorrow for shareholders.” Sadly, investors haven’t done enough to keep them all in check. They – scratch that – *we* need to hold management teams and boards more accountable on this issue.

Times they are ‘a changing…

Don’t get me wrong – Zoom it great and all. It got us all through the lockdowns. But it was good to finally get over to the States and catch up with management teams in person to hear their views. I’m off to Europe this month for more of the same.

While we learnt a lot at Roth, the experience was a glaring reminder that we can’t know exactly what’s to come. The pain on CEOs’ faces is the same pain in our own portfolios. But, focused on valuations as we are, the upside potential from here is a lot higher than it was 12 months ago.