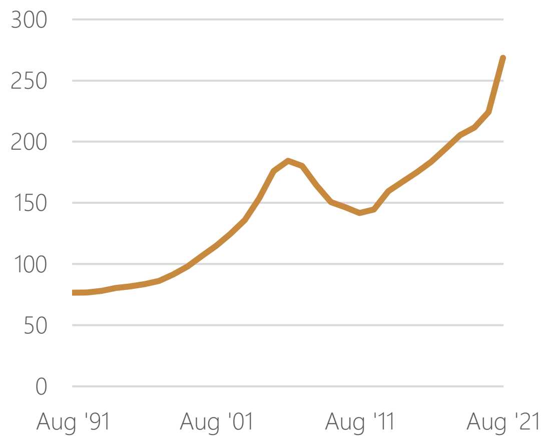
The Everything Rally by Kishore Rao

In a world awash in liquidity, the seemingly endless upward march of the "everything rally" raises the question: does free cash flow matter anymore? My personal journey and answer to that question.

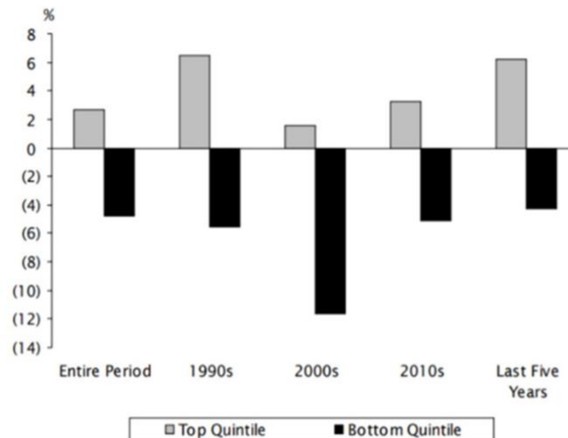
Our individual journeys can be the basis for lifelong lessons or serve as the prisons that keep us hostages to the past. My professional experiences as an internet entrepreneur, a venture capitalist, a long/short hedge fund analyst, and a quality growth investor at SGA, have all led me to a definitive opinion on the answer to that question: free cash flows matter greatly and sooner or later, decisively.



Source: S&P, FactSet

Almost 25 years ago to the day, I was a newly minted MBA eagerly beginning my investment career as a junior analyst at Tiger Management. I learned the craft of identifying the differences between companies that generated copious cash flows (long ideas) and those that somehow manufactured earnings but lacked commensurate cash flows (short ideas). I toiled with the numbers in blissful anonymity and seemingly in obscurity until one afternoon when the founder himself, the legendary Julian Robertson, unexpectedly strolled by my cube and jovially asked "How was that CEO lunch presentation today?" Having not even known about it, I replied with great embarrassment that I had missed it but would find out what had been discussed. In an era that did not have on-demand web replays or even meeting transcripts, I resorted to what any other analyst of that time would have done: I grabbed my desk phone to feverishly call various buy-side and sell-side contacts to learn what had been said at the meeting. But none of the investors I called knew about it either. The episode served as an entrepreneurial epiphany. The investment community needed a more reliable way to learn about corporate access events, filter that firehouse of data based on individualized needs, and access the content afterwards.

Soon thereafter, I founded an internet company called StreetEvents which did precisely all of that. The company was built on the insight that network effects would drive its success and a competitive moat. By convincing publicly traded corporations to provide their investor event information to our database, we drove buy-side and sell-side investors to our site, which in turn drove more corporate participation until we became an industry standard. The other key insight was that we could charge our investor clients a monthly recurring subscription fee and collect cash monthly. While this might seem like an obvious business model today, back then the New Economy era was just beginning to 'bloom', the Berlin Wall had recently fallen, and federal budget surpluses were projected for "as far as the eye can see". Given the heady times, most venture capitalists thought the idea of collecting cash every month was a quaint if not antiquated business model. Instead, many asserted we should just capture as many 'eyeballs' (e.g. unpaid viewers) as possible since each was being valued at an insane multiple based on the premise that banner advertisement monetization might someday follow. In the end, the dot com era eventually collapsed on itself with billions of dollars of cash burnt to ashes due less to a lack of good ideas, but more so to a lack of fundamentally strong, cash-generative models that could survive a capital 'freeze'. StreetEvents, however, thrived because of network effects (e.g. pricing power in the parlance of SGA), subscription revenues (e.g. recurring revenues in the parlance of SGA), and predictable cash flows. It was ultimately acquired by Thomson Reuters and continues to be a reliable source of information for institutional investment managers to this day.



As the dot com bubble ended, I went to work for one of the investors in StreetEvents, a venture capital firm by the name of Trident Capital that shared a belief in the value of recurring cash flows. While we invested in sensible, post-bubble entrepreneurs committed to building sustainable internet, software, and technology-based businesses, I was surprised, however, by the amount of deal flow we

saw from publicly traded companies. These were recent IPOs that had never reached cash flow break even and as a result, sought Private Investment in Public Equity (PIPE) deals on distressed terms. For desperately needed cash, these fallen angels offered highly-dilutive preferred equity with 15% annual pay-in-kind (PIK) dividends. These and other similarly challenged companies of the time such as WebVan and Pets.com had been birthed in an era when cash was seemingly endlessly available and thus generating sustainable free cash flow was neither necessary nor part of the DNA. But when formerly acquiescent capital markets turned less so, they could not be culturally re-engineered to generate cash quickly enough. As a result, most went out of business with some sold for parts, namely, the intellectual property which was often plundered by larger cash-rich established companies that resembled vultures picking apart highway roadkill.

Despite the prominent return of IPOs with minimal revenues, this essay is written not to suggest we are on the cusp of another dot com era collapse, but rather to sing the praises of sustainably compounding free cash flows. With those, a company is afforded the ability to control its destiny, be aggressive when others are defensive, confidently make investments, avoid raising dilutive capital at the wrong time, and invest in building a culture that supports stakeholders and rewards shareholders longer term.

Source: FactSet

As Charles Mackay documented almost two centuries ago in *Extraordinary Popular Delusions and the Madness of Crowds*, behavioral finance risks are very real and sadly quite recurring. Favorable market conditions that seem likely to persist indefinitely can produce a broad self-reinforcing confidence begetting complacency and in the extreme, bubbles that shake confidence in markets and occasionally even in the system itself. I fully admit to not knowing how this coming decade will play out – perhaps it will be another Roaring '20s (albeit hopefully with a happier ending than the prior one). There are many reasons for continued optimism including healthy consumer balance sheets, accommodative central banks, and entrepreneurial innovation tackling many of the world's largest problems. But risks abound in the possibility of higher inflation and in turn, higher interest rates; increased political polarization across many democracies; the uncertainty stemming from a more geopolitically assertive China; greater government regulation and taxation; and climate change (to name just a few). Moreover, investor behavior certainly raises eyebrows as capital amasses in Reddit meme stocks, NFTs, and the seemingly endless proliferation of cryptocurrencies which Barron's now counts at 8800 with $2.7 trillion in value.

I do know that at SGA, however, the companies in our portfolios and Qualified Company List generate recurring, sustainable cash flows that can compound at attractive rates. My prior experience gives me the conviction that our holdings have control over their financial destiny and are less vulnerable to the vicissitudes of fickle financial markets. They can continue their pursuit of important innovations in healthcare advancement, financial inclusion, and consumer and enterprise digital transformations (among others) that not only benefit society broadly, but also reliably produce compounding growth and wealth for their shareholders. In turn, we continue to have great confidence in our distinctive return pattern, namely participation in the wealth creation of the world's best large cap growth companies but with reduced volatility and superior downside protection. We thank you for your continued support.

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