

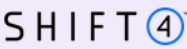




### Letter III - Share Buybacks

Dear Partners, Family, and Friends,

In our last letter, we leveraged the oft-discussed value vs growth and small vs large cap debates to prove what really matters to long-term stock performance is attractively valued earnings and free-cash-flow growth, not market cap or investment style. Specifically, the best performing stocks exhibit the following characteristics:

1. 20%+ revenue CAGR
2. Profitable, with margin expansion
3. Trading at or below 22x FCF and 17x P/E ratios
4. Minimal share dilution, preferably buying back shares

We've become enamored with companies like this which can produce meaningful FCF while also growing rapidly. Below are a few examples in the tech, consumer, healthcare, and industrials, including two of our positions Shift4 (FOUR) and Wingstop (WING):

	Company	2024 EPS Growth	2024 Net Margin	Rule of XX	P/E NTM	PEG Ratio
Technology		37.5%	12.7%	50.2%	14.4x	0.4
Consumer		51.2%	17.6%	68.8%	66.4x	1.3
Healthcare		21.5%	34.8%	56.3%	17.2x	0.8
Industrials		34.5%	8.3%	42.8%	53.4x	1.5
Financials		28.5%	23.6%	52.1%	23.8x	0.8

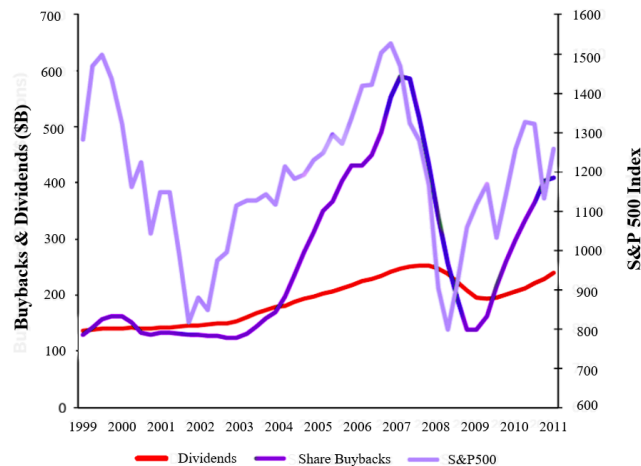
As we think about these types of businesses and the results of Letter II, we can't help but wonder what these operators are doing with all the cash they generate. Considering these aren't M&A rollups, they have minimal debt relative to market cap and FCF, and forward looking prospects are generally positive, we ask ourselves - **why wouldn't these businesses be buying back stock?** While a company may find a one-off acquisition, organic re-investment opportunity, or perhaps the stock is just flat-out expensive, we can't find many other good reasons not to.

Based on this, we posit that filtering and screening for stock buybacks should be an effective method of identifying not only cheap profitable growth situations, but also management teams which understand capital allocation and are aligned with shareholders - otherwise known as high-quality businesses. To do this we can screen for buybacks and question management teams on their buyback philosophies. By incorporating buyback history and philosophy into our investment process, we can easily understand a company's FCF profile and capital allocation stance. We prefer buybacks over other options because they can:

<sup>1</sup> "Rule of XX" is a metric initially designed to analyze a SaaS business' efficiency of driving both growth and profits but can be bluntly applied to any business. Rule of XX is calculated as revenue growth + FCF margin.

1. Generate high returns on capital for excess cash ( $<10x$  FCF = 10%+ ROIC or 10%+ “buyback yield”) that are known beforehand versus uncertain M&A or other projects
2. Boost EPS / FCFPS<sup>2</sup> growth and potentially the multiple as well
3. Signal to investors that the stock is attractive and has strong prospects
4. Provide more tax advantaged capital returns to equity investors than dividends<sup>3</sup>
5. Create demand for the stock, where stock price is ultimately a function of supply and demand forces

If management understands this, they should choose to buyback stock when their stock is depressed. Unfortunately, management teams generally view buybacks as a last resort. We can see this with the S&P 500 FCF allocation as dividends (red) are consistent, but buybacks (dark purple) are volatile:



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While most companies implement buybacks pro-cyclically, we want our portfolio companies to increase buybacks as shares decline, and opt for special dividends as valuations become exorbitant. Unfortunately, it is rare to find operators like this. And in these cases we ask: ***If the company and its management aren't buying the stock, why should we?*** In the next section we'll explore the data behind why this is an important question to ask.

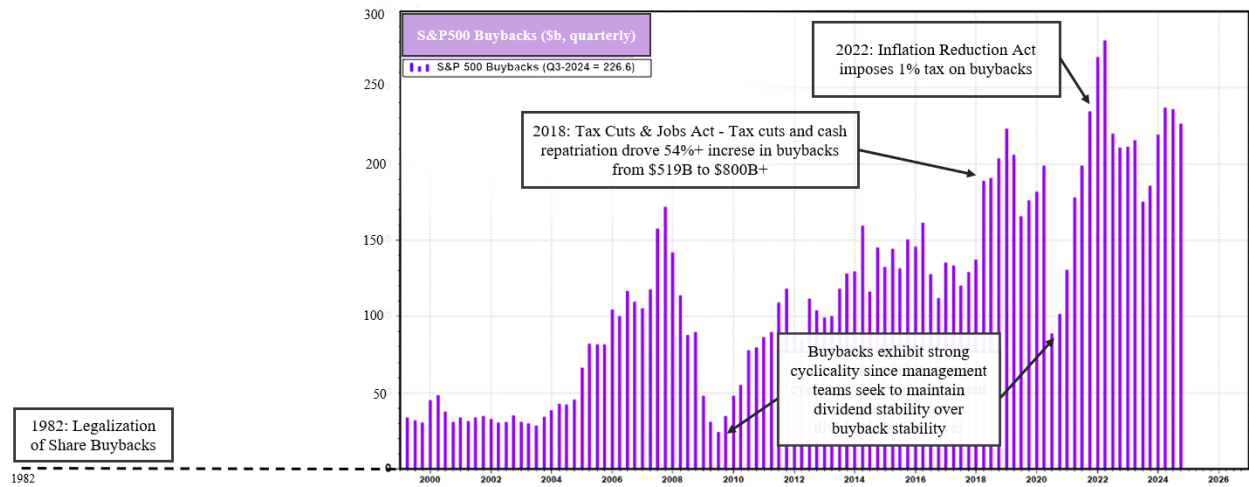
### Historical Performance of Equity Buybacks

Until 1982, share repurchases sat in a legal grey area in the US as they were thought to be a form of stock manipulation and could be scrutinized and potentially litigated as such. In 1982, the SEC introduced rule 10b-18 a safe harbor for companies to avoid accusation of stock manipulation and subsequent liability pertaining to buybacks. Since then, buybacks have played an increasingly significant role in corporate finance and capital allocation:

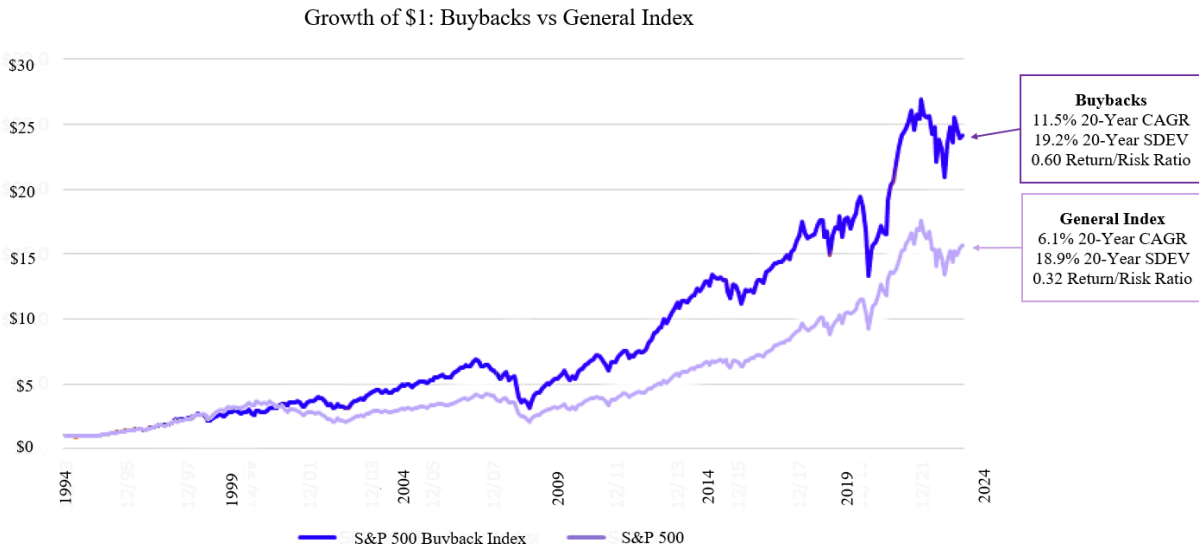
<sup>2</sup> Earnings per Share / Free Cash Flow per Share

<sup>3</sup> Ordinary dividends are taxed as ordinary income and qualified dividends are taxed at 15%, while buybacks in the US are subject to a 1% excise tax paid by the repurchaser

<sup>4</sup> Legg Mason, “Share Repurchases from All Angles”, Mauboussin



The companies which have taken advantage of buybacks have outperformed dramatically, with the large cap buyback index outperforming the S&P500 by 5.4% per year with essentially the same volatility (also true at small and midcap levels as well):



Across all stocks, the top decile of repurchasers (those buying back the largest percentage of their market caps) outperform benchmarks by 3.87% per year, while the lowest decile share diluters underperform by 7.42% per year:

<sup>5</sup> Acropolis Investment Management: Stock Buybacks: Finding Common Ground Amid Controversy

**Excess Return vs. All Stocks (%)**

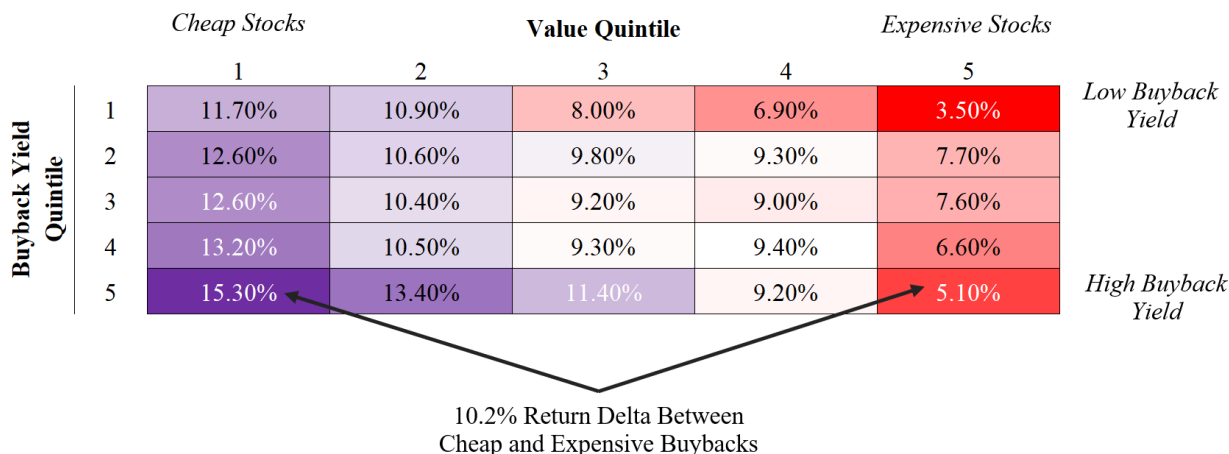
Buyback Decile	1	2	3	4	5	6	7	8	9	10	Spread (Best-Worst Decile)
"Net" Buyback Yield	-7.42	-4.33	-1.00	0.41	-0.10	-0.77	0.97	1.70	2.35	3.87	11.29
"Gross" Buyback Yield	-2.10	-1.78	-2.22	-1.69	-2.16	-1.77	0.38	1.82	2.32	3.54	5.64

**Volatility (%)**

Buyback Decile	1	2	3	4	5	6	7	8	9	10
"Net" Buyback Yield	23.99	22.90	20.89	20.14	19.48	18.39	17.39	16.29	15.91	17.00
"Gross" Buyback Yield	20.43	20.68	20.74	20.65	20.94	19.33	17.48	16.39	16.11	17.38

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When valuation is included, we see that the cheapest buybacks (those with the highest buyback yields) outperform dramatically:



Conceptualizing this is pretty simple: as investors we want our stakes in these businesses to increase not decrease, and proportionate stakes can increase more dramatically with buybacks at low valuations.

*"The math isn't complicated: When the share count goes down, your interest in our many businesses goes up. Every small bit helps if repurchases are made at value-accretive prices. Just as surely, when a company overpays for repurchases, the continuing shareholders lose." - Warren Buffett*

At 20x FCF, a company can repurchase 5% of its market cap with a single year's profits. At 10x FCF, the company can repurchase 10% of its market cap. High-conviction buybacks like these have a strong likelihood of beating equity benchmarks over time:<sup>7</sup>

<sup>6</sup> OSAM: Shareholder Yield: A Differentiated Approach to an 'Efficient' Market – US Large Cap Value

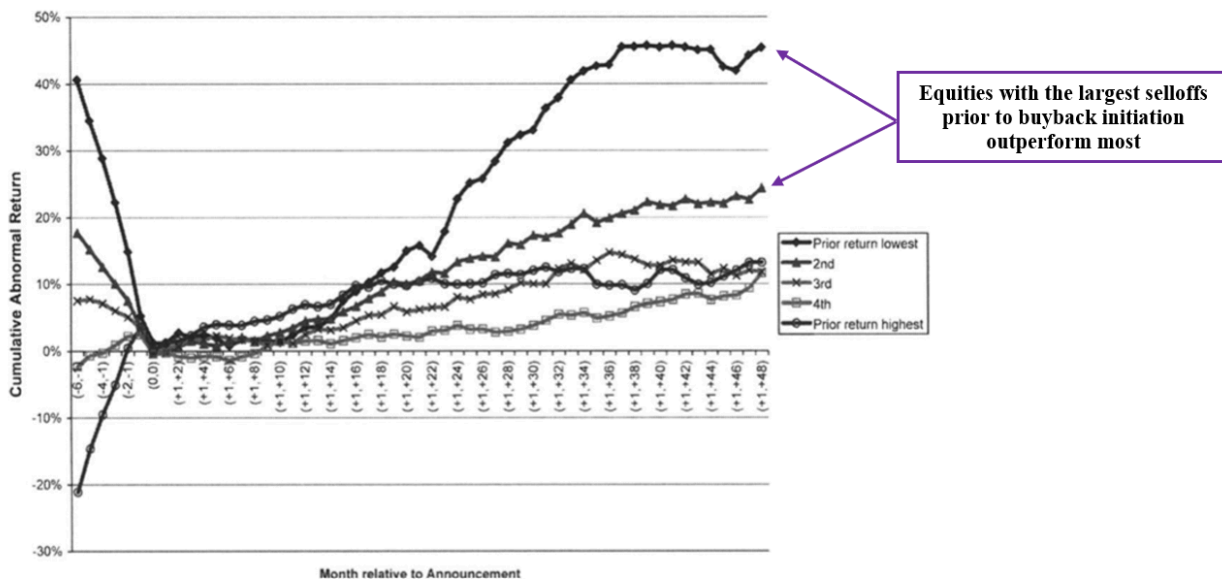
<sup>7</sup> High Conviction Buybacks, PATRICK O'SHAUGHNESSY, AUGUST 2015

**US Large Stock Base Rates  
(1987-2014)**

	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year
Net Share Issuers	35%	39%	28%	18%	6%	1%
Low Conviction Buybacks (0-5% of Market Cap)	50%	57%	66%	61%	81%	77%
High Conviction Buybacks (5%+ of Market Cap)	70%	74%	80%	86%	93%	98%

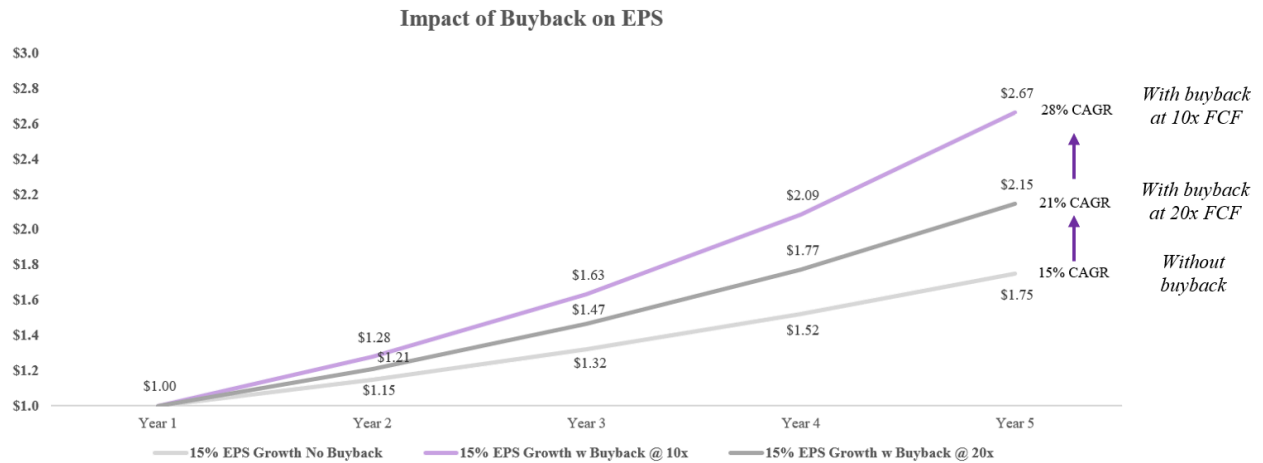
*Likelihood of  
Beating the  
Equity Benchmark*

Findings from INSEAD professors Urs Peyer and Theo Vermaelen on stock buybacks coincide with these conclusions that the most beaten down companies buying back stock perform the best - likely pointing to them being cheap and then re-rating due to the buyback and other factors.<sup>8</sup> The most beaten down quintile of repurchasers returned 45.4% in the first four years post purchase in their dataset while the stocks performing best pre-buyback still outperformed by 13.2%:

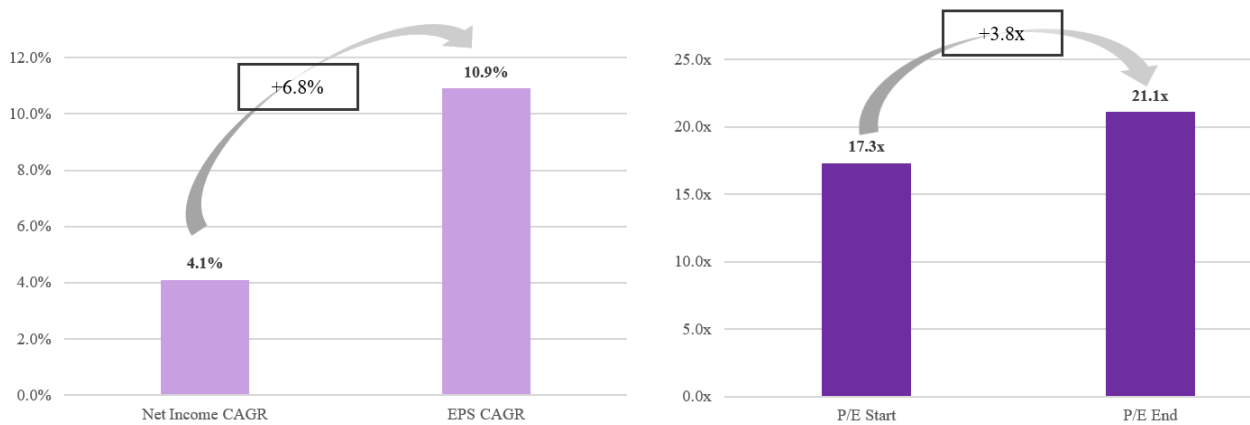


We believe this outperformance is driven by the low valuations (a 5%+ buyback is likely to be trading near a 5%+ FCF yield) and the earnings growth (the buyback will help FCF per share grow faster than FCF). Below we feature various buyback scenarios of a company growing net income 15%. Without a buyback, EPS grows with net income. A 5% FCF yield buyback drives an additional 6% CAGR, while a 10% FCF yield almost doubles the EPS CAGR.

<sup>8</sup> Peyer & Vermaelen: The Nature and Persistence of Buyback Anomalies



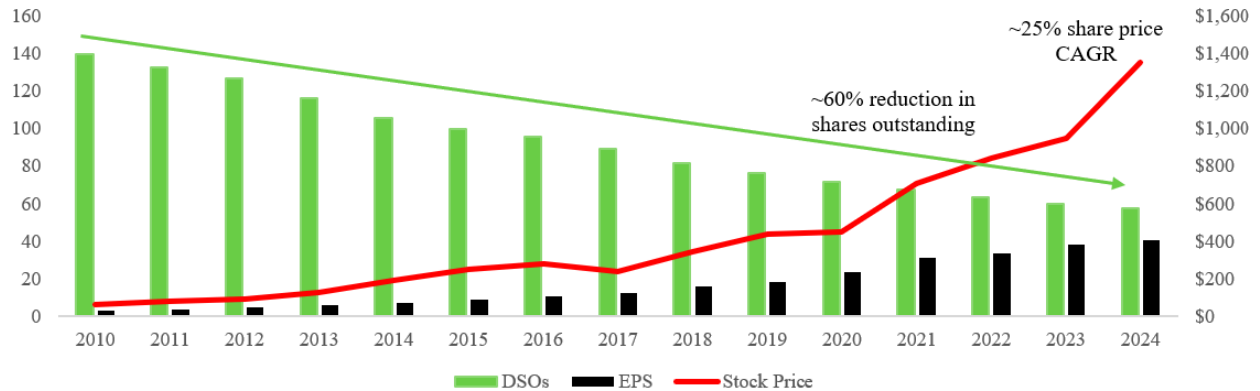
We compiled our own data on earnings growth to test this theory across 35 major buybacks over the last 30 years. Of the 35 companies in our dataset, we found that EPS was able to grow at 10.9% versus net income at 4.1%.<sup>9</sup> As these companies accelerated EPS growth and turned from share diluters to share repurchasers, these stocks rerated 21.1% from a below-market P/E ratio of 17.3x to 21.0x while the S&P remained at 20.9x on average.



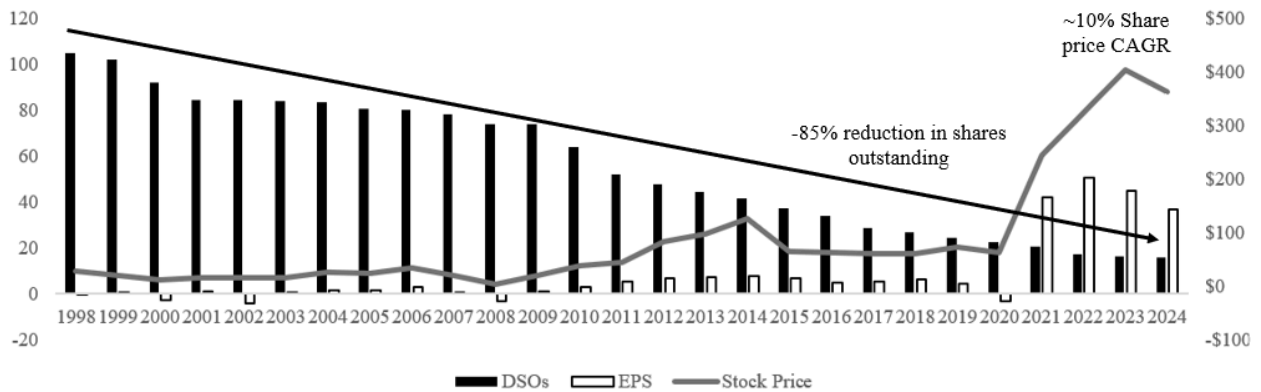
Some of the most successful buybacks from our dataset are O'Reilly Auto Parts (ORLY), Dillard's (DDS), and NVR (NVR).

<sup>9</sup> Buybacks must have driven at least 5% decline in shares outstanding, dataset focuses on normal market environments excluding cohorts ending in recession (2001, 2009, 2020)

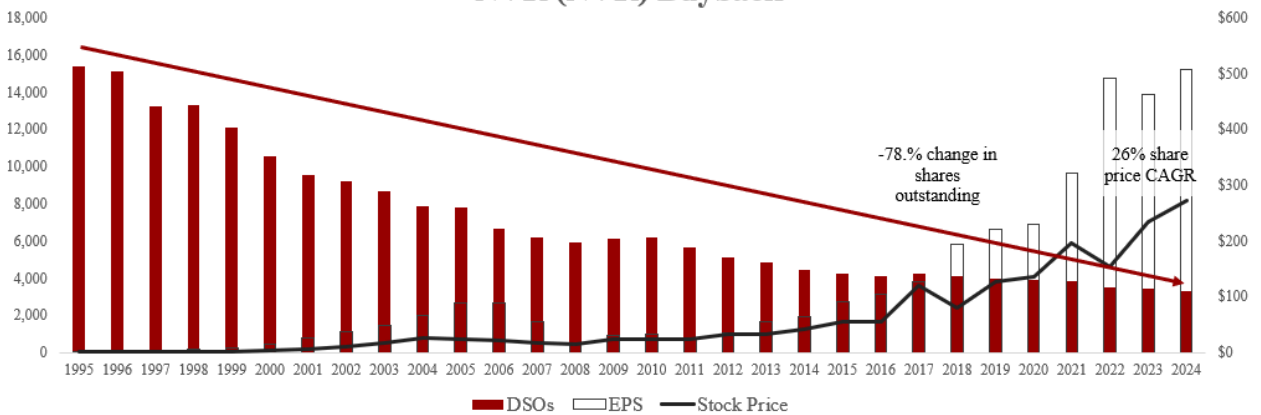
**O'reilly Auto Parts (ORLY) Buyback**



**Dillard's (DDS) Buyback**



**NVR (NVR) Buyback**



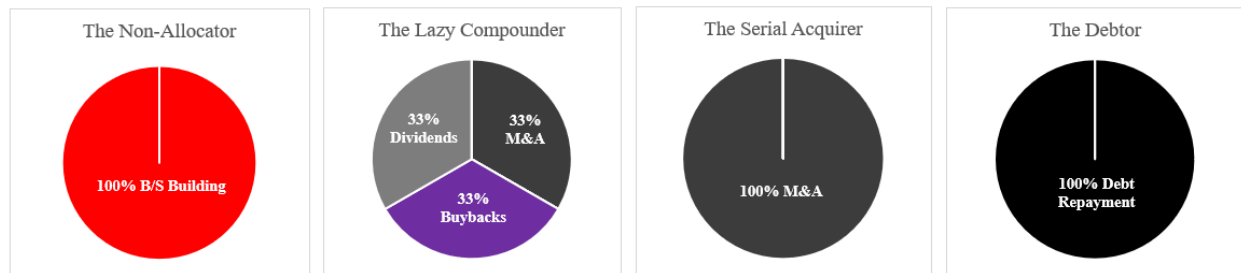
Not only do repurchasers show accelerating earnings growth and potential multiple expansion, but they generally have ~100bps higher return on assets (12.65% vs 11.59%) and 32% less debt (1.26x vs 0.86 debt to equity) than non-repurchasers according to Medury, Bowyer, & Srinivisan.<sup>10</sup> Overall, we believe the empirical data supports our

<sup>10</sup> Stock Repurchases: A Multivariate Analysis of Repurchasing Firms - Medury, Bowyer, & Srinivisan

hypothesis that buybacks are a proxy for high quality as defined by cash generation, earnings growth, return on capital, and leverage.

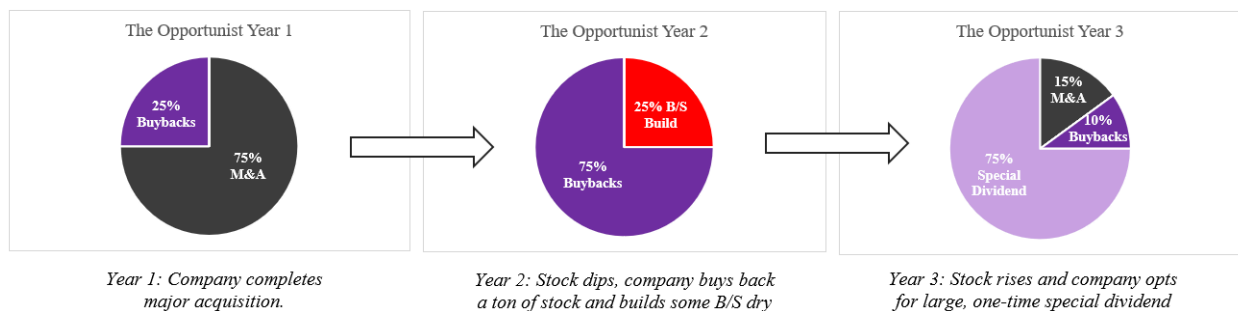
**Buybacks & Management**

One reason share repurchase programs excite us is because they can indicate a management team’s understanding and incentive to utilize the capital allocation tools at their disposal to drive shareholder value and stock price appreciation. While buybacks aren't a complex topic, we often speak with management teams lacking both frameworks and sophisticated understandings of capital allocation in general. The typical cash-flow allocation models we see are: The Non Allocator choosing to build up cash hoards rather than return capital to shareholders; The Lazy Compounder with an equally split capital allocation model; The Serial Acquirer pumping all cash flow back into new acquisitions; and the Debtor using cash to pay down leverage.



Non-owner operators, hamstrung by career risk, tend to take more conservative approaches to capital allocation like building up cash or opting for equally weighted approaches.<sup>11</sup> On the other hand, founders / owner-operators with material personal stakes tend to take bold, opportunistic measures. We would much prefer executives risk their own comfort and wealth for the benefit of all shareholders with such measures - since we are doing the same with our investments.

If a company is deploying a bold, meaningful buyback, it's very possible the team has a capital allocation framework which aligns with shareholders and allocates to the highest ROIC opportunities at any given point. Depending on the day, the opportunity set is going to vary - meaning a company’s capital allocation framework must vary as well. Thoughtful capital allocators are generally opportunistic and flexible, shifting their strategy as circumstances change:



An opportunistic leader is going to make necessary acquisitions when the deal is available, buyback stock when it is very cheap, and dividend cash back when their stock is expensive. When a stock is cheap it can represent an

<sup>11</sup> Data points to capital accumulation underperforming shedding of capital

attractive investment opportunity for a business' cash. For example, a stock trading at a 10% forward FCF yield growing FCF 15% per year that can re-rate to 15x FCF represents a 12-mo ROIC on the buyback of 82.5%.<sup>12</sup> Moreover, management teams have almost perfect insight into their own businesses and are therefore best positioned to understand near-term trends and capitalize on market overreactions.

### **Conclusion: Buybacks Give us Confidence to Double Down**

At the end of the day, stocks, like any asset, must return capital back to investors to be worth anything. Every metric investors use to value stocks from EV/Sales, EV/EBITDA, P/E, and EV/FCF are all proxies for a business' ability to do so. Some proxies for cash generation and return are better than others - but why stop at a proxy when we can go straight to the source when possible:



Returning capital to shareholders is important because these companies and stocks never go out of vogue. Stock prices are ultimately a matter of supply and demand - where demand for the asset sustainably increases in lockstep with anticipation of higher earnings and the disbursement of these earnings.

Importantly, meaningful FCF and a buyback authorization give us strong confidence in adding to our positions when they inevitably sell off. One could even go as far to say that we welcome stock price declines for active share repurchasers because the lower the valuation, the more shares the company can repurchase, and the greater the EPS/FCFPS growth and potential multiple expansion will be.




Steady buying from the company, in addition to the stock getting cheaper and cheaper, provides a floor to the stock price as these two work in conjunction to drive more bids for the equity. Unlike cash-burning companies, companies with meaningful FCF and a healthy balance sheet have a lever in their arsenal to right the ship when things go awry.

Based on the data, these companies outperform on average to the tune of 5.4% per year in the large cap segment. We believe this is due to the attractive characteristics of such businesses and teams:

1. The presence of free-cash-flow
2. Positive forward business prospects
3. Attractive equity valuation
4. Shareholder alignment
5. Sophisticated and opportunistic capital allocation

Recently, we've had some material buybacks for some of Tenebrist's largest positions:

<sup>12</sup> 10% yield + 15% growth x 50% multiple expansion = 82.5%

Company	2024 Buyback	2025 YTD Buyback	Authorization
	\$179mm (46% of FCF)	\$148mm (>100% of FCF)	\$500mm (May 2024)
	\$1.25B (18% of FCF)	TBD (authorized accelerated \$1.5B January 2025)	\$7B (February 2024)
	\$319mm (300% of FCF)	\$132mm (143% of Net Income)	\$500mm (December 2024)

Overall, roughly 70% of the Tenebrist portfolio is actively buying back stock in 2025 and we would expect this to be a staple of the book going forward. While there are obviously other types of attractive investments such rollups (eg. Constellation Software, TSE:CSU), and aggressive reinvestors (eg. Amazon, NASDAQ:AMZN) where both types are deliberately deploying FCF to M&A and CapEx to generate long-term free cash flow, we expect to primarily focus on the upper echelon of businesses which can grow rapidly, generate FCF, and cannibalize share count today.

Thank you a million times over for your time, support, and investment,



James Reynolds, CFA

**Appendix - Tenebrist Buyback Research**

Company	Initiation Year	Net Income CAGR	Total Share Decline	EPS CAGR	TSR	P/E Start	P/E End	Re-Rating
<b>Totals ex Recessions (2001, 2009, 2020)</b>		<b>4.1%</b>	<b>-11.2%</b>	<b>10.9%</b>	<b>66.9%</b>	<b>17.3x</b>	<b>21.0x</b>	<b>21.1%</b>
Hershey Co	1996	19.0%	-14.7%	25.5%	8.4%	26.5x	14.6x	-45.1%
UnitedHealth	1997	19.5%	-9.5%	23.6%	147.0%	21.4x	28.1x	30.9%
Abbott Labs	1997	10.0%	-4.5%	10.3%	47.9%	11.1x	12.2x	10.1%
Altria Group	1997	10.5%	-8.5%	13.8%	-2.8%	4.1x	2.7x	-34.0%
Autozone	1999	20.5%	-30.5%	36.0%	201.5%	14.7x	18.1x	22.9%
Dillard's	1999	-19.0%	-24.6%	-11.0%	-42.4%	9.7x	17.7x	82.1%
UnitedHealth	1999	33.5%	-16.7%	41.9%	214.5%	17.9x	19.7x	10.0%
McDonald's	2000	-9.4%	-9.1%	-6.4%	-27.0%	24.1x	21.5x	-10.8%
Oracle	2001	1.5%	-11.2%	5.6%	-25.5%	35.8x	22.6x	-36.8%
Home Depot	2002	18.0%	-5.8%	20.3%	70.8%	18.5x	18.2x	-2.0%
Darden Restaurants	2002	7.7%	-12.0%	12.3%	31.1%	17.9x	16.5x	-7.6%
Rockwell Automation	2003	28.4%	-4.7%	30.5%	121.3%	17.3x	17.2x	-0.5%
Applied Materials	2004	8.2%	-15.6%	14.5%	17.1%	20.2x	15.7x	-21.9%
Northrop Grumman	2004	18.2%	-3.8%	19.7%	44.7%	16.8x	14.1x	-15.7%
Yum Brands	2004	7.1%	-11.6%	11.6%	66.5%	13.8x	16.5x	19.8%
Williams Sonoma	2007	-28.2%	-8.1%	-26.1%	-44.6%	19.1x	26.3x	37.6%
Chevron Corporation	2007	0.6%	-8.6%	3.7%	-2.2%	11.0x	9.6x	-12.3%
Dominos	2011	15.5%	-6.4%	18.1%	181.1%	19.6x	33.4x	70.6%
O'Reilly Automotive	2011	15.3%	-25.4%	27.1%	140.9%	20.9x	26.2x	25.9%
Discover Financial Services	2011	1.0%	-15.6%	6.9%	174.9%	5.9x	13.4x	125.0%
Visa	2011	14.2%	-36.3%	32.7%	148.9%	25.7x	27.4x	6.5%
Ameriprise Financial	2012	14.9%	-25.2%	26.6%	69.9%	15.0x	12.5x	-16.3%
Apple	2012	8.6%	-8.7%	13.4%	43.7%	11.9x	11.7x	-1.6%
MSCI	2012	6.7%	-10.1%	10.5%	132.8%	20.6x	35.5x	72.3%
Seagate	2013	-40.8%	-31.5%	-32.9%	-46.4%	10.4x	18.5x	77.4%
IDEXX	2013	5.7%	-16.7%	12.3%	121.7%	30.5x	47.6x	56.3%
Dicks Sporting	2013	4.4%	-7.2%	7.0%	-18.4%	20.7x	13.8x	-33.4%
HCA Healthcare	2014	5.7%	-19.4%	13.6%	19.7%	18.1x	14.8x	-18.4%
General Motors	2015	-6.5%	-15.2%	-1.2%	-1.6%	5.9x	6.0x	2.1%
Assured Guaranty	2015	-21.0%	-42.5%	-12.8%	40.7%	3.8x	8.1x	112.3%
Ulta Beauty	2018	-31.8%	29.3%	-29.4%	27.5%	24.9x	90.1x	262.2%
Tractor Supply Company	2018	23.3%	9.1%	27.5%	174.3%	20.0x	26.5x	32.3%
Meta	2018	21.2%	82.0%	22.5%	156.6%	17.5x	24.4x	39.4%
Dollar Tree	2020	25.0%	-5.9%	27.5%	30.6%	31.1x	19.6x	-37.1%
Marathon Petroleum	2021	-64.7%	-47.5%	-12.4%	118.0%	4.3x	13.8x	224.1%

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