Too Easy?

Investors Chronicle
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Thursday, June 13, 2019

The young Warren Buffett was in no doubt at all. On a summer evening from the front porch of his friend's Bob 'Russ' Russell's house he would watch the cars streaming out of Omaha, Nebraska, to all parts of the US midWest. It almost hurt him to see all those Fords and Chevvies go by without paying so much as a dime. "Gee, Mrs Russell," he would say to Russ's mother, "all that traffic. What a pity you aren't making any money from the cars going by. That's really a shame."

The point is that when he was still in short trousers, the boy who would become the most famous investor on Earth could intuitively grasp the wonders of rent-seeking – the pursuit of something for nothing. He imagined the toll gate, the archetypal way of extracting so-called economic rents, where he who commands the toll gate can extract payment from anyone who wants to pass. In so doing, he brings nothing to the table, adds no value, performs no socially-useful function. He simply uses his power to get rich at the expense of others.

That's not good, although sometimes needs must. At roughly the same time that the young Buffett was fantasising, a few hundred miles to the south impoverished farmers did extract rents from passing motorists. Their toll gate was described in the novel, *The Reivers*, by Nobel Prize laureate William Faulkner. It was actually a mud bath. Overnight the farmers would drench the dirt-track roads outside their farms so that passing motorists inevitably got stuck. Conveniently, the farmers would be on hand with their donkeys to pull the cars out of the mud – but at a price.

Instinctively, rent extraction by the poor farmers in Faulkner's novel is acceptable; it is – if you like – Robin Hood rent extraction. Not so the wicked rent extraction – the King John version – that, the politics of outrage would

have us believe, is routinely practised by the rich and powerful in the 21st century.

Yet disapproval of rent-seeking is as old as the practice itself, even if the term, 'rent-seeking', is comparatively new. Its formal investigation dates back to an influential 1967 paper by a US economist, Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*. The term itself did not enter the economists' lexicon until 1974 when Anne Krueger, later to hold top posts at both the World Bank and the International Monetary Fund, produced a paper, *The Political Economy of the Rent-seeking Society*.

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Indeed, with some prescience, Ms Krueger's paper summarised what would become the presumptions that help drive today's anger at rent seekers. She wrote: "If income distribution is viewed as the outcome of a lottery where wealthy individuals are successful (or lucky) rent-seekers, where the poor are those precluded from or are unsuccessful in rent seeking, the market mechanism is bound to be suspect."

However, go back to the 18th century and we can find Adam Smith – always a man to be sceptical of markets – in effect writing about rent-seeking in his great work, *The Wealth of Nations*: "The proposal of any new law or regulation which comes from merchants ought always be listened to with great precaution. It comes from an order of men whose interest is never exactly the same as that of the public and who have generally an interest to deceive and even to oppress the public."

Fast forward 200 years and another great economist, Milton Friedman, was saying much the same: "Almost every businessman is in favour of free enterprise for everybody else, but special privilege and special government protection for himself."

Tacitly, both Smith and Friedman – and many other economists besides – acknowledged that rent-seeking is as old as the hills and is hard-wired into the human condition. What is it? Essentially the pursuit of an unfair advantage and the capture of something for nothing.

More formally, it starts with the concept of an 'economic rent'. That's an excess payment to a party in a transaction or, say, the retention of excess profits by a company. We can judge if the payment is excessive – if it's an economic rent – if it's more than would be needed to get the job done.

Yet that makes economic rents – and rent-seeking – more nuanced than we might imagine. Such payments may be excessive, but does that always make them unfair? Almost certainly, Lionel Messi – annual earnings estimated at £80m – is paid more than is needed to persuade him to kick around a football. To that extent, he extracts an economic rent. But it's only because he is almost uniquely good at thrilling millions of people that he can extract such riches. So the investment bankers who take home millions but who are – according to Luigi Zingales, a high-profile economist – in "an occupation that easily slides into rent-seeking" attract universal opprobrium while Mr Messi attracts universal approbation.

From this, we can frame a rule which states that an activity is only rent-seeking if we disapprove of it. But it also presents us with a paradox, especially from the perspective of investors. On the one hand, rent-seeking invites our disapproval: it's a tax on enterprise and on hard work; it stifles innovation and wealth creation. In the long run, this leaves those countries where it is rife poorer in aggregate.

On the other hand, it brings clear advantages to those who can extract rents – the ones who can maintain their wealth without effort. Publicly, we may lambast these rent extractors. Inwardly, however, we may well envy them. And, if rent extractors take a corporate form, we want to own shares in them. Companies that can charge economic rents pretty well have a licence to print money – sometimes literally so. Who wouldn't want a slice of their guaranteed revenues stretching far into the future? They are what the young Warren

Buffett dreamt of and what he has pursued for much of his nigh-on 70-year investment career.

More about rent-seeking companies in a moment. First, however, let's take a moment to consider what's good about rent-seeking because this rarely gets a mention. Chiefly, it can make us try harder. To get an insight into this, consider drug dealing – yes, really; in particular, the story of a Chicago drug-dealing gang as told by the University of Chicago economist, Steven Levitt, in his economics best-seller, *Freakonomics*.

The gang called themselves the Black Disciples and their leader, known only as JT, took home about $100,000 a year tax-free (this was some years ago). That amount was almost as much as he paid all of the foot soldiers in his gang. Per hour, that worked out at about $66 for JT, while a foot soldier – the ones with the really dangerous job, standing on street corners, laden with drugs, dealing with junkies – made $3.30.

Clearly, the foot soldiers could have been paid more but, as another gang leader explained: "You got all these guys below you who want your job, dig? So you have to take care of them, but also you have to show them you the boss. You always have to get yours first or else you ain't really no leader."

A south-side Chicago drugs baron is much like the boss of a FTSE 100 company. Both have won out in an intensely competitive game where there is just a fixed number of high-reward slots

In other words, by a combination of ability, graft, ruthlessness and whatever, JT got himself into a position where he could extract rent and rent extraction was precisely what he intended to do. No question. Why else go into such a high-risk occupation in the first place?

In that sense, a south-side Chicago drugs baron is much like the boss of a FTSE 100 company. Both have won out in an intensely competitive game where there is just a fixed number of high-reward slots. Both intend to exploit

their opportunity. And that’s good because their rent extraction signals to other capable players that they should try their hardest too.

Arguably, however, the main difference between the Chicago dealer and the boss of a FTSE 100 company is that the Footsie chief exploits his opportunity more ruthlessly. Put it this way: according to the High Pay Centre, a left-leaning UK think-tank, in 2017 the median pay for a FTSE 100 boss was £3.87m all in (basic, bonuses, the lot). In contrast, average weekly earnings that year in the UK grossed up to £24,960 a year. This meant that for every £1 earned by the average worker, the median Footsie boss took £155. Yet within the Black Disciples drug-dealing gang the ratio of JT’s take to the average foot soldier was just 20:1 – almost egalitarian in comparison.

Then again, the evidence of rent extraction by directors of UK quoted companies has been mounting for years. Back in 2009, median pay for FTSE 100 bosses was £2.19m compared with £21,580 for the average UK worker. That meant the 2009 ratio of boss-to-worker pay was 102:1. Then, between 2009 and 2017, bosses’ median pay grew by 7.3 per cent a year while the average UK worker’s pay grew annually by just 1.8 per cent. The effect of those differing growth rates was to take the boss-to-worker ratio to 155:1.

It would be fatuous to suggest that the average boss had somehow become 50 per cent more capable than the average worker in that period. Yet, in effect, this is what the apologists for UK corporate governance would have us believe.

It fools no one. For example, Lucian Bebchuk, a professor at Harvard Law School who specialises in executive pay, is in no doubt that rising executive pay since the 1980s is all about power and rent extraction under the cloak of corporate-governance rules. These rules are chiefly framed by what Professor Bebchuk labels “the optimal contracting approach”, which attempts to overcome the core problem present in almost every organisation, namely that the people hired to run it don’t have the same interests as the people who hired them.

This is especially true of companies where bosses – whatever they may protest – don't have the same interests as the shareholders who own their company. The way to overcome this so-called 'agency problem' is to frame bosses' contracts so that their interests align with those of shareholders. The specifics almost always involve loading up contracts with performance-based incentives that are paid in company shares. That way, if targets are met, the share price goes up and everyone is happy.

Much of this is a front, however, according to Professor Bebchuk. What really drives executive pay, he says, is "the managerial power approach" where bosses get what they want because they can; because, in effect, they have much influence over their own pay; because they are hired by bosses of other companies doing a non-executive director's stint. Thus performance targets are rarely as tough as they could be; in particular, options to buy shares (or, in effect, to sell them) are granted at give-away 'at-the-money' prices.

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The factor that chiefly limits bosses' pay, suggests Professor Bebchuk, is "how the arrangement is perceived by outsiders and, in particular, how much outrage it can be expected to produce". Hence – in order to minimise outrage – the rigmarole of nomination committees, renumeration consultants and all the trimmings of corporate governance. This paraphernalia does not solve the agency problem but, the professor suggests, is part of the problem itself "designed to camouflage the extraction of rent".

If rent-seeking is ubiquitous and if bosses are busy extracting rents then it follows that there must be companies that extract rents, too. In a way, this is obvious. It is abundantly clear there are natural monopolies in corporate form that would be able to exploit their advantages but for the contrived markets forced upon them by regulators or the heavy-handed rules that bind them.

However, what really excites investors, and captures customers and suppliers alike are the rent extractors that are not regulated; the ones whose power has

not been spotted and emasculated or who are, in effect, too powerful to control. True, it is debatable whether there are such companies, but the circumstantial evidence of their existence is persuasive. At least it is becoming conventional wisdom that there is an elite group of big companies that remorselessly get bigger, dominant companies that have become domineering.

This phenomenon has been dealt with in any number of academic papers and was tackled by Investors Chronicle earlier this year (Competitive Pressures, 8 February 2019). It is about 'winner-takes-all' companies; firms that somehow manage to avoid averaging down and for whom economies of scale just keep on giving. They are epitomised by the new 'robber barons', the US technology titans that threaten to do to the commercial landscape what the robber barons of late 19th century USA – the likes of Jay Gould, Cornelius Vanderbilt and Andrew Carnegie – were supposed to have done back then.

True, the debate – if one can call it that – tends towards the hysterical and the simplistic. Besides, we are not concerned here with whether, say, **Alphabet (US:GOOGL)** should be broken up or whether **Facebook (US:FB)** should be compelled to sell its data. From an investor's perspective, the need is to stand back and ask: what would be the characteristics of a corporate rent extractor and how could they be spotted from a distance?

We would reason that, by dint of its power, a rent-extracting company would be brilliantly profitable and that would show up in its financial ratios. In particular, its profit margins would be wide thanks to its pricing power and its return-on-capital metrics would be similarly impressive, a function of those profit margins and of the need to employ only limited amounts of capital. Its ability to generate cash as well as accounting profits would also be clear because that's what real profitability boils down to. Last, its dominance means that it does not have to try too hard, so its capital spending will be lowish compared with less fortunate companies.

Put these notions into four simple financial ratios and we come up with the table, Spot the Rent Extractor. This takes profit margins (operating profits over revenue), return on assets (rather than on capital, since the equity

recorded in any listed company's accounts is so often an unreliable figure), free cash flow return on assets (where free cash is the cash left over after payment of all deductibles including tax and capital spending) and capital spending as a proportion of revenue.

The data in the table are the average of the past five years' returns for each company. In other words, they are not based on one exceptional year (good or bad) but indicate each company's typical effort. Indeed, the rows for the average performance of each of the three sub-sets (shown in italics) is extremely typical since it distils so much data; for example, for the five modern-day 'robber barons', each average figure contains 25 years' worth of returns. In that sense, the figures should be reliable.

Of the sub-sets, the robber barons choose themselves. These are the five companies that include four of the world's biggest by stock-market value – the exception is Facebook – and which, in their different ways, dominate the consumer-facing side of the IT industry. Not just that, but they are demonised for their supposed bullying, either now – in the case of Facebook and **Amazon (US:AMZN)** – or in the past in the case of **Microsoft (US:MSFT)**.

The seven 'global greats' were chosen rather randomly, although few would quibble about labelling them as such. They have sufficient reputations for excellence and longevity that they prompt the question: are they, in effect, robber barons? Have they got themselves into the position where they can extract rents? Related to that, is the vital question: is it possible to distinguish a robber baron from a brilliant company?

Third are the 'regulated rent extractors', UK monopoly suppliers that could have been except that the regulators captured them first. These are included by way of contrast. They are the ones that have suffered the fate that, some argue, should be meted out to Facebook and Amazon. As such, their returns should be a doleful reminder of what could have been, a pale reflection of what robber barons produce.

The evidence of rent extraction by directors of UK quoted companies has been mounting for years

And the data pretty much bear out these notions. The robber barons generate the best returns of the three sets. They have easily the best profit margins – 26 per cent on average in the past five years, a third more than both the global greats and the regulated rent extractors. Their return on assets is usefully better than the global greats and their free-cash return hugely better. It is only on the need to spend on capital account that the robber barons trail the global greats (in other words, they spend more). Perhaps that's a function of the need to maintain the lead in fast-changing technology. Alternatively, it might simply be the effect of different accounting treatment of capital spending and development costs. After all, the rates of capital spending among the five vary considerably – does Facebook really layout capex at more than three times the rate of **Apple (US:AAPL)**? Unlikely.

At the other extreme, the regulated rent extractors look just like that – regulated. Their profit margins are fine, but profits conspicuously fail to feed through to a high return on assets or acceptable cash flow. Indeed, their lousy cash flow is mirrored by extremely high capital spending, which most likely reflects the pressures that regulators impose.

In the middle sit the global greats, who do a pretty good impression of being robber barons. To explain why, we have to dig a little into the nature of their business model and that of a typical rent extractor. Both are likely to have the following characteristics:

- Market dominance, especially of discrete self-contained markets. These need not be restricted to geographical areas or product types. They could also be in niche services or in cyber space.
- Barriers to entry that make it difficult for competitors. Just as there can only be one toll gate through which all must pass, so, for example, there might be just one quarry from which a city's needs for aggregates must be served. Or – as is currently the aim in so many fields of business – just one technology platform through which all electronic transactions

can go. Licences and patents serve a similar function. They restrict supply and give pricing power, at least for a while. Patents expire, although clever companies find a way to roll them over. Licences expire, too, although they often have a habit of staying with the incumbents.

- Customer captivity, which is another form of barrier to entry. If would-be competitors can't access an established company's customers then the established company may be on the way to collecting rents. Finance, IT and media companies are very good at this where the cost to a customer from switching from supplier A to B is simply not worth the effort. So customers get locked in. Much of the time aiming to capture customers is part of the hurly-burly of business life. But sometimes it strays into market abuse, such as when Microsoft restricted the ability of PC makers to use alternative browsers when it bundled Internet Explorer with its Windows operating system and was labelled a monopoly as a result.

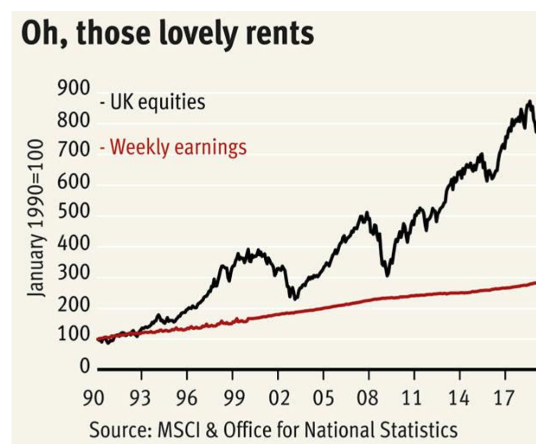
The irony is that in describing and explaining great companies and rent-extracting ones we are pretty much describing the same thing. To outward appearances they are one and the same. Perhaps rent extractors are simply great companies that have morphed; that – to exaggerate – have found it is more profitable to grease palms than to innovate.

Yet if they are the same, then Warren Buffett's childhood intuition was correct – the best company is a toll booth, that's what allows it to extract rents. Whether that franchise is gained through merit or by some form of corruption matters from an ethical point of view, but not from the perspective of making good investment returns.

This also means that the search for rent extractors or for great companies is the same process. Mr Buffett – with a little help from his eventual business partner, Charlie Munger – realised that too. He sought companies with a business 'franchise' in the original sense of the word, a place of safety, a sanctuary.

If this is a little dispiriting, if it implies that, for investors, there are no free rides; that, in order to find shares in rent extractors, as much effort needs to be spent as to find shares in outstanding companies, then it shouldn't be. Look around and it seems as if rent extraction comes with the very fact of investing in financial markets, equity markets included.

For proof of sorts, consider the chart below. Using 1990 as an arbitrary start date, it shows relative changes since then of returns to work and returns to equity capital. Work is proxied by average weekly earnings in the UK; equity returns are measured by the total return (dividends included) on the UK index from markets data provider MSCI. Sure, the comparison isn't quite like against like; one measures capital and saving, the other income and spending. But the main message is that, in the 28-year period, earnings power has risen 2.8 times while savings power, which is probably subject to lower taxation anyway, has risen 8.5 times.



Back in 2011, the French economist, Thomas Piketty, whose work has specialised in explaining today's concentration in wealth, was taken only half seriously when he suggested that "at the very top of the income ladder, pay increases reflect mostly greed and socially wasteful activities rather than productive work effort". Increasingly, however, that view is occupying the economic mainstream.

In which case, the question is no longer are those income and wealth differentials fair? Rather, it is: are they rational or logical? If the reply is 'no'

then they stem from rent extracting. Enjoy it if you can do it; envy those who can do it more effectively than you, and despise those who imagine that good luck plays no part in it.

Spot the rent extractor				
'Robber barons'				
Company	Profit margins (%)	Return on assets (%)	Free cash flow return (%)	Capex/ revenue (%)
Microsoft	31.3	14.5	13.4	8.2
Apple	28.1	20.3	18.7	5.3
Alphabet	25.3	13.7	11.6	14.3
Amazon	2.6	3.9	8.1	5.8
Facebook	42.8	18.7	16.8	17.3
Average 'robber baron'	26.0	14.2	13.7	10.2
Global greats				
3M Company	22.7	20.8	14.7	4.7
Heineken	14.5	7.7	4.8	8.6
Carlsberg	13.3	6.8	4.8	7.0
Nestlé	16.0	11.0	7.8	5.0
Johnson & Johnson	27.2	14.3	11.6	4.6
The Coca-Cola Co	25.1	11.2	7.8	5.1
Procter & Gamble	20.5	11.0	8.4	5.3
Average global great	19.9	11.8	8.6	5.7
Regulated rent extractors				
BT	16.7	9.2	5.1	10.7
Drax	1.6	1.4	1.2	4.8

National Grid	23.3	5.8	2.7	22.8
Pennon	20.1	4.8	-1.2	24.7
Severn Trent	28.6	5.7	2.9	30.3
SSE	5.1	6.7	1.4	5.8
United Utilities	36.7	5.4	0.4	41.8
Ave reg'd rent extractor	18.9	5.6	1.8	20.1
Source: S&P Capital IQ; all data based on the average of the past five years				