**A Question for Passive Investors: If You'd Buy 100% of the Business at Today's Price – Should You ALWAYS Buy the Shares?**

One of Warren Buffett's basic tests for buying a stock is the idea that if you wouldn't buy the whole company at this price – market cap, enterprise value, etc. – you shouldn't buy the stock. Not even to hold it for just a week, month, or year. Does the reverse hold true though? If you would buy the entire company – does that mean you should buy the stock?

If you like the management, controlling shareholders, etc. and you like the way they've been allocating capital and are likely to be allocating capital in the future – then, the answer would be yes. But, what about the much more common situation where owning an entire business and controlling all of its cash flows yourself might be more attractive than buying a piece of it as a passive, minority shareholder. This situation is more common than you think. Andrew and I can usually find some business somewhere that we'd be happy to acquire 100% of at the current market cap – or even at some fairly large premium over that – but, are less sure we'd be happy as passive, minority shareholders. Why does that happen? Are we really so much more confident in our ability to allocate capital than those of most management teams?

No. The reason it happens is price. Good businesses do sometimes – though often not for long – trade at big discounts to what they would be worth to a private buyer. Sometimes very illiquid stocks, very misunderstood businesses, currently unpopular industries, etc. are also a reason why a public company might trade at a big discount to where it would sell in a private, negotiated transaction. But, a much more common reason for extremely persistent cheapness is the capital allocation. Controlled companies aren't any better or any worse capital allocators on average than non-controlled companies. But, whatever they are – good or bad – is amplified tremendously by their control. The reason for this is the long duration of a stock as compared to most bonds you'll come across. A lot of a stock's value comes from the discounted future cash flows out many, many years in the future. Your average public company retains a lot of earnings. It could be 30%, 50%, or 75%. I know 30% sounds low. But, if a company is retaining one-third of its earnings each year and it's growing, and it's selling at 10 times earnings (a typical "value stock" type P/E) – that business will re-allocate way more than its current market cap over the next 30 years. And 30 years – given today's extremely low interest rates – is probably a good time frame to think of the value of a stock over. You're unlikely to hold the stock for 30 years. The stock may even be unlikely to stay public for 30 years. But, the period over which the discounted cash flows are still relevant on a present value basis is likely to be as long as 30 years these days. So, a lot of capital is going to be re-allocated relative to the intrinsic value of this stock.

A lot of investors look at stocks trading at similar multiples much the same way. You assume a stock with an EV/EBITDA of 8 in the restaurant industry is a lot like any other stock with an EV/EBITDA of 8 in that same industry. But, there's an assumption underlying these EV/EBITDA type peer comparisons. The assumption is that another buyer in the industry, a private equity firm, etc. can come in and acquire the company and use those cash flows as they see fit. So, naturally a firm considering acquiring a business in a certain industry is going to be thinking in terms of those EV/EBITDA multiples. But, the truth is that some of these companies are for sale and others aren't. Some aren't for sale at any price. They are controlled and want to stay in the business doing much the same thing they always have been. Management in these firms are also owners. And they have enough control to limit capital allocation to those areas they are most interested in.

Let's take the example of Avalon Holdings (AWX). This stock is a micro-cap value stock and has been for a very, very long time. It has often appeared cheap. The company owns (and in one case has a long-term lease that is renewable several times unilaterally at its option) over 1,000 acres of land in Western Pennsylvania and Eastern Ohio. Almost all of this land is directly related to country clubs generally and golf courses specifically. So, it's a very special use of capital. By the way, the capital used to fund the purchases and improvements of these country clubs didn't come from the country club business – it came from the waste management business (primarily the waste brokerage business) and bank loans. So, you have major capital re-allocation over a period of more than two decades at this company. Free cash flow and debt capacity from a waste brokerage business was used to acquire a large amount of land with a specialized purpose in a small area of the country. These sites are quite close to each other. Andrew and I visited all of them in person on the same day while in those two states.

The company is controlled by a shareholder who has one class of stock that is different from the class of stock you can buy in the market. The situation is not as pure control a situation as some. Outside, minority shareholders don't have to be completely passive in this case. As a group, they can always appoint one of every four board seats (at a minimum). So, on a four person board – they could have one seat. On a five person board – they could have two seats. But, the other class of stock is sufficiently controlled by one person that a majority of the board is always going to be electable purely based on his wishes. As a result, you have a company here where outsiders can get on the board. But, they can never get control. This is a little different than most control situations. Most control situations in the U.S. today would allow the controlling shareholder to keep outsiders off the board completely. That means outsiders could cause more problems for this company, any fight could be uglier, and it invites lawsuits and those sorts of things once an outsider was on the board. But, that's really all it does. There is zero path – absent reaching an arrangement with the controlling shareholder – to a sale, recapitalization, restructuring, change of strategy, etc. at this company.

As a result, you can end up with an asset play that might be attractive if bought in the entirety – even at a premium to today's market cap – but, not a stock that is attractive as a passive purchase.

It's not luck that Avalon Holdings trades at a low value relative to its assets and is controlled. The two go hand in hand. Control itself is not the reason the stock is often cheap. But, control is what stops outsiders from making a run at the company. This is a smaller factor than the bigger day to day trading impact. A lot of investors – read any stock message board, blog write-ups etc. of "asset plays" for examples of this – don't intend to do any activism themselves, but they do buy into situations assuming that someone else will eventually do the heavy lifting for them. They buy expecting insiders to sell out, to die, or to fail to completely fend off an activist and to therefore have to come to some kind of accommodation. In situations like Avalon – where there is literally no path to forcing the issue –

investors see not just no immediate catalyst, but no hope for any catalyst ever appearing. So, Avalon might be the kind of situation where someone could be wise to buy the whole company – but foolish to buy the stock. I'm not sure. I don't think I'd want the task of actually taking over such a company and re-allocating the capital. Land is not a quick asset. Re-allocating assets like what Avalon owns would be a much longer and more involved process than the kind of thing Buffett did at Sanborn Map, Dempster Mill, or Berkshire Hathaway. I've seen the land. There's a lot of it. But, it's not in such a desirable area for re-development as to stir up immediate plans for what you'd do with the land and how quickly. Still, the stock probably does get cheap versus the actual value of that land sometimes. And the land has been easy to finance at a reasonable cost of capital and high amount of leverage relative to its value (as is often the case with land), so I wouldn't be surprised if the company if it were offering 100% of itself for sale would get more bids than the stock gets trading publicly as a purely passive investment opportunity.

On the other hand, this aversion to "value traps" can be taken too far. I invested in Japanese net-nets that seemed to have no path toward changing capital allocation. Within a year, two of the companies were sold in their entirety. I've also followed companies like Paradise and Vulcan International – which were seen as permanently cheap stocks where value would never be realized. Both companies decided to liquidate and pay everything out to shareholders. In other cases – like Keweenaw Land Association (KEWL) – I've seen a firmly entrenched management that owned a lot of stock pushed out by an investor willing to buy so much stock and fight so hard that they eventually gained control of a much harder than normal target for an activist campaign. In most cases, controlling shareholders aren't really controlling. Multiple classes of stock and poison pills have become much rarer in the U.S. than they were 30 years ago. So, it is the unwillingness of any one shareholder to buy up a lot of stock and keep buying – even long after having to file their intentions with the SEC – and the expense they will have to pay and the even higher price of the negative publicity they'll face when mud gets slung at them that stops outsiders from committing fully enough to change capital allocation at stocks where there's a lot of asset value but not a lot of good capital allocation.

Then there are stocks where the argument is a little different. Sometimes you come across stocks where there isn't a controlling shareholder making capital allocation decisions investors dislike. Rather, the company is just very small, very illiquid, and completely unknown or unliked. But, the actual record in terms of intrinsic value is interesting – even good. These are the most fascinating stocks to me. Because it seems to happen that if a stock doesn't do well as a stock (regardless of how it has done as a business) it will eventually develop a reputation as a loser. Everything the company does will be seen through this lens. And so you come across stocks that double book value over 10 years or whatever (that is, they are returning 7%+ a year, a lot like the market often does in many decades) and yet because the stock has gone nowhere people start to assume the business's value will never go anywhere either.

Finally, you have the natural impulse of almost every value investor I've met to shoot for the quick sale. If it's known a company isn't for sale – the stock suddenly becomes a lot less interesting in their eyes. If there's a possibility it might be up for sale in the next few years – even if it isn't clear the company would fetch much more in a private sale than it currently is appraised for in the public market – value investors circle the stock. Hope for "strategic alternatives" is the kind of action value investors crave the same way momentum investors love to see the right kind of price action.

These last two cases are the safest to bet on. If you'd buy the whole company and your only reason for not buying the stock is that you're unsure how quickly and in what exact manner value will ever be realized – just buy the stock. If value is compounding nicely, you don't need to know when the whole company will ever be sold. Nor do you need to know what will ever make the stock price go up. As long as value isn't being destroyed, you don't dislike or distrust management, etc. – if you'd buy 100% of the business, you should buy the stock. In cases where you're not comfortable with management and where you can't change management – you're best off avoiding the stock even though 100% ownership of the business at today's price would prove profitable.