The VIEW *from* BURGUNDY

MAY 1998

A CAPITALIST HOTBED

Continuing our bullish cases for overlooked and under-researched venues, we turned to Quebec. It is probably fair to say that Burgundy's fine performance in Canadian equities in the 1990s was substantially due to investments in Quebec stocks. Allan MacDonald was always extremely impressed with the calibre of managements in Quebec and argued for an issue of The View from Burgundy *on the subject, especially in the atmosphere of undervaluation prevailing after the October 1995 referendum. We translated this issue of* The View *into French (something we now routinely do, of course) and it attracted some favourable attention among the business and financial community in Montreal.*

Richard Rooney, 2007

One Canadian province has led all others in small- and mid-cap stock market performance over the past two years. Two of the three top performing Canadian small-cap mutual funds over the last year invest exclusively in this jurisdiction. It is a motherlode of fine, underfollowed companies at reasonable valuations. It has a pro-business culture and a union movement that is focused on international competitiveness. The population of the province overwhelmingly approved of the Free Trade Agreement with the U.S. We refer, of course, to the province of Quebec.

The Canadian media and Canadian politicians spend a great deal of their time finding political or economic reasons why Quebec should stay in Canada. From our focus on the stock market and its publicly traded companies, Burgundy takes a different tack – Quebec's departure would be a blow to all Canadian investors because it might make it more difficult to invest with some of the most dynamic and creative management groups in North America. Our subject in this issue of *The View* is one of the best-kept secrets in Canada – the fine companies and terrific stock performance that are offered by equity investments in Quebec.

It is a sad truth that companies only really learn to compete during tough times. In Quebec, capital and population flight have so suppressed economic growth that any management whose company has been able to grow and prosper really must know its stuff. A generation of business leaders has grown up in Quebec without being able to count on strong underlying economic growth to bail out bad decisions. The result is a tough, pragmatic group of entrepreneurs who can be relied upon to make money in just about any circumstances.

Part of their success has been in their closeness to their customers. The old Anglo business establishment in Quebec catered, naturally enough, to the Anglo minority. The new entrepreneurs know the market in French Quebec and have built strong businesses serving local tastes. Another factor is that they are pioneers – they haven't learned many of the bad habits that have plagued English Canada's business community: the complacency and timorousness that have characterized so many of Canada's largest companies. Lastly, they tend to own big positions in their own companies, so their interests are aligned with other shareholders. They usually got their stock the old-fashioned way: by investing seed capital in the business, rather than through options.

An Embarrassment of Riches

So who are some of these companies and their leaders?

Uni-Select ($27)

Five-year compound return: 29.2%. Five-year average return on equity (ROE): 21.3%. Five-year compound growth in pretax income: 23.2%. Price-to-earnings ratio on trailing earnings: 15.1 times.

If we had to pick a favorite stock at Burgundy on the Canadian equity side, Uni-Select would probably win. It performs brilliantly yet never gets overpriced. Even now, after a terrific run, it is one of the cheapest stocks in Canada.

We wrote about this wonderful company and its crack management team in a previous issue of *The View*. As one of Canada's wholesalers of aftermarket auto parts, Uni-Select is in a rather humdrum business. But by attention to detail and clever program design, the company manages to earn returns for shareholders that are outstanding. The price-to-earnings ratio for this company has never reached the TSE average, yet its returns have been absolutely spectacular. Jacques Landreville, the affable and capable CEO, must find this discount frustrating, since it does no justice to his excellent management team and its great achievements. Since Uni-Select actually generates more than 60% of its revenues and profits outside Quebec, the reason most often given for the discount is invalid. We would argue that a premium is appropriate, given the track record of this company.

Metro-Richelieu ($16.75)

Five-year compound return: 28.5%. Five-year average ROE: 19%. Five-year compound increase in pretax income: 20%. Price-to-earnings ratio on trailing earnings: 12.6 times.

Metro-Richelieu is Quebec's second largest food retailer/wholesaler. This is a true Quebec stock – virtually all sales and profits are earned in Quebec. But what profits! The company's margins and other productivity measures compare favourably with those of Loblaw, but the stock sells at less than half Loblaw's multiples.

Pierre Lessard, Metro's Chief Executive, is a terrific merchant who has gone from strength to strength since joining the company in 1991. The company uses franchisees for most of its business, with the exception of its Super-C store, which is the big-box corporate format. The franchisees have fairly small stores on average, but are very close to the customer and willing to invest in their businesses. Some of the discount in the stock is due to the entry into the Quebec market of Loblaw in the Montreal market and Sobey's from the Maritimes. These are marginal threats in the medium term, however, since neither new competitor will have critical mass in the Quebec market for a number of years.

One great advantage of having a cheap stock is that when it is bought back, the accretion of value for shareholders is very large. Metro bought back over 20% of its stock through a Dutch auction in 1996, and has been able to post ongoing 20% plus earnings per share increases as a result. As long as the market is unwilling to recognize the value in this company, Metro-Richelieu will probably continue to be a buyer of its own stock, and we will continue to benefit.

Radiomutuel ($15.50)

Five-year compound return: 37.2%. Five-year average ROE: 4.3% (currently 14.3%). Five-year compound rate of growth in pretax income: 36.7%. Price-to-earnings ratio on trailing earnings: 41.3 times.

There is no better turnaround story in Canada than the turnaround story in radio. From a period in which AM radio was an unmitigated disaster (which accounts for Radiomutuel's low five-year average ROE), we are moving into a period where radio will be a licence to print money. Due to proposed new CRTC regulations allowing ownership of multiple stations in individual markets, tremendous economies will be realized in the Canadian radio business. And nowhere is the story more dramatic than in Quebec. Essentially, two players – Radiomutuel and Telemedia – share the Quebec French market. Telemedia, after 11 years of bungling, was able to persuade some very short-sighted, but very large shareholders to sell their positions for a song last fall, and the company went private. Burgundy held too small a position to be able to contest the takeover, but it still rankles. At least it was the mismanaged company that disappeared, and not Radiomutuel.

Norm Beauchamp, Radiomutuel's chief executive, is yet another example of the kind of smart, no-nonsense executive that Quebec seems to produce in batches these days. (We should mention that there is almost always a crackerjack CFO as well. At Radiomutuel, the CFO is George Rossi, at Metro it is Serge Gadbois, and at Uni-Select, it is Jean Guenette.) M. Beauchamp and his partner have put together a very good collection of communications assets, including not only 11 radio stations, but also several specialty TV channels such as Musique Plus (the French version of MuchMusic), and a billboard business that is the little-known crown jewel of the company.

Billboards are a fantastic business. For a modest capital investment, a company can possess an asset that generates strong cash flow for an indefinite period. Payback for billboards, while varying depending on the location, is usually less than two years. And prices being paid for billboard companies by acquirers are sky-high, with 12 times cash flow being a common price. Radiomutuel is the only public play in Canada in this great business, through its Omni subsidiary.

The return on this stock has been extraordinary, and current valuation is extended, but earnings are still growing strongly and we feel that Radiomutuel is just getting started.

Honourable Mentions

That is just a small sampler of the delights that await the equity investor in Quebec. We have not talked about Jean Coutu Group. We had the honour of meeting M. Jean Coutu in person during our last trip to Montreal. (We should mention the extraordinary openness of these managements to shareholders and potential shareholders. M. Coutu gave us well over an hour of his time, and we learned a great deal. Unfortunately, we didn't buy his company's stock, which has since done brilliantly.) From one corner pharmacy in Montreal, M. Coutu has built a very large and very profitable pharmacy chain that competes successfully in both Canada and the U.S. He received us, as is his wont, in his white pharmacist's jacket, and spoke wistfully about getting back behind the counter some day.

Nor have we discussed GTC Transcontinental, a large printing company of which M. Remi Marcoux is Chief Executive Officer. M. Marcoux is a man of great charm and humour, who will tell you that he has only two investments: his house, and his 11 million shares of GTC. He is too modest to mention that the latter has increased in value from $1 (when he bought a small printing company out of bankruptcy) to about $175 million over the past 22 years. Pretty good investing, we'd say.

We have not discussed San Francisco Boutiques, the best fashion retailer in Canada. M. Paul Roberge has designed a new department store format called Les Ailes de la Mode and has opened three locations in Quebec. All are doing brilliantly, and deservedly so, as we would judge from our visits. Again, we think that this shows the vibrancy of the Quebec business culture. Who would have thought that in the brutal retail environment of the early 1990s, someone could come up with a powerful and very profitable new department store concept?

Videotron, Logistec, BMTC, Maax, Couche-Tard, Van Houtte: we have only scratched the surface in our discussion of Quebec's small- and mid-cap attractions. And there are some superb investors based in Quebec as well. Everyone knows about the great Paul Desmarais, but fewer people have heard of Charles Sirois, whose record is scarcely less impressive, especially given his relative youth. These are people that one can invest alongside with great confidence.

Long live Quebec free enterprise!

A New Leaf

In June of 1995, we wrote a comparison of Imasco and Rothmans, Canada's two publicly traded tobacco companies. The comparison was most unflattering to Imasco, which at that time was feeling the aftereffects of a long "di-worse-ification" spree. Taking cash flow from the tobacco business, which despite its unpopularity is a superb cash flow generator, Imasco bought companies in financial services, fast food and pharmacy retailing, rather than returning the cash to shareholders. The result was a decade of mediocrity.

Rothmans, by contrast, stuck to its core business and returned cash to the shareholders through regular special dividends. The result was a decade of sparkling total returns to shareholders. The contrast between these companies' performances in the stock market despite the similarity of their base businesses was what caused us to use them as the subject of *The View*.

We are very pleased to say that, since then, Imasco has turned over a new leaf. A dramatic restructuring has occurred since mid-1995, and has caused a distinct change for the better in the fortunes of its shareholders.

The turnaround may have already started when our article was published. Mr. Brian Levitt had been appointed President and CEO of the company at the beginning of 1995, and some good things were happening within a few weeks of his appointment. For example, in July of 1995, the company announced a four-million-share buyback, the first of several undertaken since. And in the autumn of that year, rumours were rife of a pending divestiture of Hardee's, the troubled restaurant chain that had cost Imasco shareholders so much in profitability and performance. Hardee's Roy Rogers restaurants were put up for sale at year end 1995, and the deal was completed in August 1996. The Annual Report for the calendar year 1995 had a very strong stress on Economic Value Added, which has continued to the present day and is usually a good sign for shareholders. The dividend was raised in February of 1996, and again at the beginning of 1997, so shareholders began to see some cash from this cash flow machine.

The remainder of Hardee's was disposed of in July of 1997, leaving an Imasco composed of Canada Trust, Shoppers Drug Mart and Imperial Tobacco. There have been repeated denials that Imasco is interested in selling its Canada Trust unit.

The stock performance has reflected the improvement in capital allocation strategy at Imasco. For the one-, three- and five-year periods ending March 31, 1998, Imasco stock returned 68.1%, 41.5% and 28.1% compound, respectively. The comparable numbers for Rothmans are 44.5%, 38.8% and 26.1%. Over the same period, the TSE 300 returns are 31.3%, 22.9% and 18.5%.

So that is the happy ending to our story. When a management with good assets starts to manage them in the shareholders' interests, the results can be most gratifying for all concerned. We await the really gutsy call from Mr. Levitt and Company: Why does Imasco exist at all? Each of its units is attractive on its own (though Imperial Tobacco, with 25.7% operating margins and a 94.7% return on assets, is the crown jewel) so why not set them loose to grow and thrive on their own?

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