The View from Burgundy

MARCH 1996

Capital Punishment Part II

In our December 1995 edition of *The View from Burgundy*, we shared with you some interesting data regarding the 728 Canadian public companies in the Stock Guide database for fiscal year-ends closest to the five-year period January 1, 1990 to December 31, 1994. In that article, we pointed out that roughly 38% of the 728 companies lost money in aggregate over the five-year period. We also noted that a small number of the companies – 59 of them – had been able to improve results each year during the survey period. We referred to these companies as "the cream of the crop" and pointed out that this small elite group, making up only 8% of the sample, had experienced a median 185% appreciation in stock market value in that period.

Following its publication, a number of our readers contacted us seeking a list of the 59 companies or asking if some of their particular favourites were on the list. So in response to the demand, we list below the 59 elite companies in declining order of their market capitalizations:

Barrick Gold Corporation
Bank of Montreal
Bombardier Inc.
Imasco Limited
Newbridge Networks Corporation
Potash Corporation
Magna International Inc.
Renaissance Energy Ltd.
BCE Mobile Communications
BC Telecom Inc.
Investors Group Inc.
Franco-Nevada Mining Corp.
Canadian Natural Resources Ltd.
United Dominion Industries Ltd.
Loewen Group Inc.
Euro-Nevada Mining Corporation
London Insurance Group Inc.
Rothmans Inc.
Goldcorp Inc.
Metro-Richelieu Inc.
Chauvco Resources Limited
SR Telecom Inc.
Cinram Ltd.
Trimac Limited
Maple Leaf Foods Inc.
Morrison Petroleums Ltd.
Linamar Corporation
Tarragon Oil & Gas Limited
Quebec Telephone
Fortis Inc.
Unican Security Systems Ltd.
Pinnacle Resources Ltd.
Rio Alto Exploration Ltd.
Sceptre Investment Counsel Ltd.
Acklands Limited
Winpak Limited
Jordan Petroleum Ltd.
Dorset Exploration Ltd.
Domco Industries Limited
Gennum Corporation
Northrock Resources Ltd.
Transat A.T. Inc.
Uni-Select Inc.
Lassonde Industries Inc.

Hartco Enterprises Inc.
Schneider Corporation
Electrohome Limited
ADS Associates Limited
Richmont Mines Inc.
Maax Inc.
Maxx Petroleum Ltd.
GSW Inc.
Premier Choix: TVEC Inc.
Primex Forest Products Ltd.
Samoth Capital Corporation
Intermetco Limited
Foremost Industries Inc.
Goodfellow Inc.
Logibec Groupe Informatique

A few observations about the list are in order. First, it is a rather one-dimensional view, taking a short period of time (five years) and concentrating on only one variable – namely, increasing pretax income. The period is short enough that there may be some companies whose cyclical uptrend coincided with the survey period. The presence of no fewer than 11 oil and gas producers would tend to be a tip-off that we should extend our survey period to see what happened to our sample in 1995.

We find the presence of 15 Quebec-based companies interesting. We have found a lot of cheap stocks in Quebec of late (no surprise, under the circumstances) but our work in this survey has revealed a lot of very high-quality companies as well. We would venture that firms like Bombardier, Domco, Hartco, Lassonde, Maax, Metro-Richelieu, Premier Choix, SR Telecom, Uni-Select and Unican have managements that compare favourably with any others in their industries. We feel that management makes an enormous difference and there appear to be many good managements in Quebec.

Those who consider Toronto to be the centre of the Canadian business universe might ponder the extreme scarcity of Toronto-based companies on this list, compared to the city's preponderance of head offices in the country. There are quite a few Ontario-based companies represented, but they tend to be the kind of firms where the management lives "over the store," like Linamar in Guelph or Newbridge in Kanata. Often, the Toronto companies on the list do not have a downtown address, such as Cinram and Acklands.

Specific outstanding business opportunities have placed clusters of stocks on the list. Thus, we see the Carlin Trend in Nevada giving us Barrick Gold, Euro-Nevada and Franco-Nevada. Unsurprisingly, both of Canada's public plays on tobacco, Imasco and Rothmans, are represented. The Canadian money management companies that were public throughout the period and whose performance did not stumble were Investors Group and Sceptre Investment Counsel. (Trimark went public only in 1992, otherwise it would certainly be on the list.)

We decided to further winnow the list in hopes of coming up with a few truly outstanding companies on which to focus. An obvious way to cut down the number of stocks was to eliminate those companies that had started the survey period in a loss position. (Remember, our survey included companies that had improved pretax results every year, even if they started from a loss.) We then carried forward our survey to the latest reported earnings in 1995 to eliminate companies whose string of earnings increases ran out in that year.

The result of our screen was the following list of 27 "super-elite" stocks:

Barrick Gold Corporation
Bank of Montreal
Bombardier Inc.
Imasco Limited
Potash Corporation
Renaissance Energy Ltd.
BC Telecom Inc.
Investors Group Inc.

Franco-Nevada Mining Corp.
Loewen Group Inc.
Euro-Nevada Mining Corporation
London Insurance Group Inc.
Metro-Richelieu Inc.
Cinram Ltd.
Linamar Corporation
Quebec Telephone
Fortis Inc.
Unican Security Systems Ltd.
Sceptre Investment Counsel Ltd.
Winpak Limited
Domco Industries Limited
Gennum Corporation
Uni-Select Inc.
Lassonde Industries Inc.
Maxx Petroleum Ltd.
Premier Choix: TVEC Inc.
Samoth Capital Corporation

As we had suspected, the 1995 price swoon in oil and gas removed nine of the eleven oil and gas companies from the list. No one will be surprised to see Renaissance Energy, that paragon of an energy company, still on the list, and we are sure a lot of our readers will want to take a closer look at Maxx Petroleum. We certainly will.

It is encouraging to see a fairly wide dispersion of industries represented in this super-elite group of stocks. Tobacco is represented, of course, as is the Carlin Trend group and the money managers, but we also see heavy industrials like Bombardier, niche manufacturers like Cinram and Winpak, and companies from insurance, food retailing, auto parts distribution, potash mining, and banking and finance. Great results coming from a tough business are usually indicators of an exceptionally well-managed firm. A good example of such a firm is Uni-Select.

Uni-Select Inc. (current price $10) – doing unremarkable things remarkably well

With a coast-to-coast network of resellers, Uni-Select (UNS) is Canada's second largest distributor of "after-market" auto parts, with 20% of the wholesale market. Operating in a mundane industry, Uni-Select's profitability has been anything but mundane, with after-tax earnings growing by a compound 33.4% since 1990. Even more remarkable, their return on equity has increased from 10.4% to 22%, averaging 18.6% over the past six years, a figure that places UNS among the elite of Canadian corporations. These results are a particularly noteworthy achievement for a company whose industry is growing at only 3-4% per year.

You might wonder if this outstanding record was achieved by aggressive use of leverage, an unsustainably low income tax rate, or creative accounting. The answer is "No" on all counts, since debt has been eliminated over the survey period, and the company has paid full taxes of about 40% every year. Most importantly, UNS has maintained its status as a free cash flow machine, with six-year cumulative cash flow from operations of $55 million exceeding their $6.5 million in capital expenditures by more than eight times. In fact, capital expenditures have exceeded depreciation in only one year since 1990. And, in a test we at Burgundy like to employ when assessing the economic characteristics of a business, UNS's pretax return on deployed capital (the sum of net working capital, plus long-term debt and fixed assets) was an exceptional 39% in fiscal 1995.

Having met with and spoken to their CEO, Jacques Landreville, and members of his management team on a number of occasions, we can assure you that their outstanding track record is anything but luck. Take a bow, Uni-Select management and employees, you deserve our applause.

What does Bay Street think of UNS? Not much, apparently. While we would never say that they could not have a down earnings year, the market is currently valuing the stock at just 7.5 times 1995 earnings or half the multiple of the TSE 300 Index. This for a company that, we repeat, is not capital intensive and generates reliable free cash flow. Needless to say, we are shareholders.

The Final Test

We decided on one final screen. We subjected our sample of 27 super-elite companies to the supreme test – the earning and maintaining of a high return on the shareholder's equity. We decided to screen out all companies that failed to earn a return on equity of at least 15% each year for the entire survey period. Imagine our chagrin when the result was known – only four companies made the grade! That's four out of 728 in the initial sample.

Now there is no doubt that the business climate in Canada over the survey period was awful, with corporate earnings falling to their lowest level since the Depression and a debt-laden, overtaxed and fearful consumer trying to stay afloat, but we would have thought that more than four businesses would have been able to meet our tough challenge. The four that did: Investors Group, Franco-Nevada, Sceptre Investment Counsel, and Premier Choix. (Premier Choix had a change of year-end in 1993, but adjusting for a seven-month stub period, they make the grade easily.)

We wish that we could have been the perspicacious investor who bought Premier Choix, Investors Group, Franco-Nevada and Sceptre Investment Counsel at the end of 1989 and held them for six years. Take a look at this:

Six-Year Return (Annualized)	
Premier Choix	23.7%
Sceptre	27.5%
Investors Group	22.1%
Franco-Nevada	25.8%
Portfolio Average	**24.8%**

These numbers are approximate, including income for the six years ended December 31, 1995. Obviously, this portfolio would have blown the doors off any major index over that period. Selling them at almost any time would have been a serious error. A $10,000 investment in these stocks would have accumulated to $37,782 at the end of the period. We think that this is convincing proof of the power of the buy-and-hold strategy for great businesses.

Kudos to all of these fine companies. Premier Choix has such a tiny float that we have invested in it through its parent company, Astral Communications. We feel that the capital markets are a little too late in their bull markets to buy Sceptre or Investors now, but we will keep our eye on them, since their results show what a great business money management can be. As for Franco-Nevada, we have the value investor's usual trouble with gold-related investments, especially in the current supercharged environment, but it is definitely on our watch list.

For comparison purposes, we ran the same screens on the U.S. market using our Compustat database. There were 95 companies that had experienced six consecutive years of rising pretax earning along with a return on equity of at least 15% in each year. When we raised the return on equity hurdle to 20%, no less than 38 companies made the cut. For a discussion and analysis of these superb U.S. companies, look for an upcoming edition of *The View.*

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