# *The* VIEW *from* BURGUNDY

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## DOING IT RIGHT

IN PREVIOUS ISSUES OF *THE VIEW FROM BURGUNDY*, we justifiably have tended to be hard on managements that have failed in what we consider to be arguably their primary function: to allocate capital produced by the business in ways that will create shareholder value. We reject woolly notions of "stakeholders" who have a prior claim on company policies or wealth and we confidently assert the following truth to be self-evident: that a company which successfully rewards its shareholders over a long period of years will also be a company that delivers to these "stakeholders" what they want: namely, safe jobs for employees, steady taxes for governments and a clean environment for the general public.

In order to provide our readers with examples of companies that operate in the shareholders' best interests, we wish to highlight two such companies that have found different ways of doing it right. In the U.S. market, we will look at Philip Morris – a superb company – while in Canada, we will examine recent developments in a small Alberta company – Intera Information Technologies. The examples are quite different, but nonetheless instructive.

Philip Morris (US$94) is one example of a tobacco company whose diversification strategy has not been a pure "weed-watering" exercise. With the most powerful tobacco brands in the world generating the phenomenal cash flows and returns on capital characteristic of this business, Philip Morris years ago bought Miller Brewing, Kraft Corporation and General Foods, which were also great businesses. The company is now a brand name powerhouse, with 66 products each generating over $100 million in annual sales. Its markets are stable and its profits highly predictable.

As if this embarrassment of riches wasn't enough, the company is run by a management headed by Geoffrey Bible that has rewarded shareholders for holding Philip Morris stock. The company has increased its dividend on average every nine months for the past 20 years. Compound dividend growth per share has been 22.8% over 10 years. Over the last decade, return on equity (ROE) has averaged over 30% and cash flow has grown by a stunning compound 17%. Because of this plethora of cash, the company has been able to buy back $5.6 billion worth of its own stock (over five years), which has in turn greatly increased the per share values in the company. It doesn't get a lot better than this.

Intera is a smaller example of a Canadian company that shows what can happen when a management decides to stop "watering the weeds" and realize shareholder value instead. Intera had two businesses, one good and one bad. The good business was a software product for modelling reservoirs of oil and natural gas. The product was the best in the business and had a large market share, high margins and strong cash flows. The other business was an aerial mapping business that was perennially in the red and relied on spotty government contracts to stay in business.

The strength of the software business was overwhelmed by the weakness of the aerial mapping business, and the stock market history of Intera was a grim one since its IPO in 1990. By June of 1995, the company's stock was under $3, or about half book value. A new management team was in place, substantial write-offs had been taken and a fresh approach was obviously called for.

Management decided that the shortest difference between two points was a straight line. They announced that they were going to sell off the company's assets and distribute the proceeds to shareholders. From a low of $2.45 in early June, the stock popped to $13 in a few weeks when the software business was sold for about US$10 per share. One analyst's estimate of the ultimate distribution to shareholders is US$15 per share, or CAD$20. If the process is complete by mid-year 1996, and this analyst is correct, the management will have rewarded shareholders with a one-year return of over 700%.

Unfortunately, we must add that the trading in Intera stock immediately before the announcement of the liquidation is currently being investigated and there are allegations of stock manipulation. We do not consider these issues central to our discussion, since the returns from the liquidation strategy were so huge that, even had the stock been trading at $10 before the announcement of liquidation, the decision was still clearly right.

Our point is that there are huge returns available from managements and majority shareholders who are willing to reverse the old "di-worse-ification" practices of using free cash flow from superb business to invest in inferior business and focus, privatize or liquidate their businesses. The malaise of the Canadian stock market since 1981, we believe, in part reflects the inadequate returns on capital that corporate Canada has been able to generate in that period. In the competitive world of the 1990s, Canadian companies can no longer afford to allocate their capital poorly.

## Capital Punishment – Canadian Equities From the Bottom Up

The enormous underperformance by the TSE 300 compared to the S&P 500 (or any other U.S. market index) has led to a variety of explanations and rationalizations over the past five years. Some blame Canada's fractious, puerile politics, while some blame deficits, debt and taxes. No doubt there is some truth in these viewpoints, but we suggest that the nub of the problem is capital allocation. You thought Canada didn't have "capital punishment"? Check out these statistics derived from an extensive research project conducted by Burgundy's Allan MacDonald.

At Burgundy we make extensive use of a database called "Stock Guide," which has a large amount of financial information on almost all public Canadian companies listed on the Toronto and Montreal Stock Exchanges. At the moment, there are roughly 2,000 stocks in the Stock Guide database. Of these companies, 728 were public at the beginning of 1990, with the balance added thereafter, presumably reflecting the boom in IPOs of the early to mid-1990s. All of the statistics mentioned in this article are based on these 728 public Canadian companies.

We were astonished both by the absolute number of companies that had made a cumulative pretax loss in that five-year period, and by the magnitude of the losses incurred. Of the 728 stocks screened, 280 companies – or 38% of the sample – as a group lost an incredible $21 billion in total during that five-year period. The losses represented 66% of the $32 billion in common equity these 280 companies had at the beginning of 1990. There were several major components of this catastrophic record; of the top-20 money losers, the major contributors were:

- $4.7 billion in losses from forest products companies, namely Avenor, Domtar, Repap, Abitibi and Noranda Forest
- $3.1 billion in losses from the unravelling of the real estate boom of the 1980s in Bramalea, Gentra (Royal Trust), Harrowston (First City) and Tridel
- $2.1 billion in losses from the two Canadian airline companies
- $1.2 billion in losses from Stelco and Dofasco

Critics may assert that these numbers include many write-downs of assets by managements in this period that do not impact cash flow. We respond that the write-offs are the result of past capital allocation decisions that obviously didn't work out. This is not to say that management action could have averted these losses. On the contrary, the economics of some of these businesses are so poor that the best management in the world could not really have much impact on cyclical profitability. In Warren Buffett's words, "When a management with a reputation for competence takes on a business with a reputation for bad economics, it is the reputation of the business which remains intact."[1]

What we find peculiar is that Canadian shareholders, who are either very forgiving or suffering from "cyclical amnesia," have been more than willing to replenish the denuded capital cupboards of these 280 companies during the new issue boom in equity markets. Who can forget the billions of equity that were pumped into the balance sheets of capital-intensive commodity cyclicals in the 1992-1994 timeframe? On average, the number of shares outstanding of these 280 companies increased by 66% since January 1, 1990. We wonder about the future returns on this new capital. The stock market is perhaps giving us some indication, since the average price to December 31, 1995 of these 280 equities declined by 6% in the five-year period ending December 31, 1994.

Now let's look at the other end of the spectrum – the companies that did not experience a single down earnings year in that five-year period. There are (alas) only 59 of them, but what a group of stocks! They produced $22.8 billion in pretax earnings. And the stock market returns were glorious – the median stock in the group returned 185% over five years.[2] It would be hard to find more compelling evidence of what we might call "the power of positive earnings." Admittedly, these 59 stocks are the elite of the elite, and the chances of having a whole portfolio of stocks in Canada that do not experience a drop in earnings during a recession is pretty small. But most of these stocks are the acknowledged cream of the crop in Canada – well-managed firms like Bombardier, Rothmans, Renaissance, Linamar, Cinram, Primex and Euro-Nevada, to name but a few from a variety of industries. The encouraging thing about this list of companies is that it includes names from capital-intensive industries like oil and gas, manufacturing, and forest products. But each has a specific competitive advantage: Bombardier – its uncanny ability to buy assets so cheap that the capital-intensive nature of its business is neutralized; Renaissance – its extraordinary focus; Primex – its lack of timberlands tying up capital. It goes without saying that all these companies are superb operators of their day-to-day business.

Cyclicals are heavily represented in the TSE 35, which, whether they admit it or not, is the core portfolio of the big Canadian money managers. These companies currently account for almost 21% of the TSE 35. In fact, no fewer than 15 of those 35 stocks have shown a pretax loss at least once in the 1989-1994 period. If you manage with reference to an Index, you end up "overweighting" or "underweighting." If investing, you only play these companies when they are selling far below their intrinsic values at cyclical lows. (The evidence so far suggests that for the airline industry, the intrinsic value of the stocks in a deregulated market is zero.) If an investment manager owns these stocks through thick and (mainly) thin, "investing" is not an apt description of his or her activities; "indexing" is more exact.

At Burgundy, we try to be very selective about which cyclicals we invest in, and when. We suspect our weighting in the cyclicals is currently below that of almost any other Canadian money manager, and we expect this situation to continue until the next cyclical trough in these stocks. The reason is that we don't care what the Index says about weightings; we only care what value techniques say about our investments. And for a value investor, the word on cyclicals is "caveat emptor": let the buyer beware.

At Burgundy, we are always talking about buying great companies at reasonable prices. Great companies, as we have defined, are companies with high ROEs, high free cash flow (cash from operations minus ongoing capital expenditures) and high barriers to entry.

The obvious examples of these kinds of companies are Philip Morris and Dun & Bradstreet. But astute observers of our portfolios have also noticed our strong interest in Property and Casualty (P&C) insurance companies. Since the value of these firms is not as obvious, we thought that we would explain some of the simple characteristics that can make these companies great.

A P&C company is really two separate businesses: one is the underwriting or operating line of the company that generates the cash flow or float, and the second is the investment management that manages the float within the confines of the payout requirements.

The underwriting business is the basic component of the industry, and the part of the business that most people focus on. The basic measure of this part of the business is the combined ratio, which is the sum of expense ratio (how much does it cost you to write the business) plus the claims ratio (how well did you price the business). If the combined ratio equals 100, then the underwriting broke even; if it is greater than 100, then the underwriting side of the business had a loss.

In 1994, the industry average expense ratio was 32.8% or $0.33 for every premium dollar written. A large part of this cost is the commission that is paid to the insurance broker for booking the business. Direct sellers, such as GEICO in the U.S. and Direct Line in the U.K. have expense ratios of 18% and 15%, respectively.

The claims ratio is a measure of how well management has priced the product. In 1994, the industry average was 75.0% or $0.75 of every premium dollar written. Because many managements are measured in part by how much business they have written, the temptation is always there to lower the cost of the insurance to attract more business. This is especially true when the industry itself is under pressure. Where managements add value is by actually turning away business that will generate underwriting losses instead of just building the book.

The industry average combined ratio in 1994 was 107.8%, or the average firm lost $0.08 for every premium dollar written. In that year, Fairfax Financial Holdings had a combined ratio of 104.0% and Kingsway Financial Services, a recent investment of ours, had a combined ratio of 93.9%.

The second component of the P&C company is its investment management. The float generated by the premium income is invested either in bonds exclusively or in a combination of bonds and equities depending upon the regulation of that firm and its requirement for liquidity. In the case of Fairfax in 1994, the value of the float equalled $173.25 per share versus the book value of $43.77 per share. This implied leverage means that Fairfax's return of 4% on investments can be translated into a 16% return on shareholders equity (= 173.25/43.77 = 4.0; 4 x 4% = 16%).

Due to Fairfax's emphasis on long-term investing and equities, management have been able to grow the book value of the firm at a compound rate of greater than 40% over the last 10 years. Growth in book value is particularly important for these types of companies because the unrealized gain or loss on their investment portfolio is reflected in their book value and not in earnings.

The final measure is ROE. In 1994, Fairfax's ROE was 12.1%, Kingsway's was 21.9%, while the industry average was 7.9%. Over the last five years, the average

ROE for Fairfax has been 16.9%, for Kingsway 26.1%, while the industry average was 9.1%.

## Frictional Costs

There are many types of costs to managing a portfolio. The one that is probably least understood is the question of trading and "frictional costs." In an effort to keep the quarterly return numbers high, many investment houses are constantly in and out of the market, looking for the next great buy and selling as soon as they have made a certain percentage gain. Their numbers look great, but after the investor has paid the taxes on these capital gains, did they really do that well?

To illustrate this point, suppose you took $1 million and invested this money with a portfolio manager who had excellent results but turned over the portfolio once every year. As well, the money to pay for the tax bill had to come out of the portfolio. Also assume that your tax rate is 52% and that your capital gains tax rate is 39%. If your investment manager is incredibly good and makes you 20% return every year, your portfolio would grow as follows:

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| 1. | $1,000,000 | $1,122,000 | $1,258,884 | $1,412,468 | $1,584,790 |
| 2. | 200,000 | 224,400 | 251,777 | 282,494 | 316,958 |
| 3. | (78,000) | (87,516) | (98,193) | (110,173) | (123,614) |
| 4. | $1,122,000 | $1,258,884 | $1,412,468 | $1,584,790 | $1,778,134 |

1. Invested capital
2. Investment return
3. Taxes paid
4. Reinvested capital

While your investment manager has done an excellent job in increasing your net worth from $1 million to $1.778 million in five years, your actual return has been only 12.2%. Put it another way, if you had left your money in companies over the same period and never sold them until Year 5, they would only have to increase in value by 12.2% annually to equal the same result as your 20% annual trading return.

Simply said, this is why we like to invest in great companies that we can hold for a long time, and indeed why returns across different types of investment managers are not as readily comparable.

**Endnotes**

1. Buffett, Warren E. Berkshire Hathaway Annual Report. 1989.
2. We used a median because some of these companies went from penny stocks to TSE stalwarts over the five-year period – especially in the oil and gas sector – which distorts the average number. For example, Canadian Natural Resources appreciated 1,347% in the period – pretty spectacular, but not all that meaningful if it's grouped in with Westcoast Energy's 9% total return. A median is a statistical device that chooses, in this case, the 30th stock in the sample as representative, because there are 29 stocks both above it and below it in the sample.

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