The VIEW *from* BURGUNDY

AUGUST 1995

ERRORS OF OMISSION

READERS OF *THE VIEW FROM BURGUNDY* are perhaps aware of the importance we place on the principle that shareholders are owners of fractions of a business, rather than builders of abstract portfolios. In this issue, we explore once again the implications of that ideal as it applies to capital allocation.

A little thought on the subject yields some simple, but radical insights. If we are owners, we must concern ourselves with the management of the business. As shareholders, the ultimate test of our interests must be long-term return on our capital. Therefore, we have not only the right, but also the duty to insist that management decisions be made with this paramount interest in mind. When we see wasteful behaviour, we must oppose it vigorously.

Unfortunately, such behaviour is not uncommon, particularly in Canada. Some companies sit on huge cash hoards for years, earning only modest returns while waiting for acquisition opportunities that seldom materialize. Even worse, some managements go on buying binges with shareholders' money, undertaking the dolorous process that Peter Lynch characterizes as "di-worse-ification": the buying of inferior businesses with the cash generated by superior ones, or overpaying for them – a very common fault.

Many corporate managers have a strong bias against returning cash to the owners of the business, whether through share repurchases or special dividends. They consider such actions to be an admission of failure of will or imagination. But they are not entirely to blame. Most often, Canadian shareholders fail to demand that management's primary focus be shareholders' interests. Thus, some Canadian companies act like "institutions" rather than economic entities, and Canadian shareholders are treated to the spectacle of various exploits in the wastage of their wealth.

In theology, two types of transgressions are recognized. The first is the "errors of commission," where wrong actions are deliberately undertaken. The other is the "errors of omission," which are failures to act when right actions are necessary.

In our last issue, we examined the "errors of commission" of Imasco Ltd., a very decent Canadian company whose management decided years ago to take the reinvestment of shareholders' money out of their hands, and to embark on a diversification program that has diluted the returns generated by its lucrative core tobacco business. In this issue, we look at the "errors of omission" of a prominent Canadian company that has been sitting on a growing cash hoard for over a decade without either returning it to shareholders or making acquisitions. Unhappily, there are several such companies in Canada, and one of the best examples is Moore Corporation.

A leader in a declining business, Moore Corporation is the world's largest manufacturer of business forms. This was a wonderful business as recently as the early 1980s, when Moore regularly earned a return on equity (ROE) of nearly 20%. At that time, the proliferation of computers led to a vast upsurge in the usage of business forms. Clients tended to inventory their business forms, which were often custom designed. As a result, Moore had an enviable return on its fixed assets and inventories, and its relatively low maintenance capital expenditures meant that it was a good, reliable free cash flow generator. Steady dividend increases were the norm.

Entering the mid-1980s, Moore was a cornerstone investment in many Canadian equity portfolios, as a non-cyclical Canadian multinational of great financial strength. While its ROE had been dropping steadily since the early 1970s, the company still compounded its equity at around 15%, which was quite respectable. Farsighted analysts were predicting a maturing of the business forms market due to competition from new electronic technologies, but the process was occurring slowly. The firm's stock had a fine run with the rest of the business services stocks in the 1985-1986 period, and again in the post-1987 crash period, when it reached its all-time high of close to CDN $40 per share.

At that point, a deteriorating economy and an increased willingness among traditional business forms users to use Electronic Data Interchange (EDI) in billing and ordering systems caused a rapid downturn in Moore's performance. Profits entered a four-year slide, culminating in the appointment of a new President and CEO, Reto Braun, from outside the firm, as well as several write-downs and some discontinued product lines. The new management group made a couple of moves, buying an interest in a small business forms software firm, and then selling its Japanese subsidiary for a hefty price. They have moved decisively to cut costs, reduce labour and close some plants.

So that's Moore Corporation in a nutshell over the past 15 years or so. It's not an uncommon story for a maturing company. So what is it that is so offensive to shareholders? The answer, as in the case of Imasco, is capital allocation. Based on the figures in the table, Moore's return to shareholders over the past 10 years to December 31, 1994 is an extraordinarily low 3.4% compounded annually, and this during one of the greatest bull markets in history. Market Value Added has been negative $337 million over the past 10 years.

Moore earned this very low return despite generating free cash flow in most years. Between 1990 and 1993 the company had taken $475 million in write-offs – the cash effects of which are unclear – so our chart in fact may be understating free cash flow. We include a column showing the value of cash and marketable securities held by Moore each year to show exactly where the money has gone – into the bank. Without stock buybacks or large dividend payouts, Moore's cash and marketable securities have ballooned to $374 million or $3.76 per share. Not only that, the company issued 10 million shares through a dividend reinvestment program between 1985 and the end of 1992, despite its debt-free position and strong cash flows! That kind of nonsense has mercifully been discontinued, but not before Moore's shareholders, in an incredible abdication of responsibility, allowed the management to adopt a poison pill provision in 1990, which was updated and confirmed at Moore's Annual General Meeting held on April 27, 1995.

MOORE CORPORATION LIMITED
(CAD$)

	ROE	Net Income	Div Paid	Retained Earnings	Chg in Common Stock	Cash & Mkt Sec	FCF/ Share	Shares Out'g	Price	Market Value	MVA
Dec 85	16.05	191.12	88.43	102.69	27.63	213.68	1.25	89.93	28.13	2,529.31	0.00
Dec 86	11.49	151.32	90.03	61.29	27.42	244.62	0.66	90.93	28.88	2,625.72	7.70
Dec 87	13.50	190.20	88.10	102.10	19.60	586.93	1.67	92.01	26.00	2,392.23	-224.90
Dec 88	15.12	221.78	86.15	135.64	9.21	314.73	2.03	93.05	30.63	2,849.66	87.67
Dec 89	14.76	233.69	95.70	137.99	33.32	320.35	1.75	94.35	33.25	3,1337.10	285.42
Dec 90	8.10	139.36	103.44	35.92	45.11	322.52	0.38	95.81	25.75	2,467.21	-398.42
Dec 91	5.64	101.36	104.97	-3.61	50.48	307.83	0.66	97.74	24.75	2,419.16	-488.63
Dec 92	-0.15	-2.96	118.33	-121.29	78.88	396.51	-0.11	99.47	21.88	2,175.88	-893.64
Dec 93	-5.57	-102.57	123.61	-226.18	18.19	345.94	-1.00	99.52	25.50	2,537.86	-402.73
Dec 94	9.07	170.18	131.16	39.02	28.03	374.09	1.76	99.57	26.75	2,663.50	-336.91
Total				160.870	310.231			Change in Market		134.188	

Source: Burgundy Investment Team Research

In their comments in the information circular prepared for the 1995 AGM, the Board stated that, “Rights plans have been a valuable tool in enabling Boards of Directors to enhance shareholder value in the face of unsolicited takeover bids.”[1] We thought to ourselves that the company’s shareholders might have been better served if the Board were encouraging takeover bids, not discouraging them. Nevertheless, the plan was confirmed.

It’s a fact that Canadian managements are not held to a very high standard in their capital allocation decisions. Shareholders have been content with being overlooked when it comes to managements’ allocation of excess cash. They acquiesce to initiatives by undeserving managements who entrench their interests, and consistently re-elect directors who have failed to insist on maximization of shareholder value as the primary goal of a public company.

Moore’s Board is one of the most institutionalized in corporate Canada. Although a good Board of Directors needs a leavening of experience, no less than five of the nine members of Moore’s board are retired executives and six are over age 65. Only two directors own more than 1,000 shares of company stock: Ed Crawford, a director for 20 years, owns 10,431 shares and Reto Braun, the new CEO, owns 12,399 shares. (Mr. Braun also had an option to acquire an additional 60,000 shares within 60 days, which was included in his shareholding in the 1995 Management Information Circular.) The remaining seven directors own less than 1,000 shares, a minor economic interest indeed, probably less on average than they would have invested in their personal car.

Moore’s reason for its unconscionable cash hoard has always been an imminent acquisition. However, any such acquisition has thus far eluded the company28 so the shareholders’ cash still sits there after 10 years, awaiting a management with the vision and shareholder orientation to either make a wise acquisition at a favourable price, or to give it back to its rightful owners. Mr. Braun and his new team at Moore may be the ones to do it; at least, we certainly hope so.

[Note: A few days after the final draft of this issue of The View was prepared, Moore announced that it was making an unsolicited bid for Wallace Computer Services Inc. at US$56 per share or $1.3 billion in total. Maybe this will be a huge merger for Moore Corporation – we certainly hope so. We note that the proposed purchase price is roughly equal to the shareholders’ equity of Moore Corp. so a lot is at stake.]

A few facts on Wallace give us some apprehension:

- Moore is offering $56 per share or US$1.3 billion in total, while only six months ago, in a bull market, Wallace’s stock price was $30, and it hit a high of $41 just prior to the takeover announcement.
- The earnings per share for Wallace have been $1.84 (1993), $2.13 (1994), and $2.35 (1995 estimate), so the price/earnings ratio based on 1995 (estimate) is 24 times the price Moore is offering.
- The book value per share is $18.32, making the offer three times book value. The return on shareholder equity has been 11.1% (1992), 11.2% (1993), and 11.5% (1994).
- The offer is at roughly two times Wallace’s sales.
- The five-year high/low on Wallace prior to Moore’s offer was $41 and $19 per share. We certainly hope that Moore’s management and Board compared the merits of buying back their own stock as an alternative to the proposed acquisition. Moore’s own shares by comparison are selling at roughly 1.5 times book value and 16 times earnings.

Market Value Added (MVA):

The concept of MVA is testing whether $1.00 retained (or raised) by a corporation adds $1.00 or more of added wealth to the shareholders. If MVA is positive, it means that management is increasing the net worth of its shareholders by retaining earnings for reinvestment.

The formula is to measure the change in market value of a company over time (in Moore's case, 10 years) and to compare this to earnings retained plus new equity raised. In Moore's case:

MVA

= Change in market value– (equity capital retained + amount raised)

= (2,663 – 2,529) – (161 + 310)

= –$337 million

Diversification

We attended a December 6, 1994 special meeting of the New York Society of Financial Analysts where a discussion/debate broke out between Walter Schloss, Warren Buffett and several members of the audience on the subject of diversification of investments. Both Schloss and Buffett are outstanding investors, and as young men both were employees of the great Ben Graham. Buffett pointed out that some of the world's greatest fortunes have been made from an investment in a single "wonderful" company. He feels there are a very limited number of "wonderful" businesses in the world and that it is quite a good position to own a piece of a half-dozen of them. Schloss on the other hand has owned hundreds of stocks, and has a terrific record over 40 years. He referred to this method as the "used cigar butt approach." Schloss feels that almost anything is a buy at a price.

At the meeting, Buffett stated the following on diversification:

"Well, the less you know, the more stocks you have to own – because diversification is a protection against... ignorance. And if your only conviction is that equities over time are a good place to have your money, you probably ought to have at least 20 or thereabouts – I'm talking about stocks, not mutual funds, which in turn own stocks themselves.

But if you really analyze businesses so that you're buying into a business and making a conscious decision about what you think the future of that business is – not just a general conviction about equities as a whole, but conviction about a specific business and the future of that business in the same way that you'd go out and buy a grocery store or a filling station in your own home town – then I really think that if you can find six or eight of those, well that's plenty.

Our method is very simple. We just try to buy businesses with good to superb underlying economics, run by honest and able people and buy them at sensible prices. That's all I'm trying to do.

But that means I have to understand the business. And that leaves out 90% of all businesses. By definition, there are all kinds of things I'm not going to understand – I don't understand cocoa beans or all kinds of other things. But the only thing that count is the pitch you swing at.

If you can find a universe of 50 companies where you think you may understand their business and then find half a dozen that look properly priced, that's plenty.

All I can tell you is what I do basically – and that's to try to figure out what a business is worth. It's exactly what I would do if I were going to buy a Ford dealership in Omaha – only with a few more zeros. If I were going to try and buy that business – let's say I weren't going to manage it – I'd try to figure out what sort of economics are attached to it: What's the competition like? What can the return on equity likely be over time? Is this the guy to run it? Is he going to be straight with me?

It's the same thing with a public company. The only difference is that the numbers are bigger and you buy them in little pieces."[2]

At Burgundy, we look for superior businesses to own for the long term. In the Canadian market, where such businesses are rare, we own them when we can. For the rest of the Canadian portfolio, we look for companies that are significantly undervalued. We do our homework, visiting management and doing our best to understand the business. Our portfolios typically contain 25-35 names, which is much more concentrated than most Canadian investment managers. The stocks we own are not cigar butts, but they are definitely not always of Coca Cola Corporation's calibre either.

In the U.S., there are more opportunities to own great companies. We try to avail ourselves of these opportunities and in the Burgundy Partners' Fund, for instance, we rarely own more than 20 companies.

To some extent, owning 20 to 30 stocks is a protection against not being Warren Buffett. Ignorance is something we can guard against by diligent research, but not having the insight of this great genius is nothing to apologize for.

Endnotes

1. Moore Corporation, AGM, 1995
2. Buffett, Warren E. "A Tribute to Ben Graham." [speech] December 6, 1994. New York Society of Financial Analysts.

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