

The VIEW from BURGUNDY

JULY 2010

GROWTH THAT MATTERS

In this edition of The View from Burgundy, we return to a couple of familiar themes: the paramount importance of capital allocation to long-term returns, and the opportunity to invest with outstanding managements in the province of Quebec. John Ewing, who has been working with Allan MacDonald on our Canadian Small Cap Fund, was recently appointed Director of Research for Burgundy. He found himself intrigued by this story of a decent but very slow-growing business that somehow managed to produce spectacular returns, and set out to unravel the mystery.

READ ANY PUBLICATION BY the Harvard Business Review or McKinsey and you are sure to see articles advising executives on how to grow their business. Most of this advice stresses rapid revenue growth and business expansion. But does growth actually matter? Very often these growth strategies do not result in good returns for shareholders. Growth absolutely matters, but as BMTC (a Quebec-based furniture retailer) shows, the only kind that matters is growth in per-share intrinsic value.

BMTC is a leading furniture retailer in Quebec operating under the “Ameublement Tanguay” banner around Quebec City and the “Brault & Martineau” banner elsewhere in Quebec. From 2000 to 2009, BMTC’s total shareholder return was 1,300% (30.2% per year) compared to just 73% (5.6% per year) for

*Why did investors love radio stocks in the 1920s? **GROWTH.***

*Why did investors love electronics stocks in the 1960s? **GROWTH.***

*Why did investors love technology stocks in the 1990s? **GROWTH.***

*Why do investors love China-related themes today? **GROWTH.***

the S&P/TSX Composite Index. While \$1 million invested in the Index turned into about \$1.7 million a decade later, the same \$1-million investment in BMTC would have turned into more than \$14 million (eight times more). How did the company do it?

Was It Revenue Growth?

Normally when retailers are successful they build more stores and increase their revenue per store. Throughout the decade, BMTC expanded from 19 to 26 warehouse stores and also built six new small-format mattress stores. Revenue per store was essentially unchanged. Combined, this resulted in revenue growth of about 51%. Not bad, but it only accounts for 13% of the total return so there must be more to the story.

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Was It Multiple Expansion?

One of the fundamental concepts of value investing is that when a stock is out of favour, it often trades at a low earnings multiple. When it becomes more popular, the earnings multiple usually increases. Did BMTC benefit from multiple expansion? Yes, but minimally. The stock traded at just 7.8 times earnings in late 1999, and the multiple expanded slightly and ended 2009 at 9.6 times earnings. The expanded multiple contributed 6% to the total return.

Was It Margin Expansion?

By controlling costs, it is possible to grow profits faster than revenue. In 1999, BMTC earned \$18.5 million in profit at a 3.4% profit margin. This was much lower than the 9.8% profit margin at Leon's, one of the best-managed furniture retailers in North America. By 2009, BMTC had more than doubled margins to 8.2%, in line with Leon's 8.1% margin. If BMTC's margins had stayed the same, the company would have earned \$27.8 million in 2009. But, thanks to efficiency gains, it actually earned \$67.1 million. So efficiency gains are a big part of the answer, but still only account for another 35% of the total return. What else could have contributed to that enormous 1,300% return?

Was It Capital Allocation?

Capital allocation is broadly defined as what management does with the money it has. The most common options are investing in growth (opening new stores, etc.), acquiring other companies, reducing debt, paying dividends and buying back stock. BMTC didn't

have any debt during the decade and, as we've already pointed out, they didn't open very many stores. How did they choose between the remaining options? BMTC didn't make any acquisitions; instead, they chose to pay dividends and buy back shares. The dividend was responsible for about 3% of the total return.

Which Only Leaves Buybacks...

Many companies buy back their own shares consistently, regardless of price. But BMTC was acutely sensitive to price, spending as little as \$9 million (in 2000) and as much as \$80 million (in 2008) to buy back shares. The key is that they only bought back stock when it was cheap.

Consequently, BMTC was able to reduce its outstanding shares by more than 50% during the decade. In other words, continuing shareholders were able to double their proportionate ownership without spending an additional penny. Opportunistic buybacks were responsible for a whopping 43% of the total return.

To summarize, in December 1999 you could have invested in Leon's, a good business with great operators, at a reasonable price (14 times earnings) and made a 120% return – 30% more than the TSX. Or, you could have invested in BMTC, a good business with great operators *and* great capital allocation, at a reasonable price (8 times earnings) and earned 1,300%. Assuming an initial investment of \$1 million, you would have made an extra \$11.8 million during the decade by investing in BMTC. That's how valuable great capital allocation can be.

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Growth That Does Matter

The way investors get returns from equities is through increasing stock prices and dividends over time. That, of course, is growth.

Most investors are simple-minded about the sources of growth. They see companies that increase their top line rapidly or that undertake aggressive acquisitions as the best candidates to produce strong shareholder returns. In fact, these companies are very often buying top-line growth at the expense of lower margins or ruined balance sheets. Such strategies are always counterproductive and often disastrous to the long-term shareholders of the firm.

The case of BMTC is an unusually clear illustration of the kind of growth that really matters: growth in per-share intrinsic value.

This kind of growth can come from any or all of the traditional sources of capital allocation – intelligent capital expenditures, prudent acquisitions, appropriate dividend increases or timely and opportunistic stock buybacks. BMTC did not use acquisitions, but was very shrewd about its capital expenditures and dividends, and positively brilliant in its stock repurchases. In Burgundy's experience, this is a very rare combination.

BMTC's owner-managers were able to make outstanding repurchase decisions about their stock because they did not care about what Bay Street

thought (investment bankers always recommend against small-cap companies repurchasing stock on the basis that lower trading volume is bad for returns). Whenever BMTC managers thought that BMTC stock was attractive to them as rational investors, they bought it. And when it was really attractive, they bought a lot of it. The purchases increased their personal percentage ownership positions, and dramatically increased the value of the remaining shares.

Quebec's small-business community is full of tough-minded mavericks like the BMTC managers.

Ironically, they have been far better stewards of shareholder capital than most companies with investor relations departments and big "incentive" plans that allegedly align

management with shareholders. The simple reason: they act like owners because they are owners, and owners are the most rational actors in the capital markets.

It should be no surprise, then, that Burgundy prefers to invest alongside managers with big ownership stakes. Long-term shareholder returns can be outstanding (as the BMTC example shows) when superior capital allocation strategies are pursued by owners running a good business.

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Appendix – How the Math Works

Revenue Growth

BMTC's revenue in 2009 was \$818.1 million, a 51% increase compared to 1999 revenue of \$543.1 million. Assuming constant profit margins, constant multiple and no dividends or buybacks, the stock price would be directly correlated to revenue. Therefore, revenue growth during the period is equivalent to the impact of revenue growth on total return.

Margin Expansion

	A	B	C
	1999	2009 – Flat Margins	2009 – Actual Margins
Revenue	543	818	818
Profit Margin	3.4%	3.4%	8.2%
Net Income	18.5	27.8	67.1

The difference between net income in column B and column A is attributable to revenue growth, but the difference between net income in columns B and C is attributable to margin expansion. Assuming constant multiple and no dividends or buybacks, the value created by margin expansion is:

$$67.1 \div 27.8 = 141\%$$

Multiple Expansion

The 1999 earnings multiple was 7.8 times, which increased to 9.6 times in 2009. The difference produced a 23% positive contribution to the 1,300% total return.

At this point, it is important to point out that the components are multiplicative – not additive – which is best explained with a simple example. Imagine a business with \$20 million of revenue and 10% profit margins. Its earnings would be \$2 million.

Now, assume that revenue triples and profit margins double to \$60 million and 20%, respectively. Earnings would now be \$12 million, which is 6 times (i.e., 3×2) more than the initial number.

Dividends

The total return with dividends was 1,300% and the total return without dividends was 1,130%. Consequently, dividends contributed 14% to the total return:

$$\frac{\text{Total Return w/o Dividends} \times \text{Dividend Impact}}{\text{Total Return w/Dividends}}$$

$$(11.3 + 1)(X + 1) = (13.0 + 1) \quad X = 0.14$$

Buybacks

Since we now know the contribution of the other four components of return, we can deduce that the contribution from buybacks was 175%:

$$\frac{\text{Revenue Impact} \times \text{Margin Impact} \times \text{Multiple Impact} \times \text{Dividend Impact} \times \text{Buyback Impact}}{\text{Total Return}}$$

$$(0.51 + 1)(1.41 + 1)(0.23 + 1)(0.14 + 1)(X + 1) = (13.0 + 1) \quad X = 1.75$$

Summary

	Return	% of Total Return
Revenue Growth	51%	13%
Margin Expansion	141%	35%
Multiple Expansion	23%	6%
Dividends	14%	3%
Buybacks	175%	43%
Total	1,300%*	100%

*Multiplicative



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