The VIEW *from* BURGUNDY

SEPTEMBER 1996

SECOND CLASS OWNERS

By the end of 1996, The View from Burgundy *was getting noticed. One of the most ambitious issues of the newsletter that we ever wrote concerned dual class share structures (DCSS), where a small class of super-voting shares controls a company, while the vast majority of public shareholders are effectively disenfranchised. We were interested in this phenomenon where it affected us most – in equity performance in the public markets. We did a vast amount of number crunching in order to get performance data on Canadian companies with and without these share structures for several years prior to 1996. We found a tendency for companies with DCSS to underperform, and gave our opinion on the potential for governance issues arising with these structures.*

Interestingly, there does not appear to have been a definitive academic study of the phenomenon, and as recently as 2005 this issue of The View *was quoted in the financial press.*

Richard Rooney, 2007

Preamble

AFTER OUR ANALYSIS OF THE RELATIONSHIP BETWEEN reliably rising earnings and stock market performance in the "Capital Punishment" issue, our researchers at Burgundy got really ambitious and decided to tackle a subject that has long interested us, namely the issuance of subordinated voting and non-voting shares and their impact on performance. This is a big, complex subject, so we decided to approach it systematically.

Let's declare our biases right off the bat. We believe that while subordinated voting and non-voting shares are a form of ownership, they are not equity in the true sense. They entrench management and may permit arbitrary decision-making. By definition, they are undemocratic. We are inclined to oppose them as an abuse of corporate governance.

The reasoning behind our opposition is simple. There is no better incentive to economic efficiency for a publicly traded corporation than a free market in the company's common equity. As the economic history of the past 20 years has shown, underperforming companies whose management is not entrenched by control blocks or multiple voting stock are routinely bought up and made efficient by new management and ownership groups. The process is often nasty, and sometimes greed, speculation and incompetence can cause tragedy, as in the case of Canada's own Robert Campeau, but it is beneficial to the economy and shareholders in the long term. Subordinated voting and non-voting arrangements block this process, enable underperforming managements to remain in control, and may contribute to sluggish economic performance.

Subordinated voting shares are rife in Canada. We decided as a first step to find out how widespread they are, and in what industries they are most likely to occur. We would then attempt to assess whether they have had an adverse effect on stock price performance.

Methodology

We should point out that our testing and sampling, while laborious and detailed, does not involve the level of precision required by academic analysis, for example. We are using large enough samples that the aggregate numbers should be accurate. But we are not doing sufficient testing to draw ironclad conclusions. As practitioners rather than pure researchers, we are trying to be approximately right rather than exactly wrong. We believe our survey will meet that standard.

The Stock Guide database accumulates the last eight years of data for the companies it contains, so the universe we used in our study was all Canadian equities on the Stock Guide database, which were public from December 31, 1987 to December 31, 1995. They totalled 413 companies. Of those, 121, or 29.2% of the total, had dual class share structures (DCSSs) and 292, or 70.8%, had single class share structures (SCSSs).

Relationship with Company Size

By market capitalization, the DCSS companies tended to be smaller, with an average market cap of $534.4 million, and a median market cap of $109.9 million, versus an average market cap of $1.24 billion and a median of $171.2 million for SCSS companies. That is not surprising since a lot of Canada's largest companies, like CP Ltd., Seagram, the chartered banks and the major utilities do not have DCSSs. In the case of the chartered banks and some utilities, they have legislative protection from takeovers, which is even more effective than DCSSs as a method of management entrenchment.

Industry Concentration

The industries where DCSSs were most likely to occur were communications and media, where 17 of the 26 public vehicles had them, followed by transportation (4 out of 7), conglomerates (3 out of 6), merchandising (9 out of 22), consumer products (16 out of 43), industrial products (20 out of 69) and financial services (13 out of 45). Generally, the resource/cyclical sectors had very low levels of DCSS incidence.

Why this concentration in the consumer end of the Canadian economy? We can think of a couple of reasons. First, the Canadian government has traditionally protected the Canadian consumer from the overwhelming influence of the American market. In some cases, this resulted in the diversion of profits earned from American products into the pockets of favoured local interests.

Take these three examples:

- Until recently, in areas like broadcasting, a small number of companies were licensed by the government to import American programs and sell them for oligopoly profits in the Canadian market.
- The old system of tariffs and duties allowed Canadian retailers to charge higher prices to Canadian consumers until the free trade agreement changed the buying habits of Canadian shoppers (remember the cross-border shopping mania of 1990-1993?).
- Canadian breweries were protected by requirements for in-province brewing and industry control of distribution channels.

The point is that if you owned a TV station or a retail chain or a brewery, it could be a licence to print money. If you went public in order to acquire other TV stations or breweries, it was a good idea to protect control through a DCSS. Ironically, this has meant that DCSS companies tend to cluster in groups of good, cash-generating businesses, which investors like Burgundy love to own.

Another reason for the consumer concentration is that these are often the kind of businesses that an entrepreneur with a good idea can start up. The problem is that entrepreneurs with deep pockets are a bit of a contradiction in terms. Once they have established a growing, prosperous business, they must find a way to maintain control while tapping the capital markets to fuel growth. DCSSs solve this problem.

And they have been used successfully by some great business leaders. Ted Rogers, George Gardiner, Frank Stronach and Prem Watsa have all created enormous amounts of shareholder wealth using DCSSs to protect their control. It is an interesting question whether Magna's Board of Directors would have left Frank Stronach as CEO in the dark days of 1990-1991 if he had not controlled the company. And if they had removed him, would Magna have made its comeback, perhaps the greatest in Canadian business history?

Obviously, there are no easy answers in this area.

Impact on Share Prices

So what is the performance impact of DCSSs on stocks? We measured the total return on all 121 companies having dual classes over the eight-year period ending December 31, 1995 and then took a simple unweighted average of the compound returns. We then compared the results to the total average compound return of all companies with SCSSs for the same period. Here are the results:

ANNUALIZED COMPOUND RETURN December 31,1987 – December 31, 1995	
Single Class Share Structures	2.5%
Dual Class Share Structures	1.8%
TSE 300 Index	8.5%

So on the face of it, it looks like our case is proven: DCSSs underperform. But that was a little too simple. The fact is that our time period starts in 1987, and we seem to recall a little volatility late in the year. Also, Canadian consumer stocks had done exceptionally well in the early 1980s and we were wary of statistical anomalies caused by end-date sensitivity.

With this in mind, we re-ran the numbers for the five-year period ended December 31, 1995. The result was the following:

ANNUALIZED COMPOUND RETURN December 31,1987 – December 31, 1995	
Single Class Share Structures	8.6%
Dual Class Share Structures	8.1%
TSE 300 Index	10.8%

Again, DCSSs appeared to be disadvantageous relative to SCSSs. It is interesting that the difference is about the same: 0.5% vs. 0.7%. Two sets of observations are obviously insufficient to draw a conclusion, but there appears to be some support for the thesis that DCSSs underperform SCSSs in the stock market. We believe that there has been some research in the U.S. that also tends to support this view. We should point out that these differences are not immaterial. (Just ask any money manager who underperformed a benchmark by 0.7% over eight years – if you can find one still in business.)

A Digression

"Random walk" proponents (those who think throwing a dart at the stock page is as likely to pick a winner as painstaking research) may be surprised at the enormous difference in returns between the average compound returns for our sample, and the returns on the TSE 300. There are two reasons for this. First, the TSE 300 benefits in a big way from "survivor bias." Survivor bias means that losers are thrown out of the sample so that there is a favourable bias to the returns. As anyone who has followed the TSE 300 for a long time knows, the Index is very unstable and changes radically over time. (Remember when Dome Petroleum was 7% of the TSE 300 Index?) Secondly, the TSE 300 is a capitalization-weighted portfolio and is driven by changes in relative weightings. Our sample, by contrast, is an unweighted average of all stocks public for the whole eight-year period from 1987 to 1995, so it represents the probable return of a random choice from this list of stocks. Throwing a dart at our sample would not have been a particularly rewarding experience, since 53 out of 121 stocks with DCSSs had negative returns over this period, as well as 117 out of 292 SCSS companies. That's right – a shocking 41% of the companies in the sample delivered negative returns over the eight-year period. We think we'd rather do the research.

Another point to remember is that the sample we arrived at is also tainted by another specific type of "survivor bias." There have been many takeovers in the Canadian market in the past eight years, and of course none of the acquired companies are in the sample. Given that the main reason for DCSSs is to prevent takeovers, it is probably a safe assumption that the vast majority of takeovers have been of companies with SCSSs. Thus, the excess returns generated by takeovers, which may have disproportionately benefited shareholders of SCSS companies, are not included in these return calculations.

Dilution Danger

We thought one reason that might account for the underperformance of DCSSs relative to SCSSs was the possibility that an entrenched management might consider its subordinated stock to be "just paper" and issue massive quantities of it, thus diluting that class of shareholder. We therefore screened to find out whether there was a greater propensity to issue stock if a DCSS was in place.

On the contrary, we found that over our eight-year test period, the 121 companies with DCSSs in place issued, on average, 92% of their original capitalization in new stock. The 292 companies with SCSSs issued 120%. We thought that we could eliminate a distortion by taking out the oil and gas sector, which, as a huge ongoing issuer of new equity, is the best friend of the Canadian corporate finance industry. After we removed them from the sample, the DCSSs had issued only 49% net new equity over the survey period, while SCSSs had issued 100%.

So, companies with DCSSs in place were not necessarily prodigal issuers of shares, or at least were less prodigal than companies with SCSSs. We were startled by the tendency of Canadian companies to issue equity, but could not say that DCSSs were a determining factor.

As we have pointed out on a number of occasions in prior editions of *The View*, companies that habitually issue equity are often below-par performers, and investors are wise to look for companies that either are buying back stock or at least issuing it sparingly.

Conclusions

So what conclusions can we draw from our work? We think that there are several.

- The stocks of companies having DCSSs tend to underperform those of companies with SCSSs. The performance differential is small, but not insignificant.
- The performance differential may be understated because it excludes takeovers that took place during the sample period.
- The underperformance may result from concentration of DCSSs in certain industries and in smaller capitalization ranges, both of which may have underperformed in the sample period.
- There does not appear to be any greater propensity to issue stock under DCSSs than under SCSSs, which we found surprising.

Unfortunately, DCSSs are not the only barrier to a free market in equities in Canada. Aside from control blocks in companies like Seagram, Weston, Imperial Oil and Imasco, which are simple majorities of single class voting shares, there are legislative barriers to takeovers of banks, utilities, airlines and former Crown Corporations. In the case of communications stocks, there is not only legislative protection under Canadian ownership rules, but also a plethora of DCSSs to entrench management, thus adding insult to injury.

And as we pointed out earlier, some people who have gone public using multiple voting stock to retain control have generated a lot of shareholder value. Izzy Asper, Jim and Les Shaw, Laurent Beaudoin – all have been big contributors to such success as the Canadian stock market has had. No investor, least of all Burgundy, should wish to stunt such careers as these. The problems seem to arise once the major entrepreneur leaves the scene. So in the interest of reasonable compromise, we suggest the following measures be taken by Canada's securities regulators:

- Non-voting stock is an abomination and should not be permitted to exist.
- Multiple voting stock should not be allowed more than 10 votes per share.
- All such stocks should have a sunset clause requiring a free vote on renewal of the dual class shares every 10 years or upon the death or retirement of the CEO.
- On a takeover bid, all shares should be treated equally.

While our research into this topic didn't yield the hard conclusions we had wanted, there was an abundance of interesting insights and avenues for further work. We will share these with our readers in upcoming issues of *The View*.

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