The VIEW *from* BURGUNDY

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THE GREAT INVESTMENT VERITIES

WE NEVER CEASE TO BE ASTONISHED at how little time and effort is spent studying the key success factors behind the small number of truly great investors – both past and present – and their application to practical money-making investment decisions. Thousands upon thousands of high-IQ people-years, and reams of articles and extensive research studies by analysts, are expended forecasting quarterly earnings, the direction of interest rates, various aspects of the economy and earnings momentum. As well, countless further studies are made on various aspects of portfolio theory and portfolio construction.

Contrast this to the relatively limited effort by major institutional capital into understanding and applying the key success factors of these great investors. Warren Buffett explains this phenomenon as occurring because so many well-educated, talented analysts and investment people with so much computer power simply yearn to do more things in order to justify themselves and utilize their backgrounds. At Burgundy, we consider ourselves fortunate that relatively few investors have seriously studied these people and their approach; it provides far greater opportunity for us.

The truly great investors have achieved their success in different ways. Burgundy has distilled these key success factors into our own philosophy of investing, which is as follows:

- Invest in companies in which the estimated intrinsic value exceeds the stock price by a significant amount. This is what Ben Graham referred to as the "margin of safety."
- Invest only in companies you understand. This is Buffett's "circle of competence" concept.
- Invest in companies in which you have confidence in the management with respect to their honesty and competence. Examine in particular their capital allocation actions – when to pay out and when to retain. Seek out managements that stress share price performance and return on shareholder's equity (ROE), rather than the absolute size of the company (many large Canadian companies fall into this trap of size versus per share progress).
- Pay careful attention to the quality of earnings, and the ability to generate free cash flow and its deployment.
- Seek out companies that have a strong competitive position or barriers to entry. If you don't have wide "moats" around your "grand castle," competitors will penetrate your territory, erode your profitability and eventually cause your downfall.
- Watch for brand names and natural oligopolies of various types. These are rare but extraordinarily valuable over time, especially if purchased when they are out of favour in the marketplace.
- Be a willing buyer of good companies when they are under pressure and when most investors are selling because of bad short-term news.

Ben Graham Tribute

On December 6, 1994, we attended a session at the New York Society of Financial Analysts entitled "A Tribute to Ben Graham." Ben Graham would have been celebrating his 100th birthday if he were still alive. Three of Graham's former students spoke at length: Warren Buffett, Irving Kahn, and Walter Schloss, all very successful investors, with Buffett obviously being the best known of the three.

Buffett presented the basics of Graham's investment philosophy in a simple way:

This is the 100th anniversary of Ben's birth, I believe. And on the creative side, if what I consider his three basic ideas are really ground into your intellectual framework, I don't see how you can help but do reasonably well in stocks. His three basic ideas – and none of them are complicated or require any mathematical talent or anything of the sort – are:

1. that you should look at stocks as part ownership of a business;
2. that you should look at market fluctuations in terms of his "Mr. Market" example and make them your friend rather than your enemy by essentially profiting from folly rather than participating in it; and finally
3. the three most important words in investing are "margin of safety," which Ben talked about in his last chapter of *The Intelligent Investor* – always building bridges that can carry 30,000 pounds but only driving 10,000-pound trucks across it.

I think those three ideas 100 years from now will still be regarded as the three cornerstones, essentially, of sound investment. And that's what Ben was all about. He wasn't about brilliant investing. He wasn't about fads or fashion. He was about sound investing.

And what's nice is that sound investing can make you very wealthy if you're not in too big a hurry. And it never makes you poor – which is even better.

So I think that it comes down to those ideas – although they sound so simple and commonplace that it kind of seems like a waste to go to school and get a PhD in Economics and have it all come back to that. It's a little like spending eight years in divinity school and having somebody tell you that the 10 commandments were all that counted.

There is a certain natural tendency to overlook anything that simple and important. But those are the important ideas. And they will still be the important ideas 100 years from now. And we will owe them to Ben...[†]

Capital Allocation

Capital allocation is one of those decisions that is so key to any business and yet so few companies do it well. At Burgundy, we believe that each business has an intrinsic return on equity (ROE) that investors are willing to pay for. The essential role of any CEO is to enhance or at least maintain that level of return to shareholders as the business environment evolves.

We have a simple concept of what that intrinsic ROE is: take the operating profit and divide it by the minimum capital it would take to maintain production. That number is what we believe should be the benchmark rate for the reinvestment of operating earnings (retained earnings). As long as the CEO continues to reinvest capital at or above that rate, the intrinsic value of the company will be maintained or enhanced.

The problem is that most CEOs are not paid according to the return to shareholders, but in the growth of the business. Thus, if the intrinsic ROE of the company is 25% and the CEO acquires another business at 12%, he has grown the revenue of the company, but has reduced its intrinsic value.

Why is this so important? As long as companies continue to reinvest in their business at rates at or above their benchmark rate, they will enhance the market value of the firm and, most importantly, increase shareholders' wealth. A more difficult concept for corporate management to accept is that if they cannot reinvest capital at the corporation's benchmark rate, they should pay it out to shareholders either in the form of a dividend or share buybacks. Both methods enhance the market value of the firm to the shareholders, although arguably, share buybacks are a little more efficient since capital gains taxes are lower than taxes on dividend income.

While the market may not immediately reflect the decline in intrinsic value, especially if the capital is being reinvested internally at lower rates, over a period of five years or more the relationship becomes very clear. The way to measure the increase or decrease in intrinsic value is a concept called Market Value Added (MVA), developed by management consultant Stern Stewart, which shows the impact of capital allocation on the market value of a firm over time. The definition of MVA is the difference between the market value of a company at a point in time, plus the capital retained within the company over the period, compared to the current market value.

To illustrate the impact of capital allocation, we used two firms within the same industry, Rothmans and Imasco, which have taken very different views on capital allocation.

In the charts shown on this page, the last column is a running balance of the MVA from 1985 to 1994. Beginning with 1985, the earnings retained for each year are added to the beginning market value and then subtracted from the current year's market value. The difference is the dollar amount of value the company has grown (or lost) due to the market's perception of the change in intrinsic value.

IMASCO LIMITED

	ROE	Net Income	Div Paid	Retained Earnings	Chg in Common Stock	Price	Shares O/S	Market Value	MVA	
Dec 85	17.319	261.745	78.700	183.045	0.300	13.938	217.816	3,035.92		
Dec 86	11.209	212.646	102.900	109.746	349.100	16.250	238.246	3,871.50	376.73	
Dec 87	12.003	245.029	129.500	115.529	1.500	12.938	238.382	3,084.19	-527.61	
Dec 88	15.293	314.310	139.100	175.210	0.000	14.000	238.382	3,337.35	-449.66	
Dec 89	16.238	366.100	157.800	208.300	1.100	18.875	238.494	4,501.57	505.17	
Dec 90	12.326	291.400	179.600	111.800	0.100	13.812	238.226	3,290.38	-817.93	
Dec 91	13.267	331.600	179.000	152.600	2.200	18.250	238.228	4,347.66	84.56	
Dec 92	14.078	380.400	189.000	191.400	5.000	20.625	238.198	4,912.83	453.33	
Dec 93	13.893	409.000	197.000	212.000	4.000	20.062	238.374	4,782.26	106.75	
Dec 94	16.110	506.000	196.000	310.000	(16.000)	19.875	233.482	4,640.45	-329.05	
Total				1,586.585	347.000	Change in Market		1,604.535		
Total Return	(13.998)	0.432	0.543	0.584	0.662	0.754	0.751	0.793	0.826	20.714
8.07%										

Source: Burgundy Investment Team Research

It is MVA that best illustrates the reason why capital allocation is such a critical, in fact the critical, decision that any CEO makes.

Given the task of choosing between these two companies, many investors would look primarily at market share and profitability of the core products as the key factors. Ten years ago, if one had to choose between an investment in Rothmans or Imasco, the choice for most would have been Imasco for the following reasons:

- Imasco had grown its market share in the Canadian tobacco business from 35% to 65%.
- Two of Imasco's products, DuMaurier and Players, made up 55% of the tobacco market in Canada.
- In 1985, Imasco had operating profit margins (EBIT margin) of 17.6%, in a business where the government had

ROTHMANS INCORPORATED

	ROE	Net Income Cont Ops	Net Income Disc Ops	Total Net Income	Common Divs Paid	Retained Earnings	Chg in Common Stock	Price	Shares O/S	Market Value	MVA
Mar 85	9.390	25.997	(1.705)	24.292	10.577	13.715	0.000	41.00	5,511	225.95	
Mar 86	(1.180)	14.236	(15.362)	(1.126)	10.547	(11.673)	0.000	35.00	5,511	192.89	-21.39
Mar 87	34.690	18.582	80.888	99.470	10.508	88.962	0.000	33.25	5,511	183.24	-120.00
Mar 88	12.720	30.378	0.000	30.378	230.910	(200.532)	0.000	39.50	5,511	217.68	114.98
Mar 89	23.390	33.701	0.000	33.701	10.454	23.247	0.000	62.50	5,511	344.44	218.48
Mar 90	23.850	40.394	0.000	40.394	12.616	27.778	0.000	68.00	5,511	374.75	221.01
Mar 91	28.460	43.318	0.000	43.318	102.924	(59.606)	0.000	55.00	5,511	303.11	208.98
Mar 92	36.540	49.305	0.000	49.305	21.946	27.359	0.000	94.00	5,511	518.03	396.55
Mar 93	34.370	55.327	0.000	55.327	22.043	33.284	0.000	101.00	5,511	556.61	401.84
Mar 94	40.090	58.654	0.000	58.654	121.235	(62.581)	0.000	83.50	5,511	460.17	367.98
Total						(133.762)	0.000	Change in Market		234.22	
Total Return	(41.000)	1.600	1.600	41.598	1.600	2.000	18.399	3.700	4.000	105.499	
27.43%											

Source: Burgundy Investment Team Research essentially frozen the status quo by prohibiting competition among tobacco companies based upon price or advertising.

- In 1985, Rothmans was, and still is, a distant second in the business to Imasco. Profit margins (EBIT margin) in 1985 were 14.6% of sales, 3% below Imasco. Rothmans' return on equity in 1985 was only 9% versus Imasco's ROE at 17%.

Aside from moral or litigation issues, tobacco is a business whose only negative is the modest, but steady declining market as fewer people smoke each year. Because of this, and because it is not a high-tech business, the tobacco industry requires relatively little maintenance capital each year to generate high returns. This, combined with a highly profitable business, has meant that tobacco has been, and still is, an unbelievable "cash cow" for its owners. Since both companies were in the same business, Imasco was clearly the better company and the one that investors would have thought would provide the highest return to shareholders.

However, over the 10-year period from 1985-1994, Imasco's ROE has fallen slightly from 17% to 16%, while during the same period, Rothmans' ROE has vaulted from 9% to 40%. Profit margins have fallen at Imasco to 13% while Rothmans' margins have jumped from 14% to 34%. This startling reversal happened despite the fact that Imasco's market share in tobacco remains a dominant 65%.

The bottom line is that between 1985 and 1994, the total stock market value of Imasco went from $3.0 billion to $4.6 billion, a gain of $1.6 billion. This works out to a total gain over this period of 53% or only 6% per annum. The gain in market value of $1.6 billion is just about equal to the earnings retained by management during the period, which totalled $1.7 billion.

By contrast, Rothmans' market value was $226 million in 1985 and by 1994 its market value had increased to $460 million. The gain of $234 million in value compares to capital retained by management of about $288 million; however, three extraordinarily large dividends totalling over $400 million were paid out during the period, so that in fact $120 million of capital was extracted from the business on a net basis and paid to shareholders. Including the dividends paid, but not any reinvestment of those dividends, the total return to Rothmans' shareholders has been an impressive 27.4% per annum, compared with 8.1% for Imasco shareholders and 9.0% for anyone who simply held 91-day T-bills over the period.

Rothmans has taken the stance that tobacco provides the highest returns that it can achieve, but this industry requires little maintenance capital expenditures. The result has been that, since 1986, Rothmans has decreased the amount of capital allocated to the business from $11 million to $5 million or so annually. As less capital is tied up in the business, both operating profits and return on equity have soared and the excess cash generated by the business has been paid out in the form of large special dividends.

By contrast, at Imasco, the emphasis seems to have been to diversify and to grow the size of the company. Imasco has taken the substantial excess capital generated from the tobacco business and reinvested it primarily in Canada Trust, Shoppers Drug Mart and Hardee's restaurants. While we at Burgundy believe that Canada Trust is one of the best of the Canadian financial institutions, it does not come close to achieving the returns of tobacco. Shoppers Drug Mart and Hardee's are both sub-par businesses in extremely competitive industries.

The incredible net result is that Imasco shareholders would have done better over the past 10 years by owning treasury bills in spite of being shareholders in a company that has a 65% market share in a highly profitable business.

At Burgundy, we see the relationship between reinvesting at a high rate and shareholder returns as being obvious, but some big public companies just don't seem to get it. We met with the management of Imasco a few months ago to talk about their business and especially their capital expenditures for 1995. We were astonished by the answer. For 1995, Imasco stated that it will commit $400 million of capital to its businesses; $40 million on its tobacco operations; $120 million on Shoppers Drug Mart (largely on a distribution system to help them fight against Wal-Mart and Zellers); and $100 million on building new Hardee's restaurants (to compete with McDonald's), which hopefully will start to turn a profit in two years.

Conversely, Rothmans has just declared an $8 special dividend on top of their normal $2, and not surprisingly, the stock rose to over $100 per share recently. Needless to say, Burgundy is a shareholder in Rothmans and not in Imasco.

Search Group; we will all benefit significantly from Allan's presence.

Endnotes

†. Buffett, Warren E. "A Tribute to Ben Graham." [speech] December 6, 1994. New York Society of Financial Analysts.

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