The VIEW *from* BURGUNDY

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THE MOST VALUABLE OPTION OF ALL

FINANCIAL OPTIONS were designed to help investors maximize upside exposure while limiting the downside. In this *View from Burgundy*, we look at how investments that closely resemble financial options can fit into a long-term, value investment approach – especially when they are free. We also find that another definition of option – the right, but not the obligation, to change your mind – may be the most valuable option of all.

A financial "option" is a contract that gives the holder the right, but not the obligation, to transact in a security. Option contracts run for specified time frames, after which they expire. Whether they expire worthless or "in the money" depends on the value of the underlying security. For example, an option to buy a stock at $25 per share is worth a lot ($15) if said stock ends up trading at $40. The same option would expire worthless if the stock was trading for less than $25. Note also that option values can never be negative because option holders are not required to transact. It wouldn't make sense to do so if the underlying security was trading at less than the option price. This means that the option's ultimate value will range from zero to a lot, depending on the underlying stock price.

With options the math can get complicated, but it's enough to know that the downside is limited, and the upside is not. Options sound like a good tool for investors seeking to minimize downside exposure (because options can never have a negative value) and maximize the upside (because their upside potential is unlimited). Unfortunately, financial options have two big drawbacks. First, they cost money. The seller of the option wants to be compensated for the chance that she will have to sell you a share for far less than it is worth. In the above example, the shareholder would have to part with the share at $25, not the $40 that the share would fetch in the market.

The second drawback? Options expire. Investors wanting the benefits of upside exposure with no downside must continually renew their options when the old ones expire and this comes at a price. Unless the upside scenario plays out every time, time will work against you, given the ongoing cash outflows needed to renew option contracts.

There is a better way. What if you could find an investment that looked just like an option – with little downside and lots of upside – and was free? Even better, one where the life of the option was open-ended with no hard expiry date. We would back up the truck and fill our boots. But, does such an investment exist? If so, what does it look like?

Finding Free Options in the Equity Markets

From time to time, Burgundy has found equity investments that seemingly meet these criteria:

- Little downside
- Lots of free upside
- No expiry date

We admit that outside of the old Vancouver Stock Exchange bucket shops, "little downside" and "equity investment" rarely belong together in the same sentence. But we're comfortable stating that the downside is limited as long as a few criteria are met:

- The business model and balance sheet must be low risk
- The company must possess a moat around its economic castle
- Management must be long term and ownership oriented

Warren Buffett calls the companies that meet these criteria "The Inevitables," where earnings, and thus intrinsic values, will inevitably be a lot higher in 10 years than they are today. When these companies are available at a large discount to intrinsic value, then the downside looks less threatening.

We also admit that we are not Warren Buffett. To mitigate this misfortune, we make sure that we own a diversified collection of undervalued Inevitables. While it may be impossible to claim that there is no downside with this approach, history suggests that if your time horizon is long enough, the risk of loss from owning a diversified portfolio of Inevitables, at big discounts to their respective intrinsic values, is very low.

In terms of upside, "normal" earnings growth for Inevitables is typically built into intrinsic value estimates. Conservatism precludes the use of growth rates that differ too much from that of the general economy. Still, intrinsic values should normally grow at regular rates over time. There's a reason that they are called Inevitables. That is also why Buffett, who typically only buys these companies, says that time is the friend of the long-term investor.

But opportunities can be supernormal, and these opportunities are not captured in intrinsic value calculations. A successful new product, geography or investment strategy may offer a way to bootstrap growth well beyond normal rates. Charlie Munger, Buffett's partner, calls any combination of these "lollapalooza" events. When they pay off, shareholders can experience enormous returns. We call these potential supernormal opportunities "options" when their prospective payoff outlook looks much like the prospective payoff of financial options as we defined above – little downside and lots of upside.

Even better, unlike financial options, these "options" do not have expiry dates. While many opportunities are time sensitive, others can persist for a very long time. As we shall see, being exposed to long-term upside can be very valuable.

So we can identify a diversified collection of Inevitables, with limited downside given their low risk business models, balance sheets, management and valuations, several of which possess upside opportunities for shareholders to reap potential lollapalooza returns. In other words, lots of upside. But how can these upside options be free?

The answer: normally, they are not. As the old saying goes, the market is a smart little fellow that typically values companies (and their upside opportunities) fairly appropriately. But from time to time it doesn't. When we are able to invest in an

Inevitable at a big discount to its intrinsic value (which includes no value for these upside options), then we are getting the options for free. It doesn't mean we will be any good at predicting which of the options will hit pay dirt. But when we own a collection of them, our experience is that some are bound to pay off handsomely. And you only need a few to magnify overall portfolio returns.

Free Options Can Magnify Equity Returns

Our investment in SNC-Lavalin (see Appendix 1) is a good example of how free options can magnify returns. When we first purchased SNC on September 1, 1999 for C$3.70 per share (adjusted for stock splits), SNC had net cash, no debt and, as Canada's largest engineering services firm, a leading franchise in a good business. Engineering services is a fee business with high margins, little capital required and a variable cost structure that is adaptable to changing business levels. While profits can be lumpy, SNC had managed to report healthy "mid-teen" returns on shareholders' capital in each year of the preceding decade. Management during that time, led by CEO Jacques Lamarre, was conservative and long-term oriented, with substantial personal investment in SNC shares. While project backlog had been falling because of impacts from the 1997 – 1998 Asian crisis, SNC was trading for less than 10 times earnings – an attractive valuation. We felt that the business decline was cyclical and temporary and that SNC would resume a more "normal" growth rate as economies recovered. As a result, our estimate of intrinsic value for the core engineering franchise was significantly higher than the actual trading price.

SNC · LAVALIN

> If 90% of portfolio holdings average a 10% annual return over a decade, and the other 10% report SNC-like 30% annual returns, the overall portfolio return will average 14% per year – a good result.

So the SNC investment seemed to meet the first "little downside" criteria since the business model, balance sheet, management and valuation were low risk. What, then, were the free options? SNC had a couple, and the first of the two was more obvious to us at the time.

In 1999, just prior to our investment in the shares, SNC purchased 27% of 407 International Inc., which owns a concession to operate Highway 407 in the Greater Toronto Area until the end of the 21st century. The 407 was the world's first open-access toll highway. It seemed to be ideally situated in the growth path of Canada's largest city.

SNC management disclosed their range of assumptions on traffic flow and tolls, which allowed Burgundy to determine that the value of the 407 could potentially be quite material for SNC shareholders. As such, a free potential upside "option" was attached to SNC shares. It was free because we were buying the core engineering franchise at a discount to its intrinsic value alone.

At the time, the second free option was a little more opaque to us. As more than half of SNC's revenue was generated outside of Canada, they were well positioned to benefit from a resumption in global capital spending on mines, aluminum smelters and other projects requiring their engineering expertise. While we had built some "normal" growth rates into our intrinsic value estimation, the option for supernormal growth was attached to SNC shares for free. Little did we know that the world was on the cusp of the biggest capital spending boom in history. We also didn't know that the 407 would turn out to be one of the world's most profitable government concession investments, thanks to annual toll increases that surpassed initial expectations. Fast forward to today and it is plain to see that both options hit pay dirt (see Appendix 2). At a recent price of close to C$60, SNC's shares are up 15 times over our original investment a decade ago, resulting in a compound average annual return of 30% from first purchase.

Even among Inevitables, very few can expect to report "normal" earnings and intrinsic value growth rates of more than 10% per year, sustained over a decade or more. SNC has done far better than that for shareholders, thanks to the supernormal lollapalooza results that stemmed from a couple of "free" options that were available at the time we purchased the shares.

A search for Inevitables with free options is a useful approach to maximize upside exposure while minimizing the downside. Not all holdings will see their respective options hit pay dirt. Nevertheless, it doesn't take many such holdings to magnify returns. For example, if 90% of portfolio holdings average a 10% annual return over a decade, and the other 10% report SNC-like 30% annual returns, the overall portfolio will average 14% per year – a good result.

Successful investing involves an ongoing re-examination of assumptions to preserve all options – including the ability to change your mind.

The Right to Change One's Mind

With the foregoing in mind, is investing a one-decision exercise, where one simply invests in a collection of Inevitables at low valuations with free options, and then sits back and pats oneself on the back for a job well done? No, it is an illusion to think that we know today how to position a portfolio for the next 10 or more years.

If you have locked yourself into a predetermined path, you lack the ability to adapt your thinking and improve your portfolio. An example outside of investing is capital punishment. It is impossible to make use of new evidence or treatment methodologies if the prisoner is dead. So too if your portfolio is locked into a "buy and hold forever" mindset. Investments should be made with conviction, but they should not be irreversible.

Investing should be an ongoing and intensely adaptive process that sets in motion a framing of events whereby the "inevitableness" of the Inevitables is continually questioned – a process that preserves, or even increases, your options as time goes by. In this case, "option" means the right, but not the obligation, to change your mind.

This type of free "option" – the ability to change your mind – may be the most valuable option of all. Things change. Moats fill in. Management can change for the worse. And sometimes company share prices trade above intrinsic value. In these cases, it is invaluable to have the option to get out of an investment to preserve capital.

The option to sell is so valuable because the power of compounding is asymmetrical. Losses hurt our ability to compound capital more than gains of the same size help. A 10% loss requires an 11.2% subsequent gain just to break even. So with losses, pressure builds to generate higher future returns by taking on riskier investments (it is much like falling behind in a golf game, where one is forced to take more difficult shots to try to close the gap). This risk-taking almost always ends in tears. In contrast, a 10% positive return in year one equates to the same dollar gain as a 9.1% gain in year two because you are starting from a higher base. So with gains, lower future returns can still be attractive because they continue moving the compounding machine forward.

You can see from this example that higher returns (which are riskier to chase) are required to rebuild net worth if capital erodes. This is why Buffett says the number one rule in investing is, "don't lose money." In other words, having the option to sell an at-risk investment to preserve capital is invaluable.

It is just as crucial to recognize when company-specific options are paying off, like in the case of SNC, so intrinsic values can be adjusted upward. Selling too soon puts a serious damper on potential returns. If we had sold SNC when it reached our original intrinsic value estimate years ago, and made no allowance as its options were hitting pay dirt, we would have left buckets of potential return on the table.

This is where the open-ended nature of our "option" shows its value. Because there is no expiry date, an investor can remain exposed to an option that is paying off and really coin it.

Let's return to the example of the portfolio where 90% of the holdings averaged 10% compound annual returns and the other 10% reported SNC-like 30% annual returns, leading to an overall portfolio return of 14%. Over a decade, 14% compounded will turn $1 million into $3.7 million, while 10% compounds to a lesser $2.6 million. Clearly, it is important to let your winners ride if their inherent options are hitting pay dirt. This is only possible if your process allows for the flexibility, not just to sell, but to adjust intrinsic values upwards as changes in the underlying economics warrant it.

This does not mean that portfolio activity will be high. Remember, transactions are at the option of the investor. Indeed, a long-term value investor may find that changing his mind happens rarely. Warren Buffett has low portfolio turnover – and produces world class results. But when warranted, the option to change your mind can add substantial value.

Conclusion

A useful approach to compound capital at superior rates is to employ an ongoing process of searching for a collection of Inevitables with free options – built-in exposures to open-ended upside with little downside. This ongoing, adaptive process preserves an investor's ability to sell if an investment is at risk, or to adjust intrinsic values upwards when warranted. Though always free, this option to change your mind may be the most valuable option of all.

Appendix 1

SNC-Lavalin Group Incorporated (SNC) is the second-largest publicly traded engineering and construction company in North America and is one of the world's largest. SNC also owns a large portfolio of infrastructure investments. Approximately one-half of SNC's C$6 billion in revenue is generated in Canada, with the balance earned internationally. Many of SNC's 22,000 employees have engineering expertise in mining and metallurgy, infrastructure and environment, chemical and petroleum, power and other industrial projects. SNC was incorporated in 1967 and remains a widely held public company.

Appendix 2

At the time of Burgundy's purchase in 1999, SNC had a market capitalization of C$520 million (with a total of 140 million split-adjusted shares outstanding, multiplied by C$3.70 per share).

Today, SNC's Highway 407 stake alone is worth approximately C$1.5 billion, as confirmed by a recent public transaction (see Exhibit A below). Moreover, after receiving dividends from 407, as well as proceeds from the sale of one-quarter of its 407 stake in 2002, SNC's net investment in 407 is negative C$155 million (i.e., it has taken out C$155 million in cash, net of its original purchase, and still owns a stake worth C$1.5 billion. See Exhibit B below). The 407 "option" alone has created more than three times the market value of the entire company at the time of purchase. Lollapalooza indeed.

In addition, SNC's engineering revenue grew from C$970 million in 1999 to C$4.4 billion in 2009, a compound annual growth rate of 16.4%. The implied market value of SNC's non-407 assets is now C$7.4 billion (a total of 151 million shares currently outstanding, multiplied by C$59 equals C$8.9 billion, less C$1.5 billion for the 407 stake). With the value of SNC's non-407 assets up more than 14 times over the course of the decade (C$7.4 billion today compared to C$520 million in 1999), the global capital spending "option" also hit pay dirt.

Exhibit A

Value of 407 confirmed by recent transaction

SNC's Highway 407 stake is worth approximately C$1.5 billion. This was confirmed in two recent transactions:

- The October 2010, Canada Pension Plan Investment Board purchase of 10% of Highway 407 for C$894 million implied that SNC's 16.77% stake is worth C$1.5 billion.
- In August 2010, the Canada Pension Plan Investment Board acquired Australian toll road operator, Intoll Group, for A$3.4 billion; 90% of Intoll's net asset value consists of its 30% ownership interest in 407. At current foreign exchange rates, this transaction also implies that SNC's 16.77% stake in 407 is worth approximately C$1.5 billion.

Exhibit B

Calculation of net invested capital in 407 International

In 1999, SNC invested C$175 million in the common shares of 407 International. In 2002, SNC sold one-quarter of its stake in 407 for C$178 million, or C$150 million after tax. SNC has also received cumulative dividends of more than C$180 million. Net invested capital (C$175 million, minus C$150 million, minus C$180 million) is therefore negative C$155 million.

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