The View *from* Burgundy

JULY 1999

Unforced Errors

In the aftermath of our last *View from Burgundy*, two things became obvious to us. One is that our readers are ardent cinema fans, since our initial lapse in casting Albert Finney instead of Peter Finch as the crazed anchorman in Network was caught immediately and corrected more times than we can count, by email, fax and phone. The second is that some people thought we were holier than thou in scolding Canadian investors about four serious investment lapses, none of which we had invested our clients' money in. Did we never err ourselves?

Oh, that we could answer no! But, unfortunately, we have made some very educational blunders in the last few years. In this issue of *The View*, we will review two of those mistakes and draw, we hope, appropriate morals from the stories.

Goldfarb Corporation

The story of this company is really extraordinary. It originated as Goldfarb Consultants, a market research consultancy founded by Martin Goldfarb in the 1960s. The company developed a fine list of clients, and a particularly close relationship with the Ford Motor Company, which helped Goldfarb to expand into foreign markets in the 1980s and 1990s. Mr. Goldfarb did a good job of building this business. Market research consultancy firms have many of the characteristics we look for in a business: low levels of capital deployment, high returns on capital employed, strong cash flows and significant intellectual property holdings. Goldfarb Corporation went public in 1988, but because it was a microcap with only three million shares outstanding, the stock attracted little attention and languished in the bear market of 1990-1991. In mid-1992, the stock was selling at only about $2 per share, less than the earnings of $2.16 that it reported just two years later in 1994! It was truly one of the very best value buys in the market at that time. Before the end of 1993, the stock had appreciated by 1,000%.

Goldfarb Corporation always had one peculiarity – Martin Goldfarb's remuneration. While his $1.2 million annual paycheque was perhaps not unusual in a private research firm, it was rather anomalous in the world of small public companies. And it was all salary, no bonus. Mr. Goldfarb, whose talents as a market researcher were undoubted, also fancied himself a corporate financier. He had an "override" provision written into his corporate compensation policies to the effect that he personally would collect up to 7.5% of pretax, pre-bonus profits of the company. Note that it was not just operating profits, which would have at least aligned his interests to some degree with those of his shareholders. There was a definite incentive, under this type of structure, to engage in deals to increase the pretax income of the company from non-operating sources. Note also that no mention is made of pretax losses. And since Goldfarb is structured with the ever-popular dual class share structure, and Mr. Goldfarb and his family own the multi-voting shares, he had a free hand to compensate himself as he saw fit.

Mr. Goldfarb's major effort in the field of corporate finance was to take a position in then-private Speedy Muffler King, the franchise auto repair chain. Unfortunately, after an early success with the initial public offering, Mr. Goldfarb held onto his position too long and was stuck with a deteriorating situation. His response was to average down. His method, unfortunately for Goldfarb Corporation shareholders, was to pay for Speedy shares with Goldfarb shares.

After a series of share exchanges, Mr. Goldfarb had succeeded in taking a company that had three million shares outstanding and 1.2 shares of Speedy per Goldfarb share, and turning it into a company with six million shares outstanding, with 1.1 shares of Speedy per Goldfarb share. The practical effect was to dilute by 50% the Goldfarb shareholder's ownership of the market research business, which was the main reason to own this stock. So when Speedy expanded too rapidly and blew up, Goldfarb Corporation's fortunes were tied closely to a deteriorating holding and Goldfarb blew up as well. The stock performed very poorly indeed, declining to only $6.40 in mid-1998 from a high of $22 in 1994. The stock market averages rose by over 60% in the same period, and good businesses like the market research business would have done substantially better than that. So Mr. Goldfarb's corporate finance activities in this later period cost his shareholders at least $15 per share, and at least $25 million in market capitalization. His 7.5% share of the value destroyed was between $1.8 million and $3.2 million, at a conservative reckoning. In 1997, Goldfarb Corporation reported a pretax loss of over $80 million, due to huge write-offs of assets. Mr. Goldfarb's 7.5% share of the loss exceeded $6 million, but no payment to the company was forthcoming.

When he sold his market research business in 1998, Mr. Goldfarb awarded himself 7.5% of the value he had "created" through the deal, or about $2.2 million. There was no consideration of the substantial losses suffered by shareholders on the previous deals. So Mr. Goldfarb was apparently responsible for the good things that happened to his company, but not for the bad. If only we could identify the culprits for those bad decisions!

Goldfarb Corporation's story illustrates several vital lessons for investors. These lessons are: (i) the importance of equal treatment of shareholders; (ii) the importance of compensation systems as reflective of the core values of a corporation; and (iii) the importance of focus and good capital allocation by top management.

The structure of a company often tells potential investors a great deal about the way they will be regarded by management. The use of limited voting shares is a signal that the company welcomes your money, but not your opinions. Often, it is a sign that the management really wants to run the business like a private company. The goal of public company management is to maximize wealth for all shareholders by making prudent, high-return capital allocation decisions in order to grow the business and its stock price. Private companies, of course, can be managed with a wide variety of goals. In the case of Goldfarb, the existence of restricted voting shares and the override where the CEO took a potentially large piece of the upside for himself indicated that the company was not being managed in the interests of all shareholders.

We pointed out that Goldfarb Corporation's compensation arrangements were peculiar. What do they tell us about the core values of the company? The obvious conclusion to be drawn about Goldfarb Corporation is that it is a one-man band, and that its primary goal is the enrichment of Martin Goldfarb. In his latest proxy circular, Mr. Goldfarb maintained his 7.5% override, but cut his salary to a mere $120,000. Any thought we may have had that matters were improving was dispelled by the grant of 105,000 share options by Mr. Goldfarb to himself at very attractive prices. Options were hitherto one type of compensation concerning which Mr. Goldfarb had shown some restraint, awarding himself one grant of 75,000 options in 1996. Also keeping the wolf from the Goldfarbian door are the director's and management fees of about $180,000 that he collects annually from Speedy Muffler King, and the $1 million salary he continues to collect from the consultancy business until 2001. It is interesting that when he sold that business, he arranged for a continuing personal subsidy from the consultancy business rather than increasing the selling price, which would have benefited all shareholders. And in the latest quarter, he awarded himself another multi-million dollar payday at shareholders' expense. In this case, he rewarded himself for selling assets that were substantially written down in 1997.

Managements with unfettered control over their own compensation packages are like Oscar Wilde: they can resist anything but temptation. Mr. Goldfarb set up an irresistible temptation for himself when he put that override in his corporate articles, to ignore value subtracted and reward himself for value "created." And, of course, Mr. Goldfarb's predisposition to resist temptation may be open to question.

Capital allocation, as usual, is the most important issue for investors. Goldfarb Consultants was a terrific business, one of the best we have seen. It was the major reason we bought the stock. Had Mr. Goldfarb stuck to his knitting, and put his very considerable talents to work growing that particular business, he might very well be a wealthier man than he is today, and the tone and content of this issue of *The View* might be very different. As it was, even with Mr. Goldfarb distracted by his adventures in corporate finance, the business showed an ability to grow at double-digit rates in both revenues and earnings over a very long period of time. But Mr. Goldfarb succumbed to the temptation of doing deals.

Why is deal-making such a huge attraction for so many corporate managements? It is because the system rewards it. An acquisition is a good way to get your name in the paper, and to make you feel like you are at the centre of the action. The potential for more deals and more equity and bond issues means that investment bankers and analysts will treat you like royalty. So more money managers will become aware of your "story" and your float and market capitalization will increase, though not necessarily your share price. It is so much more psycho-socially rewarding than tending to your core business, making little tuck-under acquisitions and quietly maximizing profits.

We do not condemn an acquisition strategy root and branch. A lot of good companies have been built through acquisition strategies. If the businesses are complementary, clearly understood by management and bought at good prices, then the strategy can work very well. We simply believe that a company that has a good basic business should stick with it through thick and thin, and resist the temptation to make a big splash in unrelated businesses.

In Goldfarb Corporation's case, Mr. Goldfarb got lucky with his initial Speedy investment, and made a lot of money in the short term. The stock market tends to do this to people – it rewards you richly for doing something you shouldn't, and sets you up for a fall. The vast majority of Goldfarb Corporation's score on Speedy was later given back through a very ill-advised "averaging-down" strategy, which badly diluted Goldfarb Corporation shareholders.

Which brings us to another capital allocation issue – the use of common stock as currency. This tendency has reached its reductio ad absurdum in the technology area, where valuations are meaningless and gigantic nominal dollar value paper trades are commonplace. This is all rather harmless as long as people don't get the impression that they are engaging in real transactions. In the case of Goldfarb, however, real harm was done to the holders of Goldfarb Corporation shares by the use of its equity as currency. These shares were fractions of the market research business, and they were traded on a disadvantageous basis for shares in Speedy Muffler King, a much poorer business. Buffett calls this process "watering the weeds and digging up the flowers." A really superior management treats its common shares as the most expensive form of financing, not the cheapest, and issues its shares sparingly.

So our two-minute monologue on Goldfarb ignored one vital factor – the reliability of management and the extent to which their interests were aligned with ours. While we haven't lost money on this stock, the opportunity cost of holding it instead of almost any other company in our portfolio has been large. In compensation ideas, business strategy and treatment of minority shareholders, Mr. Goldfarb's actions have been the opposite of everything we stand for. As part owners of his company, we believe that he should mend his ways.

Future Shop

Future Shop is a well-known Canadian retailer with a dominant market share in the computer and home electronics business. It has grown from modest origins in the Lower Mainland of British Columbia to a familiar presence in malls and main streets across Canada.

This company competes in a brutal business. The prices of the goods in inventory fall precipitously on an ongoing basis. Obsolescence is rapid and inevitable, and renders unsold goods almost valueless. Little wonder, then, that most of Future Shop's Canadian competitors of several years ago have either gone bankrupt (like Majestic Electronics and Adventure Electronics) or abandoned the segment (like the department stores). No competitor comes remotely close to Future Shop's dominance of its segment.

What accounts for Future Shop's success in Canada? Well, it is a pretty good merchandiser. And it has structured its supplier arrangements so that the obsolescence risk is controlled. But the biggest source of profits for the company has always been the extended warranties sold with its products. Anyone who purchases an appliance or computer at Future Shop is subjected to a very hard sell on the virtues of an extended warranty by the salesperson. A high percentage of shoppers buy one, since these are very complex products that most buyers do not understand. But in practice, the claims against these warranties are low. So Future Shop is a little like a property and casualty insurance company with a very low claims ratio. And that is a very good business to be in.

The story of Future Shop differs from that of Goldfarb in almost every way. Future Shop never lost its business focus; it never indulged in excessive compensation practices; the majority owner suffered right along with the rest of us over the past three years in terms of his stock's underperformance (although in his case the pain was self-inflicted); and the company only issued shares when it had to. Yet the result has been the same: essentially the stock has done nothing for three years during a great bull market. And it can clearly be demonstrated that one specific initiative cost shareholders of Future Shop millions of dollars over that time period. The problem is a familiar one to investors in Canadian retail stocks: Future Shop decided to expand into the U.S.

It is commonly observed that Canadian retailers have a tendency to destroy shareholder wealth when they venture into the U.S. The list of casualties is familiar: Dylex, Canadian Tire, Imasco, Northwest Company. The only exception we can think of is Suzy Shier, whose big score on Wet Seal is perhaps the best-kept secret in Canada. All the others wasted huge amounts of shareholders' capital. All entered the U.S. market assuming that the previous adventurers simply didn't know what they were doing. All were correct, but failed to draw the obvious inference.

We once heard an American retailing executive give the following definition of retailing strategy in the U.S.: "First, you think of the very most irresponsible, destabilizing and damaging thing your competitors could do to you; then, you do it to them first." Into this environment, red in tooth and claw, the kinder, gentler Canadians entered like Daniel into the lion's den – but without divine protection.

Future Shop's decision to enter the U.S. illustrates one of Buffett's major points about business. The company left its "circle of competence" when it left Canada. It left behind its competitive advantages as well. The U.S. market is served by several large national electronics retailers, such as Best Buy, Circuit City and Good Guys. These are immense companies, with corresponding economies of scale. There are also several large regional players. Gross margins are lower in this business in the U.S. than in Canada, and advertising costs higher, so economies of scale are even more important there than in Canada.

Future Shop initially expanded into the Pacific Northwest, where competition was not yet as fierce as in most parts of the U.S. Shareholders were warned that there would be several years of start-up losses as the company built a critical mass. They weren't kidding. The U.S. operations cost Future Shop about $30 million in earnings in each of fiscal 1997 and 1998 (year ending March 31). That amounts to a startling $2.50 per share of annual earnings. With the U.S. operations consolidated, Future Shop reported marginal profits in those years, and the stock price stagnated around $11, where it has been since 1996. As a stand-alone company, Future Shop's Canadian operations would have easily supported a stock price in the $25-30 range. So in terms that we care about, namely market performance, Future Shop's foray into the U.S. was a $200 million error.

By the time Future Shop management decided to cut their losses in early 1999, the write-off of the U.S. operations essentially wiped out the book value of the company, and they were forced to issue $42 million in new common stock to recapitalize it. Insult was thus added to injury. All of a sudden, the U.S. was no longer necessary for the long-term growth of the company. Apparently, Canada now offered growth aplenty.

Predictably, Future Shop management insist that they are sadder, wiser and better merchandisers than they were before the U.S. adventure. We wish they had gone to school at their own and not their shareholders' expense. A good school might have taught them George Santayana's wise saying about those who fail to learn the lessons of history are condemned to repeat them.

In Conclusion

We wish to deal with one obvious question: Why are you still holding these stocks? In both cases, the answer is value. Goldfarb, after selling its market research business and most of Speedy Muffler King, is an unindebted company with a lot of cash and a net asset value of probably $18, trading at $11. Future Shop has demonstrated earning power of over $2 per share, and is trading at only $11. And should Circuit City ever decide to expand into Canada, they could buy the dominant market position in the whole country by buying Future Shop. So call us cockeyed optimists, but there seem to be reasons for patience. Future Shop management saw reason; so might Martin Goldfarb.

Some people work according to the old Wall Street Rule: If you don't like it, sell the stock. That is always an option, of course, but we prefer to view it as a last resort. A few years of gentle reminders can be quite effective in reminding people of their duties. Canada does not have so many good investment opportunities, after all.

Warren Buffett says that there are no called strikes in investing. You can stand at the plate forever if you wish, waiting for your pitch. We didn't do that with these investments. Clearly, there was reason not to invest in either of these situations. Future Shop management told us that they were committed to growth in the U.S., and that it would be costly. Martin Goldfarb's compensation arrangements are disclosed in his annual shareholders' circular. We ignored the warning signs, and were stuck with dud investments as a result. No one made us buy these stocks. At the risk of mixing our sports metaphors, these were unforced errors.

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