# The (Canadian) capital allocators

A special report by the Portfolio Advisory Group – Equities

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All values in Canadian dollars and priced as of December 31, 2017, market close, unless otherwise noted.

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*It is impossible to produce superior performance unless you do something different.*

– John Templeton

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In his New York Times Best Seller *The Outsiders*, William Thorndike profiles eight company leaders and their successful approaches to leading their organizations. One of the more compelling profiles was of former Teledyne CEO, Henry Singleton. While at the helm of Teledyne, Singleton aggressively repurchased over 90% of the company's shares. He did this at a time long before the practice of repurchasing stock had become all the rage on Wall Street, all the while generating a compounded annual return of 42% over a 12-year period.

What made the Singleton story even more compelling was the fact that he was calculating in his approach to utilizing share buybacks, using them at periods of time when he believed that the highest returns would be generated by returning capital to investors. Naturally, one can't help but wonder if there are companies today that are pursuing similar strategies?

We tackle this question by focusing on Canadian companies and addressing whether any such strategies of aggressively repurchasing shares have led to positive results for shareholders.

## Capital allocation & the share repurchase

As stewards of investor capital, every corporate management team and board face tradeoffs. The balance of reinvesting retained earnings back into the business, pursuing value-accretive acquisitions, and returning capital to investors in the form of dividends and buybacks are among them. Issuing debt or equity to buy an asset in the hope that it will be accretive to the intrinsic value in the future is a strategy that many corporations practice but few management teams have a proven track record of being able to accomplish on a consistent basis.

Price paid, execution challenges, cultural differences across organizations, timing issues, and cost synergies proving to be less than initially hoped are a few reasons why the return on invested capital (ROIC) on external asset purchases can fall short of the desired outcome. Moreover, as famed investor Warren Buffett stated in his latest annual letter to his company's shareholders: "Once a CEO hungers for a deal, he or she will never lack for forecasts that justify the purchase. Subordinates will be cheering, envisioning enlarged domains and the compensation levels that typically increase with corporate size. Investment bankers, smelling huge fees, will be applauding as well. (Don't ask the barber whether you need a haircut.)"

In a share repurchase transaction, management is using internally generated free cash flow (most of the time) to purchase an additional stake in an asset that they have perfect information about. The risks are considerably lower than an alternative like purchasing an asset held by a separate organization, or buying a company outright.

## The return of shareholder capital leaders

| Time period 2010–2017 | % change in shares outstanding | Dividend growth | | Return data | |
|---|---|---|---|---|---|
| | | Absolute | Annualized | Absolute | Annualized |
| Celestica Inc | -34% | NA | NA | 32.3% | 3.6% |
| Metro Inc | -28% | 194% | 14.4% | 208.0% | 15.1% |
| Great Canadian Gaming Corp | -27% | NA | NA | 325.0% | 19.8% |
| Magna International Inc | -26% | 424% | 23.0% | 435.2% | 23.3% |
| Dollarama Inc | -21% | 196% | 14.5% | 1304.7% | 39.1% |
| WestJet Airlines Ltd | -20% | 1020% | 35.3% | 112.8% | 9.9% |
| Canadian National Railway Co | -19% | 206% | 15.0% | 261.5% | 17.4% |
| Canadian Tire Corp Ltd | -18% | 298% | 18.8% | 185.0% | 14.0% |
| Thomson Reuters Corp | -15% | 19% | 2.2% | 61.4% | 6.2% |
| Canadian Pacific Railway Ltd | -14% | 107% | 9.5% | 304.4% | 19.1% |
| Onex Corp | -14% | 167% | 13.1% | 290.6% | 18.6% |
| Genworth MI Canada Inc | -13% | 95% | 8.7% | 60.5% | 6.1% |
| Canfor Corp | -10% | NA | NA | 204.8% | 14.9% |
| Gildan Activewear Inc | -10% | 149% | 12.1% | 212.5% | 15.3% |
| Methanex Corp | -10% | 90% | 8.3% | 271.0% | 17.8% |
| Average | -18.5% | 247.0% | 14.6% | 284.7% | 16.0% |
| S&P/TSX Composite | | 36.0% | 3.9% | 38.0% | 4.1% |

Source - Bloomberg

So why do so many pursue these external growth strategies? The answer likely lies in the fact that returning capital back to investors can be regarded simply as an uninteresting strategy. Rarely will that practice land one on the front page of *The Wall Street Journal* or *The Globe and Mail*. Further, few CEOs may choose for their legacy to be known as the person who grew the dividend or bought back a meaningful amount of company stock.

### The Canadian return of capital leaders

The table above presents a screen of the constituents of the Canadian equity market that saw the biggest reduction in shares outstanding over 2010–17. Companies that reduced their share count by less than 10% were eliminated. Additionally, dividend growth and stock performance of these "buyback" constituents were evaluated over the same time period. Some key observations that we gleaned:

- There is no guarantee that an aggressive share repurchasing strategy alone can lead to outsized shareholder returns for a stock.
- The companies that bought back the most stock over the past seven years generated an average annualized return of 16% vs. 4.1% for the broader Canadian market (see table).
- The buyback group generated an average of 247% cumulative dividend growth, or 14.6% annualized vs. 3.9% for the broader Canadian market.
- A portfolio of buyback constituents may be a more prudent strategy rather than trying to find the "one" that could outperform.

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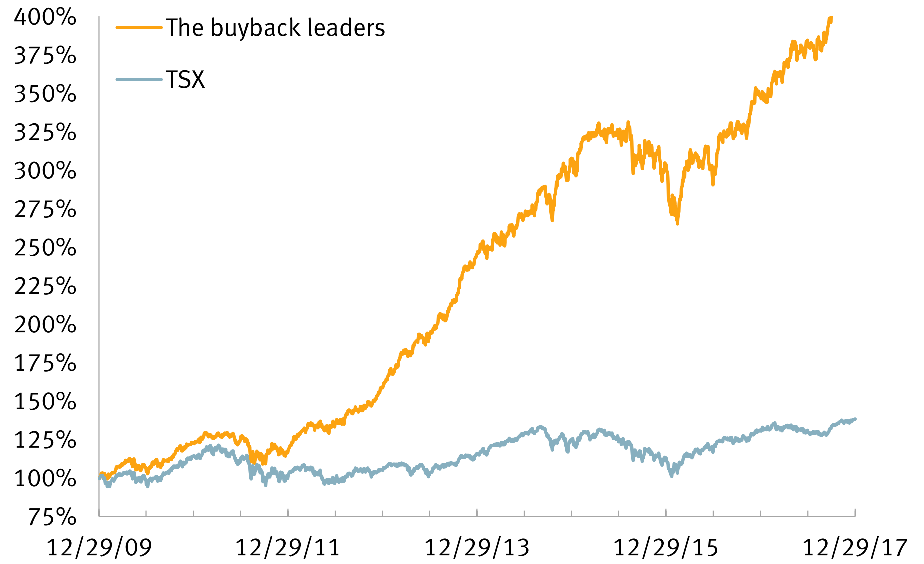
Performance of the buyback leaders versus the TSX




Source - Bloomberg

Long-term value is created by management teams that pursue shareholder-friendly initiatives.

Note that while the Canadian equity market over this period of time was particularly poor, the table on the previous page illustrates that even in difficult periods it is possible to identify good quality businesses focused on maximizing shareholder returns.

More importantly, in our view, this exercise reminds us of the long-term value created by management teams that pursue shareholder-friendly initiatives, and we would continue to view attributes like this—among several others—as a key tenet of portfolio strategy.

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