CIBC PRIVATE WEALTH MANAGEMENT

CIBC WOOD GUNDY
BALLARD MUDGE FINANCIAL GROUP

David Mudge, MBA CIM, Portfolio Manager
514 846-2632 | David.Mudge@cibc.ca

BUYBACKS VS THE DIVIDEND FETISH

This summer CIBC has welcomed 450 interns as part of our 2021 summer intern program. Our group has been working with Patrick Bisson, a McGill University Economics major, on some client facing material and most recently our latest blog post. He wanted to focus his first blog post as a spotlight on BRP Inc. a holding in our Canadian Focused Equity Portfolio. In preparation for the piece we had a good discussion on share buybacks and why they are undervalued by Canadian retail investors. I thought I would expand on that conversation here.

Canadian investors have a dividend fetish and it is a problem.

I have known investors who seemingly only cared about the dividend yield a company provides and little else. Why? It is easy to understand the logic. If I hold XYZ company and it pays out a 7% dividend then that is better than ABC company that only pays out 3%. It is also easy reasoning that if you need to earn 7% to meet your retirement goals finding companies with a 7% payout is as simple as screening for dividend yield.

Unfortunately, investing is not that easy.

Regardless of the advice provided, some of the same investors got burned with the collapse of the high yielding income fund/dividend companies in the energy space. These companies had a broken business model that seemingly looked like this: Come to the markets to raise equity capital, drill to extract energy, sell off the oil/gas, pay out dividends or distributions and repeat the cycle. Investors were wagering retirement savings on the stability of commodity prices and these companies' future ability to raise capital.

This seemed insane to me yet investors were drawn in by the yields. Investors should focus on the quality and profitability of the business and not focus solely on the yield.

If a company is profitable, at the end of the year they will have excess cash left over beyond what they need to reinvest in the business. I have written about the company's choices on how to spend their money before here. Canadian retail investors prefer dividends but share buybacks can be an attractive alternative.

Very simply, buybacks are the company repurchasing their own shares from investors. A firm may deem that their shares are undervalued and buy the shares in the markets. The shares are then cancelled by the company and the remaining shareholder's percent ownership of any future profits goes up. For example, A firm with 1,000 shares outstanding earns $10,000 or $10 per share in profit. They then elect to buy back 4% of the company's shares. If the firm earns $10,000 in profits the following year their earnings per share increases to $10.42 since there are 40 fewer shares outstanding.

Buybacks have many benefits over dividends that seem vastly under appreciated.

1. Capital gains are taxed more favourably than dividends- Corporations buying back shares increase their earnings per share and tend to create capital gains vs dividends. Capital gains tax is much lower than the taxation on dividends. If you want a quarterly payment from a company you can simply sell off a small portion of the gains and save taxes while doing it!

2. Buybacks can be done more opportunistically than dividends. Once a dividend is started dividend investors expect the same (or higher) quarterly dividends to be paid like clockwork regardless of the operating conditions. Is business bad? Pay the dividend. Oh you had a fire? Pay the dividend. Got hit by lighting? Pay the dividend.

   Buybacks can be done with greater flexibility than dividends. If the business has excess cash or the share price is weak for any reason management can elect to increase the buyback and take advantage of the low prices without being locked into a contract with the dividend mafia.

3. Buybacks today will increase earnings tomorrow and every tomorrow to come. Once the shares are repurchased the future earnings per share in all future periods is increased.

Why is it when companies choose to buy back their own shares Canadian retail investors hardly notice?

For a good example of the power of buybacks we could take a look at BRP Inc. The company has a paltry yield of 0.4% and typical dividend focused investors may turn up their noses at such a low yield. BRP Inc. has instead chosen to primarily return money to shareholders in a different manner. The company buys back some shares every year and when management feels that the conditions are right they opt for a larger buyback.

BRP Inc	1/31/2021	1/31/2020	1/31/2019	1/31/2018	1/31/2017	1/31/2016
$ for Repurchases of Shares (Millions)	$ 172.1	$ 447.5	$ 248.6	$ 454.7	$ 72.9	$ 95.9
Sustantial Issuer Bid (Shares Purchased)		6,342,494		8,599,508		
Normal Course Bid (Shares Purchased)	2,476,300	2,955,555	4,383,370	2,320,900	3,396,074	3,703,442
Shares Repurchased	2,476,300	9,298,049	4,383,370	10,920,408	3,396,074	3,703,442
$/Share Repurchased	$ 69.50	$ 48.13	$ 56.71	$ 41.64	$ 21.47	$ 25.89
Current Share Price (June 7th, 2021)	$ 92.54					
Annualized Gain	33.15%	38.66%	17.73%	22.10%	33.94%	23.65%

If we take a look at the share buybacks over the last 6 years and do some rough math[1] regarding how they have done on their purchases we see that BRP Inc has managed to return at least 17.7% annually on any of their purchases. Further when they have chosen to deploy larger amounts ($447.5M in Fiscal Year End 1/31/2020 and $454.7M in Fiscal Year ending 1/31/2018) they have managed to return 38.66% and 22.10% annually. This tactic works particularly well for cyclical businesses like selling very expensive toys. Management has the ability to take the profits from the tops of cycles and buy back shares when their end markets retreat. Not a bad trick.

How much have you earned annually reinvesting your dividends?

I bet it is less. It almost has to be. If you are like most investors the dividends will sit as cash for a while until there is enough there to make a reasonably sized purchase. Even without the delay can you consistently earn 20% returns?

We are long term investors but we can't help but notice the volatility around quarterly earnings releases. BRP Inc. recently announced their quarterly numbers. Sales up 47% vs 2020, adjusted EBITDA up 3x vs 2020 a further $278.2M spent to buyback another 2.8M shares. All in all a great quarter pushed ahead by homebound consumers barred from travel with extra cash to spend. These results far exceeded expectations of analysts yet COVID 19 issues may also hurt future sales as the business deals with supply chain issues. Since the earnings release the shares have slid +/- 10%. I am comforted with the knowledge that management replenished inventories and has a fresh $165M of cash generated in Q1 for management to go shopping if the share weakness continues.

Investing for consistent high returns is difficult and it makes me feel better when I know that the management team is also trying to invest the corporation's excess capital the best way possible and not simply stuffing it in an envelope each quarter to send it back to me.

Buybacks can be a sign that management believes that their shares are currently undervalued.

I think it is fair to say that "Mr Market" didn't like Alimentation Couche Tard's failed attempted merger of the French grocery giant Carrefour. Rumours of the acquisitions talks leaked January 12th, 2021 and the shares slumped from the year end $44 per share range to a low of $36.09 a 18% decline. Not well received indeed! Not to let a good failure go to waste, management appears to have increased the pace of buybacks. The company had announced a new year long

[1] **There are some massive assumptions and simplifications in the calculations here. Please email me if you have questions.**

normal course issuer bid November 27th, 2020 to buy 33 million shares. The company has finished the bid and bought all 33 million shares by April 21, 2021 **seven months early!** The company also announced another bid to purchase a further 32 million shares.

For another example you could look at Real Matters Inc., the real estate services firm that is changing the way that mortgage providers source their property appraisals. On June 11th 2020, the company announced a round of buybacks with the announcement of a normal course issuer bid in a press release. In the **11 months** from last June until May 12th, 2021 the company bought back 2,770,734 shares at an average cost of $18.54. In the **month** since until June 8, 2021, the company has bought back an additional 1,825,300 shares at an average cost of $16.40, renewed and expanded their repurchase program. This may be a good sign that management feels that their shares are cheap.

The drop in interest rates to historic lows have left income investors scrambling to find some kind of yield. Investors simply cannot earn what they used to in the fixed income and have shifted some of their holdings into dividend paying stocks. Low/no growth dividend paying companies are now commanding multiples once reserved for high flying tech companies. It's true that investors have to do more digging to follow buybacks vs dividends but I believe that the extra work is worth the effort

As always, Please let me know what you think.

Sincerely,

CIBC Wood Gundy

David Mudge, MBA, CIM

Portfolio Manager

Ballard Mudge Financial Group

BRP Inc. 12, 2g

Alimentation Couche Tard Inc. 12, 2g

12 The equity securities of this company are subordinate voting shares.

2g CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.