PRIVATE WEALTH
MANAGEMENT

CIBC WOOD GUNDY
BALLARD MUDGE FINANCIAL GROUP

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

ROI is King!

How much return am I getting based on how much I invest? Seems simple right?

All other things being equal[1] this is what investment decisions should be based on.

Too often this basic idea seems to get lost in business. It is easy for the management of large corporations to no longer think like an owner and make decisions based on other goals. Targets like increasing market share, increasing revenue growth, becoming a larger company or even hitting personal bonus compensation targets may take priority.

At what cost to the owners of the business are these goals pursued?

Return on Equity (ROE) as a tool

Investors should be looking to find businesses that have some sort of durable competitive advantage allowing the company to earn a higher than average returns on investment (ROI) or more specifically the returns on the investor's equity. Studying the Return on Equity (ROE) over time can be one of your tools in finding these companies.

Too much competition, a commodity product, no perceived brand value or easy substitution of products are all things that will decrease a company's pricing power and therefore decrease the profits and the subsequent return. Companies with these traits will struggle to achieve a meaningfully high ROE over the long term.

Screening for conservatively financed companies with a high ROE can help identify high performing companies.

Armed with a list of potential high return companies, the work begins.

We have to determine what is the source of the company's advantage? Is it due to some first-mover advantage like developing a new technology or is the advantage sustainable over time? Can their advantage be expanded to other products or is it limited to one very small niche? How large of a business can be built within the protection of the competitive advantage?

These are all difficult questions.

The good news is that companies with a high return on investment end up having a lot of excess capital. Watching the impact of how management utilizes this capital can give you clues to predicting the future returns of the business.

With excess capital, corporations really have just six options regarding what to do with the money:

1. They can reinvest in the business
2. Buy another business
3. Pay down debt
4. Pay a dividend
5. Buy back their shares
6. Accumulate cash

Let's look at these options one at a time.

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[1] This actually assumes a lot. ESG concerns, size & scale of the investment, risk, funding availability and cost of funds etc.

1. Reinvesting in the Business

By far, our favourite option is to have companies with a high return on investment reinvest back within that same high return business line.

Our stated goal of the Canadian Focused Equity portfolio is to invest capital and earn 15% annually. If a portfolio company can earn 25% on its internal investments, why would we want them do to anything other than reinvest back into the business.

Go for it! Keep all the money and plow it back into the business.

If management chooses to reinvest profits back into the business, obviously the capital invested in the business increases. The ROE earned the following year will remain the same if management can earn the same returns on this additional capital. ROE will fall if the projects are substandard or it will rise if they can somehow increase their returns.

2. Buying another Business

This options is pursued by many businesses with high ROE characteristics or not with mixed results. Investing outside of your core business often dilutes the high return on investment.

Management can set too low of a hurdle rate for potential acquisitions, not fully understand all the risks involved in the target business or they may fall into many other potential pitfalls.

Few companies have continually acquired successfully with the exception of a few businesses where this is a core ability. Constellation Software and Boyd Group Services Inc. come to mind as companies who have built an acquisition model as a core competency of their business.

If done well (and that is a big if!) these transactions will allow the companies to continue earning a high ROE on an increasing base of invested capital.

3. Pay down debt

Remember that we were interested in finding <u>conservatively financed</u> businesses that have a high ROE. If the business is conservatively financed, investors shouldn't be too excited to see a company paying down their existing debt.

This effectively increases the shareholders' investment in the business increasing the difficulty of earning the same high returns on investment in the future. Investors should be even less keen to see conservatively financed companies paying down debt when the cost of debt is at historic lows.

4. Pay a dividend

We get a lot of questions about dividends from our retail investors. Some investors seem to be blind to any other characteristic of a company outside of dividend yield. A company can be a capital destroying business with a current high yield and people will want to own it. This clearly does not make sense.

Unfortunately, the truth is that there are limits to the size businesses can be and remain within their competitive advantage. After that limit is hit we would prefer to have our capital returned through dividends or share buy backs. We are in favour of dividends when the business does not have enough opportunities to earn a sufficiently high return on the invested capital and the shares are trading above their intrinsic value.

5. Buy back their own Shares

For some retail investors share buybacks are a very misunderstood idea. Investors argue that buybacks are not a good use of capital or that the profits aren't "real profits" but rather caused by management's accounting gimmicks.

If the management team of a high ROE business, who had shown themselves to be capable investors, felt that their shares were trading at a share price below the true intrinsic value of the business then we are happy for them to buy back their own shares.

This will decrease the outstanding shares and increase the earnings per share for all remaining shareholders. If an investor truly needed income from the portfolio, they could simply sell a portion of their investment each year and the capital gains incurred would be taxed more favourably.

Share buybacks at inflated prices are just as bad a decision as an outside investor overpaying for shares. We try to avoid this situation.

6. Accumulate Cash

Companies accumulating cash simply defer their capital allocation decision to a later time. An increasing cash pile will also begin to erode the return on investment numbers.

Management will eventually need to decide which mix of these options is the best use of investor's capital.

Tying it all together

We attempt to consider all of these decisions that management will make and project out the next five years by asking the following questions.

How much will the company's book value per share grow in five years? How profitable will it be based on this new asset base? How much should future investors be willing to pay for these earnings? [2]

Like anything though, the devil is in the details. The quality of the output is determined by the quality of inputs. Developing detailed discounted cash flow models can give a false sense of security as margins are estimated to a fraction of a percent years out into the future and errors too easily compound. Focusing on the return on equity over time and making fewer, larger estimates can add another powerful tool for investors.

Sincerely,

CIBC Wood Gundy
David Mudge,
Portfolio Manager

To find out more, please check out our website at www.BallardMudgeFinancialGroup.com or contact us directly at David.Mudge@cibc.ca

[2](Current BV/S * (1+BV/S Growth Rate)^5 * Future ROE* Future PE) / (1+ 15% Return- current dividend Yield)^5