WARATAH

# Brad's Musings

*You Get What You Pay For*

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

- Warren Buffett, Letter to Shareholders, 1989

I recently attended the Berkshire Hathaway Annual Shareholders' Meeting for my very first time. I thoroughly enjoyed the experience and I plan to attend for many years to come. Warren Buffett is one of my heroes and I have admired him since I was in grade seven. He and Charles Munger have acquired a treasure trove of investing experience and wisdom and they genuinely love to share this knowledge with other investors. Many commentators have observed how remarkably adaptable Warren Buffett has been with his investing style over the decades. Although Warren Buffett started his career as a value investor modeled after his mentor, Benjamin Graham, he has increasingly exhibited a preference for "paying-up" for exceptional business. Appreciating the qualitative aspects of a business is a core part of the investing philosophy of both Philip Fischer and Charles Munger, two of Buffett's other mentors.

One of the realities of being in the investment business is that institutional clients often need to put their managers into a neat little box. The check boxes include: value, growth-at-a-reasonable-price (GARP), momentum and event-driven, among others. If I had to choose a box for myself to fit in, it would be quality. I love looking for, discovering and owning great businesses. I can and do lots of other things required of a portfolio manager and business owner, but the search for quality is where my skills and passion intersect.

So what is a great business? Unfortunately, "great" is such an over-used word that it has lost its powerfulness and meaning in everyday use. Of the many definitions of the word, the most fitting that I found was: markedly superior in character or quality. The characteristics of a great business can be defined and the quality of its assets, products, process and management team can be assessed. This task gets easier with experience – one starts to get an idea of what to look for and what to avoid. Based on my experience, the greatest businesses often look expensive at first glance but with the passage of time they appear to have been bargains at almost any price.

There are two obvious conditions to satisfy if one is to build an investment philosophy around owning great businesses: 1) great businesses must first be identified and; 2) these great businesses must be valued correctly. Getting these two things right is not easy. Most people interpret the latter condition to be synonymous with not overpaying for something. After all, we've all heard the expression, "A great company does not necessarily make a great stock". I have a different perspective. The more common mistake investors make is not being willing to pay for greatness when one sees it. Not buying a great business because you wanted it at 18x P/E instead of 22x P/E is often a more expensive mistake than overpaying for a stock. A truly great business with a competent, honest and passionate manager is so rare that in almost every case the right thing to do is to buy it and hold on to it for as long as those criteria remain true. The following is by no means a complete discussion of the attributes of a great business but it's a good start:

## 1. Equity Value of the Business Has Compounded At Very High Rates Over a Long Time

A fantastic history of value creation is no guarantee that it will continue in the future but it is an excellent indicator. We like to invest with management teams that have produced compounded returns higher than 15% over more than a decade. These managers know the value of compounding and they have built their businesses to take full advantage of it. Executives who we invest alongside that have demonstrated this ability include Michael Rose (Tourmaline Oil Corp. and Duvernay Oil Corp.), Rene Amirault (Secure Energy Services Inc. & CCS Income Trust), Mark Leonard (Constellation Software Inc.), Stephen Sadler (Enghouse Systems), Mark Davis (Chemtrade Logistics Inc.), Michael Cooper (DREAM Unlimited Corp.) and Tor Wilson (Badger Daylighting Inc.). These CEOs are superstars. As a reminder of the power of compounding consider that $1,000 will grow to be worth $27,393 if an 18% compounded average annual return can be achieved over 20 years.

## 2. Organic Growth That Comes With Little or No Capital Spending

Business owners usually have to choose between generating free cash flow or re-investing in the business. If high returning capital investments or acquisitions are available, a rational owner will defer the free cash flow and pursue growth. Businesses with limited or low-return investment options will typically buy back shares or return cash to owners through dividends. Weak management teams will often deploy capital into low or negative returning investments in an attempt to diversify away from a problem or to pursue empire building (these make great shorts). Sometimes, however, there is no trade-off between growth and generating free cash flow. Some businesses experience organic earnings growth without the need for capital spending. C.I. Financial Corp. is a great example of this. CI Financial is one of the largest asset managers in the country with nearly $100 billion under management. It is reasonable to expect equity markets to produce a return of approximately 9% over the very long-term. Therefore, on average, we can expect CI Financial's revenues to grow approximately 9% per year as well. This growth comes with very little need for additional capital or expenses. The best thing about organic growth is that we still have the cash flow available for re-investment or for dividends and buy-backs.

## 3. Irreplaceable Assets

These are "one of a kind" assets that cannot be replicated due to regulatory, environmental or physical constraints. How much would it cost to build another coast-to-coast railroad in Canada capable of carrying the same tonnage as CN or CP do today? How many tens or hundreds of billions would it cost to assemble the land and rights of way to say nothing of the construction costs? If Upper Canada College did not exist, how much would it cost to replicate it today in its current location? How many $10 million dollar homes would one have to buy and bulldoze to assemble the land? This is what irreplaceable means. Of the many benefits that come from owning irreplaceable assets the greatest by far is the ability to raise prices without much competitive response. Some of the businesses in our portfolios that own irreplaceable assets include Simon Property Group (it owns many of the best malls in America), Canadian Apartment REIT and Martin Marietta Materials (gravel pits and quarries).

## 4. Platform Economics

Some of the best businesses have the magical benefit that assets are worth more to them than to anyone else because of how they fit into their existing operations. We call the existing operation a platform. Platforms can take a lot of time and money to assemble but once they have been created they are nearly impossible to replicate. Imagine that your family owned a cable business in some small town in Ontario. You've watched the industry consolidate from hundreds of family owned businesses into a handful of goliaths. Finally, you decide to sell to Rogers Communications. Rogers can buy content, advertising and technology at a large discount to what your small firm can. Most importantly, they can run your entire operation from their existing locations without hiring any additional staff. Some businesses have two completely different income statements: one as a standalone entity and the other with significantly higher margins when owned by a platform company. One of our largest investments, CCL Industries Inc., is building a valuable platform today. Already, CCL is the world's largest manufacturer of pressure sensitive labels for consumer goods and pharmaceutical companies. Its largest customers include Procter & Gamble and Johnson & Johnson Inc. CCL's customers are expanding globally and want CCL to follow them by opening or buying plants wherever they go. This often gives CCL an advantage when pursuing tuck-in acquisitions or when constructing plants as the management team knows they can count on volume from existing customers.

## 5. Recurring Revenues

Recurring revenues are incredibly valuable and this is often under-appreciated by investors. Imagine you have the choice of owning a construction company or a fund administration company. You may be wondering what a fund administration company is. A fund administration company calculates net asset values for clients who are invested with asset managers. The industry has grown enormously over the last decade as investors recognized the need for an independent company to maintain the account records and calculate asset values as opposed to leaving it up to the actual manager (Bernie Madoff did not use a fund administrator). As a client of Waratah, you will notice that your statements are prepared and your net asset values are calculated by CommonWealth Fund Services or Harmonic Fund Services – independent fund administration companies. Now let's get back to the construction company. In the construction industry your entire sales effort is directed towards landing one-time contracts. Once the highway is widened or the school is built it is a race against time for you to find the next project before you have to lay off your staff. All of your competitors are in the same position, which inevitably leads to irrational pricing where your competitors bid on jobs just to keep the lights on and to cover their fixed costs. All your creativity, all your passion, all your hard work is directed at replacing the work you already have. The same is true for many manufacturing businesses. Now contrast this with the fund administration business where revenues are received every month for as long as the fund remains a client. On January 1st of each year you would know with a high degree of certainty what your revenues and earnings will be for the upcoming year. Customer retention is typically high as long as good service levels are maintained. Switching costs are high and asset managers would rather be focused on investing than undertaking a project to switch to another fund administration company. Finally, the fund administration business is based on relationships and requires a sophisticated knowledge of tax and accounting. In contrast to the construction business, the sales team at the fund administration company is always focused on finding the next new customer. The hard work and enthusiasm of the owners and sales staff is continuously growing the recurring revenue base and increasing the value of the business. We have recently invested in the largest non-bank owned fund administrator in the world, SS&C Technologies. In addition to a recurring revenue base, it also generates high free cash flow as the assets of this business are its people rather than hard physical plant and equipment. The company has also been acquiring other independent fund administrators and integrating them into its platform.

## 6. Minimal Capital Required + High Margins = High Return On Equity

There is a very strong relationship between the margins that businesses earn and the amount of capital required to produce the good or service being offered. Investors require a return on their capital in addition to a return of their capital when they decide to make large capital expenditures. Large expensive assets like ships, pipelines, office towers and toll roads almost always produce high margins. Businesses that don't take much money to get into usually have low margins. Examples of low margin businesses include distribution, low value-added manufacturing and assembly, call centres and many other service businesses. The best businesses are the anomalies that produce incredibly high margins despite requiring almost no capital. This is made possible when significant barriers to entry (other than capital) are present. Law firms, software companies and asset managers have high margins while requiring very little capital due to the specialized nature of their services. Businesses that have attained a network effect, such as Mastercard and Google, are able to earn high margins because their scale and reach has made them essential services.

## 7. Beyond Great There Is Beauty

There is something even beyond great. Occasionally, you may be lucky enough to have the opportunity to invest in a beautiful business. Beauty is hard to define and truly rare. These businesses are so amazing that it is almost impossible to overpay for them provided you have a long-enough investment horizon. What multiple of cash flow would have been too high if you had the opportunity to purchase the Yorkdale Mall sometime in the 1960s or 1970s? Would 100x cash flow (that's a 1% cap rate) have been too high? I doubt it. What would you pay for the 407 Highway if it were to come public? These two examples are the "Mona Lisas" of beautiful businesses. The only problem is that everybody knows they're beautiful and that's why they aren't for sale very often, if ever. We search for undiscovered or underappreciated beauty. Finding it is one of the most rewarding and emotionally thrilling aspects of our profession.

At Waratah, we live on both sides of zero. That is to say, we short stocks too. Great and Beauty have opposites. If you would like to understand how we approach shorting when we are looking for alpha (as opposed to shorting for risk mitigation) take everything you just read and invert it.

Brad Dunkley

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