Wednesday January 21, 2015

Analyzing Capital Allocation Decisions: Empire's Acquisition of Canada Safeway

Sionna often speaks about the importance of prudent capital allocation in the art of investing. Accordingly, we strive to partner with management teams that carefully evaluate their investment alternatives and efficiently allocate capital toward high-return opportunities. Depending on the scenario, these allocation decisions can include acquisitions, dividends, debt repayments, share buybacks, or internal growth opportunities.

When a business that we are invested in announces a decision to allocate capital, we do our due diligence to ensure that we agree with the strategic direction that management has chosen to pursue. Empire Company Limited's acquisition of Canada Safeway provides an example of such analysis.

Empire is a Nova Scotia-based company focused on food retailing and related real estate operations. Empire's food retailing segment is carried out through its wholly-owned subsidiary Sobeys, while its real estate operations primarily consist of a 41.5% interest in Crombie REIT. Crombie REIT owns and operates a portfolio of grocery and drug store anchored shopping centers. Empire is historically known as a holding company with a diverse collection of assets. However, since the internalization of Sobeys in 2007, the company has focused on its core competency of food retailing and related real estate, while shedding non-core assets. We are advocates of management teams who know their core competency and faithfully stick to it.

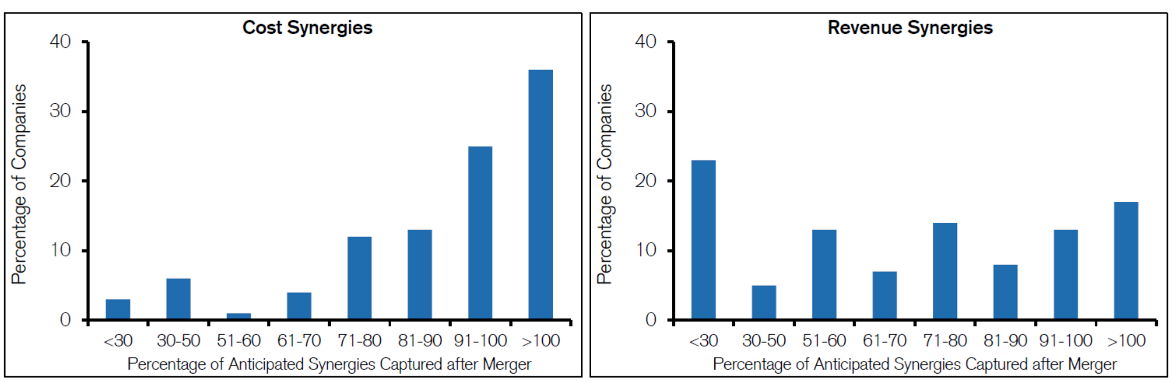
In 2013, Empire acquired Canada Safeway, a Western Canadian based food retailer for a purchase price of C$5.8 billion. Upon hearing the news, we immediately rolled up our sleeves to analyze the deal based on four overarching criteria: strategic rationale, the price paid, synergy potential, and management's track record. Since Sionna is typically skeptical of acquisitions, we used a critical eye to evaluate the deal and its associated risk/reward tradeoff.

The first step in our analysis was to determine whether we believed the acquisition had strong strategic rationale. Prior to the acquisition, we suspected that Empire lacked adequate scale to compete effectively in Western Canada. Economies of scale are an important key to success in the food-retailing industry. Since this acquisition provided Empire with a full national presence, we concluded it was positive from a strategic standpoint. Another benefit of the acquisition was gaining ownership of key real-estate locations in Western Canada. In addition, the acquisition, which focused on food retailing and related real-estate assets, was certainly within management's core competency.

The next step in our evaluation was to determine whether Empire's offering price was fair, or better yet discounted. Admirably, Empire had analyzed and studied the Safeway assets for some time prior to making their offer. Empire pursued the assets at a time when Safeway's U.S. parent was cash-strapped amidst a challenging food retail environment in its domestic market. We appreciate Empire's opportunistic approach. The company's offering price amounted to a multiple of 11.3 times Safeway's adjusted earnings before interest, tax, depreciation, and amortization. We assessed the impact that the deal's anticipated synergies (discussed further below) and Safeway's real estate value would have on the valuation. When these factors are accounted for, the effective multiple decreased to 7.4 times. We therefore concluded that Empire paid a fair price that was also in line with historical comparable transactions. Given the competitive nature of the industry, we would be surprised if such high quality assets would have been available at a discounted valuation.

This brings us to the next step: analyzing the potential for synergies. Synergies are a particularly important part of the analysis, since they are often incorporated into the price an acquirer is willing to pay for a target. In our view, the potential value differential between *revenue synergies* and *cost synergies* is significant. Cost synergies are the savings from redundant or duplicate costs that can be taken out of the consolidated entity. An intuitive example of a cost synergy is consolidating the buyer and target's separate distribution centers into one. Conversely, revenue synergies represent an expected increase in sales due to the combination of two companies. An example of a revenue synergy is a buyer anticipating an increase in sales as a result of offering its own private label brand within the target's stores.

Empirical evidence has shown that cost synergies are far more attainable than revenue synergies. According to a study from McKinsey (shown below), more than half of the companies surveyed were able to achieve at least 90% of their anticipated cost synergies, while only about 30% of executives surveyed were able to achieve the same level of anticipated revenue synergies. At Sionna, we are students of history and pay particular attention to strong pragmatic evidence of this sort. In this case, it confirms our view that cost synergies are superior to revenue synergies when analyzing the merits of any acquisition.



Source: Scott A. Christofferson, Robert S. McNish, and Diane L. Sias, "Where Mergers Go Wrong," McKinsey on Finance, *Winter 2004, 1-6.*

Empire Company is targeting 100% cost synergies with their acquisition of Canada Safeway. As outlined below, management has candidly outlined all of its projected synergies, from both a functional and timing perspective. Empire expects to generate synergies through integrating and modernizing their distribution network, and reducing costs in procurement, administration, marketing, and IT, among other areas.

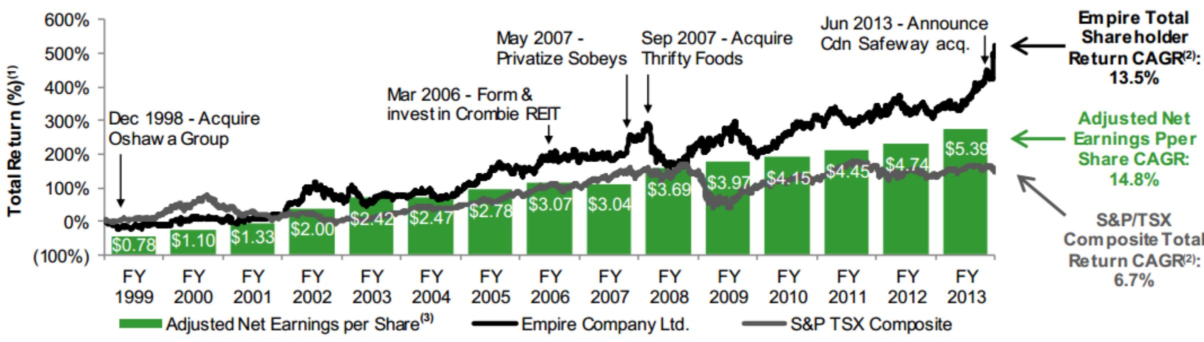
	Function
$100 million run rate at the end of Year 1	Procurement
	Marketing
	Pharmacy
Synergy opportunities Year 2 and Year 3	Logistics & Distribution
	SG&A
	Information Technology
	Total Synergies by Year 3: $200.0 million

Source: Empire Company Presentation, September 16, 2014

Given historical transactions in the consumer staples sector, the savings identified by Empire's management logically align with the types of efficiencies that we would anticipate as a result of sector consolidation. In addition, management's detailed disclosure of its proposed strategy to achieve these efficiencies gives us increased confidence in their ability to do so.

Finally, we evaluated management's historical track record. Safeway is not Empire's first acquisition endeavour. In 1998, Empire acquired The Oshawa Group for C$1.5 billion, and claimed that it had identified C$70 million in synergy opportunities. These synergies were forecast to be achieved over a three-year time period and were to be focused on areas such as combined procurement, reduced overhead, and distribution-network rationalization. Three years later, Empire reported that it had *met and exceeded* the anticipated synergies by the end of fiscal 2001. Although the acquisition certainly came with some logistical challenges, we believe it was a good long-term decision. The Oshawa Group provided Empire with talent, increased scale, and exposure to important regions in Canada which it previously lacked. Since the acquisition, Empire has generated a compound annual total return of 13.5%, which is well in excess of the market's compound annual return of 6.7% over that time period. The chart below outlines the long-term success the business has achieved and highlights key capital allocation decisions along the way. Given management's strong historical track record, we have a high level of confidence regarding its ability to execute on its future plans.

Exhibit 22 - Empire Delivers 13.5% CAGR Shareholder Return Post F1999



Source: (1) Includes dividends paid; (2) Between Jan 4, 1999 and Jun 28, 2013; (3) According to Empire, referred to as Operating EPS prior to F11; Source: Company reports; Bloomberg.

Source: Scotiabank, November 5, 2013

Sionna has been a long-term shareholder of Empire. We have maintained a core position in the company for over a decade, since this is a business that has grown its intrinsic value over time. During this period we have taken advantage of opportunities to add to the position when the stock's discount to intrinsic value was wide, and trimmed it back when that gap has narrowed as a result of strong performance. Our analysis of Empire's announced acquisition of Canada Safeway further increased our confidence in management's ability to allocate capital and execute on their promises, which we believe should result in excess returns for investors as their objectives are realized over time.

The Sionna Team