Sionna Investment Managers®

INSIGHT

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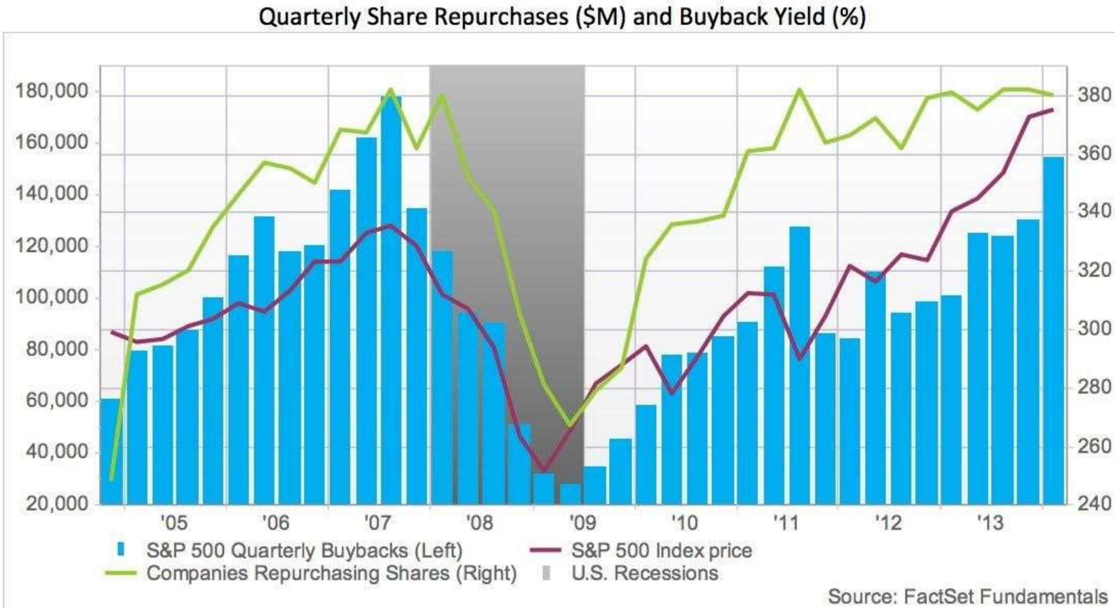
Harnessing the Power of a Misunderstood Tool

With the number of buybacks hitting record-breaking highs, share repurchases have increasingly become a popular topic on the news. Many commentators were arguing that the surge in buyback activity was an impending sign that the market was set for a correction. History, and recent market weakness, tells us that there may be some truth to this belief. Chart 1 below illustrates that share repurchases have typically reached peak levels when market participants were optimistic and stock prices reached new highs – often the exact wrong time to be repurchasing your own shares. Critics of share buybacks use this chart to support the view that buybacks are inherently inferior to other methods for returning capital to shareholders. However, this view uses a broad approach to assess companies' general behaviour; it does not attempt to distinguish whether share repurchasing is being used effectively or not. The key distinction is whether purchases are made above or below the true worth of the shares, otherwise known as the intrinsic value. The challenge for companies is the same one that investors face – often the best time to buy your stock back is when it feels the worst to do so. This is why it is so rare to find companies who effectively wield this powerful tool.

Quarterly Share Repurchases ($M) and Buyback Yield (%)



When you do find one of these outliers that uses the tool of buybacks effectively, they can be tremendous investments. We believe one such example is Great Canadian Gaming Corporation (Great Canadian); a gaming, entertainment and hospitality facility operator in British Columbia, Ontario, Nova Scotia, New Brunswick and Washington State. Great Canadian benefits from sustainable barriers to entry and, as a result, generates attractive returns and free cash flow.

Great Canadian is a good example of the beneficial power of buybacks (when executed in an opportunistic manner) and demonstrates what can happen when there is a shift in thinking around capital allocation. For Great Canadian, the inflection point came in 2011 when the current CEO took over from the entrepreneurial and growth-oriented founder. Now, it is easy to identify the impact of this change after the fact, but how would one have known what to expect before it occurred? We find this often involves meeting with, and listening to, as many management teams as possible and talking to them about their competitors. This is exactly how we identified the opportunity with Great Canadian.

In 2013, we were researching a competitor of Great Canadians' called Gamehost Inc. (Gamehost). While speaking with Gamehost's CFO we asked what they thought about Great Canadian. The CFO stated that the company's management had changed and the new CEO, Rod Baker, was making positive changes to the business. Great Canadian has a somewhat challenged past with an overleveraged balance sheet and some corporate governance issues under the previous management team, but Gamehost CFO's endorsement intrigued us, and led us to read Great Canadian conference call transcripts. What we were looking for was an indication that the new management was more shareholder oriented, which would likely manifest itself in shareholder-friendly actions. It was pretty clear that the new CEO planned to take the company in a different direction, in fact, he stated as much in his Q3 2011 conference call. Two particular quotes stood out and gave us an indication that this might be a disciplined capital allocator.

On the subject of buybacks he stated: *"We are certainly not a company that's going to say like lots of large U.S. companies, 'we're going to go and buy these (shares) back come hell or high water irrespective of the price'. That's absolutely never going to be the case."* He then went on to emphasize the importance of discipline and having a value orientation: *"We want to be the guy that can do some really amazing things for all of you shareholders in a very disciplined way. And you don't know me very well but I'm a value guy and we're a value company now."*

Despite the impressive words, we judge management teams by their actions. We dug deeper to see whether, since taking over, Mr. Baker's actions lived up to his words, and were impressed by what we found. Immediately after taking the CEO role, the company launched a substantial issuer bid in August 2012 and repurchased 10 million shares or 12.6% of outstanding shares at a price of $10. However, we do not view all buybacks as being equal, and larger buybacks are not necessarily better. The attractiveness ultimately depends on whether or not you are buying shares back at a discount to intrinsic value. Repurchasing a piece of a business at a discount to its true worth is a prudent use of capital. Allocating a predetermined amount to buybacks regardless of where the stock price sits compared to its intrinsic value is a misallocation of capital. To assess Great Canadian's track record, we can use the stock's trailing free cash flow yield (free cash flow/market cap) as a simple proxy for the expensiveness or cheapness of the shares. At the time of substantial issuer bid, the free cash flow yield for Great Canadian was 9% (approximately 10 times cash flow). At that level, we believe that the company bought back shares at a substantial discount to intrinsic value, creating tremendous value for remaining shareholders.

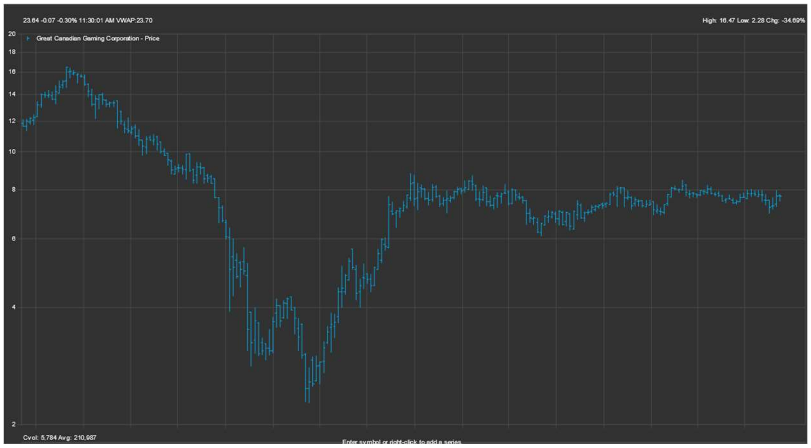
To help quantify this value creation, consider that a business with such an attractive business model that generates $0.90 per share in cash flow would normally trade at a 5% free cash flow yield (~20 times cash flow). On this basis, the stock should trade around $18 per share (20 times cash flow of $0.90 per share). At a buyback level of $10/share, they were buying at a 45% discount to intrinsic value. Buying more than 12.6% of its shares back at a 45% discount increases the intrinsic value for remaining shareholders by more than 5.5% (12.6% * 45%). This bold and opportunistic move convinced us that Rod Baker was an astute capital allocator likely to create considerable value for shareholders. Even better, this behaviour has not abated over the past few years, with the company continuing to repurchase the stock at attractive valuation levels, as seen in Chart 2 below. At the same time, Great Canadian has been prudently reinvesting in the business to improve its operating results. We view this as a critical component since buybacks are not a substitute for operational excellence; they are merely another tool to enhance shareholder returns.

Chart 2: Overview of Share Repurchases Over the Last 5 Years

	2011	2012	2013	2014	2015	Aggregate
Amount Spent	$10,593,936	$130,100,000	$46,560,166	$0	$77,690,000	$264,944,102
Shares Repurchased	1,479,600	13,657,210	4,511,644	0	3,400,000	23,048,454
Average Price	$7.16	$9.53	$10.32	$0.00	$22.85	$11.50
Number of Shares at Beginning of Year	82,870,000	82,480,000	70,440,000	67,330,000	68,810,000	
Percentage of Shares Repurchased (as % of Outstanding at Beginning of Year)	1.8%	16.6%	6.4%	0.0%	4.9%	
Free Cash Flow Yield (Free Cash Flow/Market Capitalization)	11.2%	10.0%	7.8%	8.2%	7.1%	

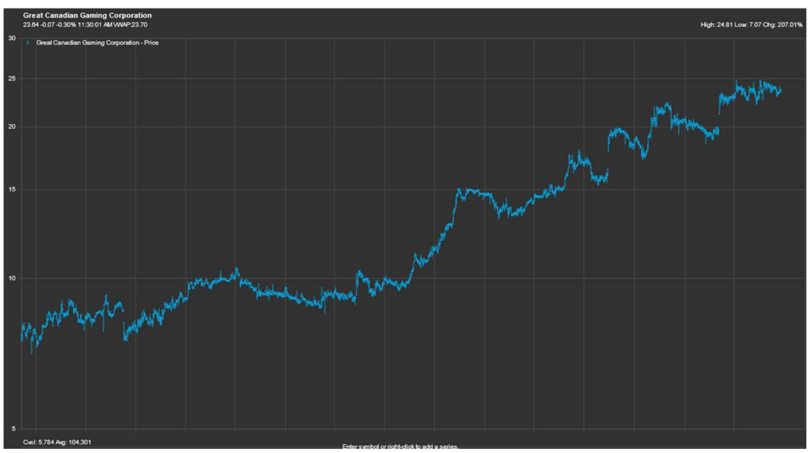
The result of this inflection in capital allocation and the ensuing highly accretive share buybacks can be seen in the following stock charts. Chart 3 shows the stock price in the five years prior to the current CEO taking over; Chart 4 shows the subsequent five years. We believe that the market is beginning to apply a basic investing principle to Great Canadian – a business is worth far more in the hands of a shareholder-oriented management team.

Chart 3: Stock Price in the 5 Years Prior to Current CEO



Source: FactSet

Chart 4: Stock Price in the 5 Years After Current CEO Took Over



Source: FactSet

As value investors, we are sympathetic to the challenge presented by buybacks. It is quite difficult to take bold action when faced with a wave of bad news and uncertainty. However, we believe this is exactly how impressive long-term track records are created. These are the types of partners that we look to invest alongside of across all of our mandates.