April 2023

Should a Holdco Discount Apply to this Canadian Company?

Business and finance folks have been accused of “physics envy” before because of their incessant search for universal and unbreakable laws that can explain market behaviour. Some investors have a deep desire for formulas with precise inputs and outputs. Yet, they are also okay with defying the laws of mathematics. For example, business “synergies” suggest that 1+1=3! There is some sense to this if there are cost savings by combining two companies for instance. In this Insight piece, we will explore perhaps another mathematical anomaly in the markets – why sometimes you can buy a dollar for 70 cents. But first, some technical details.

A company’s intrinsic value should equal its net asset value (NAV), which is the sum of assets minus liabilities. This makes a lot of sense. After all, once you subtract creditors’ claims on your assets, you’re left with the assets that are all yours – in essence the intrinsic value of the company. But sometimes a stock’s share price can trade persistently below NAV. Something’s up. What’s going on?

For a conglomerate, or a holding company (holdco), often there is a “holdco discount” applied to its stock price. The result is a share price that trades below its NAV. This is especially peculiar when most of a holdco’s assets have publicly available market quotes such that when you sum them up, along with reliable book values of other “stub” assets, the total value is more than the holdco’s trading price. Essentially, Mr. Market is unwilling to pay fair value for the holdco’s assets, even if many of these assets have publicly observable share prices. This is because Mr. Market applies a discount to the sum of the assets’ value – a holdco discount.

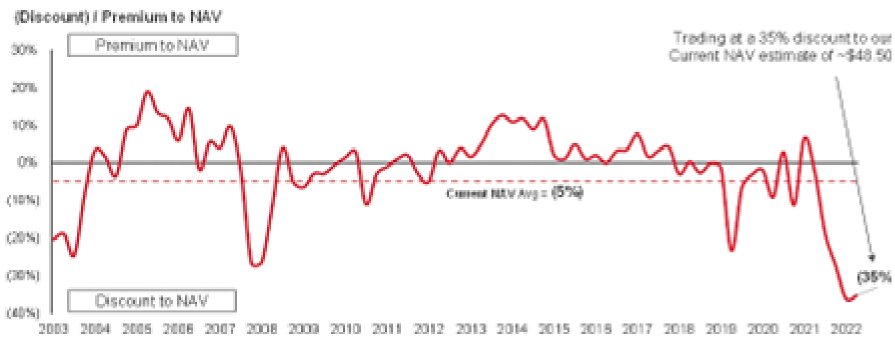
Why do holdco discounts exist anyway? There are many reasons, but they are all tied to inefficiencies. First, there is the illiquidity issue. You can’t freely buy and sell the individual public securities (or private assets) underlying the holdco. Instead, you have to buy and sell the full bundle. Holdcos also have an added layer of management and overhead, so expenses are higher. These added layers of complexity extend to financial statements as well, which can confuse some investors. For these reasons, holdco discounts exist empirically. This is somewhat sensible.

But how big should a holdco discount be?10%? 20% 30%? There is no right answer and judgement is required. However, there are ways to reasonably deduce an appropriate holdco discount using history and case studies.

Of particular interest to us recently is Brookfield Corporation. After Brookfield spun out a portion of its asset management business in December 2022, there seems to be some confusion regarding its business model and valuation. Brookfield is a complex entity that holds both public securities (with freely observable share prices) and private assets. As a holdco, a discount on its NAV is reasonable but the market appears to be undecided as to the magnitude of this discount.

At the current valuation, the market is valuing the business substantially lower than its NAV, which could be an attractive opportunity for investors who do their homework. However, this valuation gap may persist if the market is going to permanently assign an overly large holdco discount to Brookfield’s stock.

Should a holdco discount be applied to Brookfield? If so, how big should this discount be? Let's start with Brookfield's trading history. Over the past two decades, Brookfield traded at an estimated 5% discount to its NAV on average. As can be seen in the following chart, some periods the stock traded at a premium to NAV, and other periods it traded at a discount. This is to say that there was no clear trend over time, and reversion to the mean (to a 5% discount) was strong. Today, this discount is approximately 35%, which would represent the largest discount in over two decades.



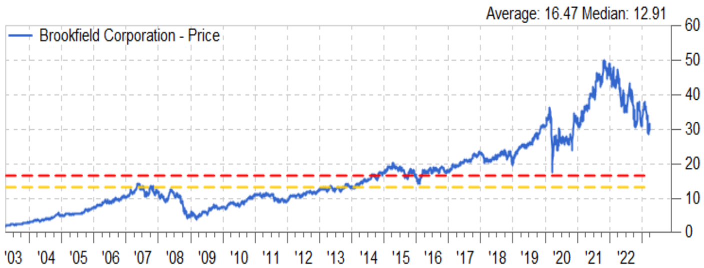
Source: Scotiabank and FactSet. March 2023.

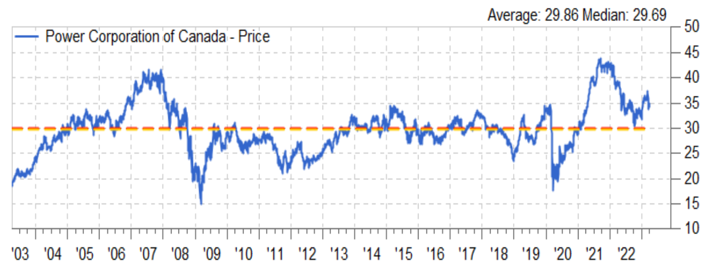
We attribute this wide discrepancy to rising interest rates, Brookfield's exposure to real estate, and investor confusion after a portion of the asset management business was spun off. Rising rates, along with inflation, are manageable as many of Brookfield's operating businesses benefit from inflation-linked revenues. As for real estate, it's clear to us that market sentiment is worse than what the fundamentals suggest. Even when you apply a punitively large discount to NAV, it appears Brookfield's portfolio of real estate assets is valued at zero. That is, for a portfolio of real estate assets with debt that is non-recourse to the parent corporation (or to any other parts of the company), you can own iconic and high-performing assets such as One Manhattan West in New York City and Canary Wharf in London for free.

After the asset manager spin-off, there seemed to be confusion in the overall market that led to questions, including "what is the appropriate holdco discount?" With so many macro-related issues to contend with (rising rates, inflation, a wobbly banking sector to name a few), investors don't seem to have time to dig deep into Brookfield's widening discount. Instead, selling on headlines that suggest all commercial real estate is troubled, which Howard Marks would categorize as "first-level thinking", appears to be the favoured approach. Since nothing about the business changed fundamentally after the spin-off, it is reasonable to argue that Brookfield should continue to trade at only a minor discount to NAV.

Now let's look at Power Corporation (Power) as a case study since it's also a holdco with a long history of being discounted by the market. Incredibly, Power traded at a consistent 20-30% discount for three decades. After restructuring to simplify the organization a few years ago, Power's discount has narrowed to around 20%.

So, should Brookfield trade at a 20% discount as well? We don't think so. Brookfield's underlying businesses are much higher quality, compounding at much higher rates than Power's businesses. As you can see in the following charts, the result is that Brookfield's stock grew 15- to 20-fold over two decades while Power's stock was rangebound over the same period. This discrepancy in returns over two decades is absolutely massive.





Source: Sionna and FactSet. March 2023.

Brookfield's management also has a stronger track record, especially when it comes to mergers and acquisitions, whereas Power had missteps in this area. These missteps were tied to management quality. The founding Desmarais family were business titans at one point, but later generations seemed more complacent and favoured wealth preservation over improvement and growth. We believe that given the companies' track records, Brookfield's discount to NAV should be lower than Power's.

Pairing our analysis of Brookfield's trading history with the Power case study, we can deduce Brookfield's holdco discount should be somewhere between 5% and 20%. We believe that a 10% holdco discount is a reasonably conservative assumption when determining Brookfield's intrinsic value.

The beauty of value investing is that precision is often not required. As long as we have a wide enough margin of safety in place, our investment should yield handsome returns no matter the assumptions applied (within a reasonable range). This would be the case with Brookfield. Our estimate of intrinsic value shows that Brookfield's valuation is attractive whether you apply a 5% or a 20% holdco discount. In fact, one can place an even higher discount and we still believe that Brookfield's valuation and NAV growth will yield an attractive return for patient investors.

We all know that market dislocations occur from time to time. We believe that the ingredients are currently present (an abundant of macro concerns, poor market sentiment, and investor confusion with the spin-off) such that Brookfield is misunderstood and mispriced – making it a classic value opportunity. The market may chalk up the current disconnect to a new, permanently higher holdco discount for Brookfield, but we don't believe this is the case. The dust will settle, and the fundamental drivers of intrinsic value will be the ultimate arbitrator in the fullness of time.

Gary Chow, CFA, MBA
Portfolio Manager
Sionna Investment Managers

Sionna Investment Managers 161 Bay Street Toronto, Ontario M5J 2S1
For further information, please email clientrelations@sionna.ca.

