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ROC and a Class ACT

Often, I get asked how we decide which companies we want to invest in. One of our tests in selecting investments is studying the financial record of a business. A useful tool in reviewing this record is the return on capital (ROC) ratio. ROC allows us to compare the profitability of one company versus another. ROC is calculated by taking the earnings before interest and taxes (EBIT) divided by the capital employed in the business. Earnings exclude the interest cost because we do not want the calculation to be skewed by the amount of debt or the interest rate one company pays versus another. We also use a standard tax rate to account for different tax rates. Capital is calculated by adding the shareholders' equity to total debt.

Let's look at ROC with an example of two imaginary companies in the same industry. Tango Corp.'s EBIT was \$8 million on sales of \$100 million in 2015, while Delta Inc.'s EBIT was \$5 million on sales of \$100 million. At first glance it looks like Tango is the better company because it has more profitability with an EBIT margin of 8%, while Delta is at 5%. However if we calculate the ROC for each, it is Delta that is a better capital allocator. If we assume Delta has employed \$50 million in capital and Tango has employed \$100 million of capital, Delta would have a ROC of 10% versus 8% for Tango. For every \$1 of capital employed in the business by Delta, it earns \$0.10 vs. Tango's \$0.08. The above example is based on results of one year, but we always look at more data. We try to find as much data as possible to see if the ROC has been consistent over time.

The next area of review is the trend in the ROC. If Delta has spent a lot of money over the last four years on acquisitions, building new facilities, or both, we would want to see what the ROC is on these investments. We have seen scenarios where the ROC might have been at 10% for an extended period of time, but then the return declines. This might be a result of generating lower profits because a particular project was significantly over budget (a higher capital employed than originally calculated) or management's expectation of profitability being incorrect. Again, our analysis would not end here. If we find other attractive attributes of the business, we would want to find out from the management team why the ROC has declined and understand the reasons. We would also want to know what changes in the organization have been implemented to reduce the probability of this happening again.

Now, you might be asking how an understanding of the ROC and its trend translates into a positive move in a company's share price. Essentially, if one company is able to generate more profits on the same amount of capital, it will have more profits than its competitor. This could be used to build more factories, acquire companies, or spend money on research and development to improve its product or service versus the competition. This might lead to even more profitability. A company could also use the excess profits to increase the dividend or increase share buybacks, which improves the earnings per share by reducing the number of shares. Fundamentally, the company with the better ROC has more flexibility and the potential for better investor returns.

A company in many of our large cap and balanced strategies that has an impressive ROC track record is Alimentation Couche-Tard (ACT). ACT is one of the largest convenience store operators in North America. It also owns stores in certain European countries and provides franchises to operators in Asia. The ROC of ACT has averaged an impressive 13.8% over the past 10 years. For comparison, StatsCan disclosed that the average ROC for all Canadian companies for the ten years ending 2014 was 7.2%. When we review the trend of ROC at ACT, we see it has been increasing as acquisitions were made over the years. The most recent deal was announced last week with CST Brands as the target. CST Brands is a convenience store operator in the United States and Canada with very complementary assets to ACT. If this deal is consummated, ACT estimates that the synergies from the combination will result in a cost saving of between \$150-\$200 million. This is almost half of the current profitability of CST Brands. Economies from scale and in-store expertise has allowed ACT to continue to generate strong ROC, so we are excited about the CST opportunity. We believe this strength keeps ACT ahead of its competition and is a main reason why we are invested in this business.