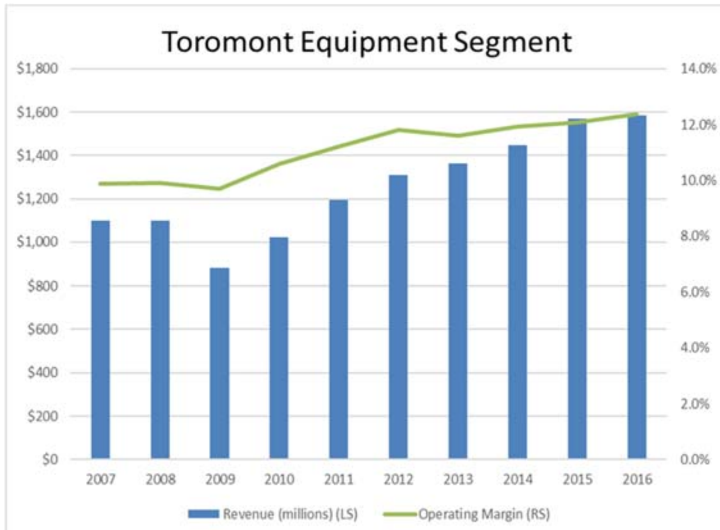
Focus and Discipline

When I visited the offices of Caterpillar (CAT) equipment dealer Toromont Industries over 10 years ago, I thought I had made a mistake. I was dropped off in front of a light industrial building in Concord, Ontario that housed a CAT dealership. I had to ask the receptionist if it was also the head office of Toromont, which at the time had over a billion dollars in sales. I was in the right place – the head office was upstairs in the corner of the dealership. This seemingly small detail was insightful because it indicated to me that costs and return considerations were important to management. The unassuming head office was just one example of the disciplined decision making at the company.

Toromont, a long-time QV holding in the Canadian equity, small cap and balanced strategies, has one of the best records in the Canadian market for return on capital, a measure of profitability. Over the years, Toromont has been seen as a leader within the global family of CAT dealerships. For example, it has developed an internal computer system for managing its equipment business that assists in its quest for strong profitability. It now licenses this system to other CAT dealers globally.

For many years, Toromont has wanted to expand from its current territory of Ontario, Manitoba, Newfoundland and selected regions of Labrador and Nunavut. It stated it would look globally for an acquisition but would not compromise on its return hurdles. Management continued to pay down debt and waited patiently for the right opportunity.

In August of this year, Toromont struck a deal to buy Hewitt Group, the CAT dealership with exclusive rights to Quebec, Western Labrador, and Atlantic Canada (basically, next door to Toromont). According to the documents released by Hewitt, the privately held company had a profit margin of 6.3% in 2016, materially below Toromont's operating profit margin of 12.4% in the same period. As shown in the chart, Toromont has not seen margins below 9.7%, even in the financial crisis of 2008-2009. We would have to go all the way back to 2002 to see margins near the current level of Hewitt. When we asked why Hewitt's margin was so low, Toromont cited weaker sales in Quebec due to slower construction over the last number of years, as well as a slow down in the mining of base metals. We noticed Hewitt has a larger percentage of sales in material handling (essentially forklifts) than Toromont. When we asked Toromont why it had lower exposure to this area, management described a highly competitive market that resulted in lower margins. Toromont had assessed the segment and determined management time and capital would be better spent elsewhere. Decisions like these explain Toromont's industry-leading profitability over time.



Source: Company Reports and QV Investors Inc.

For many CAT dealers including Hewitt, the rental business is not very profitable. The dealers reluctantly offer this service because it is encouraged by CAT. As the outlier, Toromont has been very successful with its rental CAT business, and has experienced good growth recently as contractors have been more reluctant to buy new equipment. Although rentals tie up a lot of capital, Toromont still generates a return comparable to other parts of its business.

Apart from the cyclical forces pressuring margins at Hewitt, we think the structural processes that Toromont has developed over many years will be fruitful during the integration of the Hewitt business. As shown in the graph above, Toromont has continued to grow revenue even as many other businesses have struggled in the wake of declining commodity prices.

We are not surprised that the Hewitt family took some equity in Toromont as partial consideration for the deal. They have seen what this disciplined management team can accomplish. Thankfully, so have shareholders.