QV Update

October 25th, 2013

Mark Dyki
Ian Cooke, CFA

Getting its Pigs in a Row

In February, 2011 Ian Cooke wrote a QV Update addressing Maple Leaf Foods (MFI) and the issues the company was facing at that time. It had recently announced a massive $1.3 billion restructuring plan. We were aware of its blemished record of profitably deploying capital to date, but held the name because of its stable product line and attractive valuation. It appeared at the time that Ontario Teachers' Pension Plan opposed the restructuring plan given that it started to sell its 35% position in the company. Activist Investor, West Face Capital, stepped in to buy just over 10% from Teachers'. It took some polling of investors but on February 3, 2011 West Face Capital gained board representation. We supported this initiative. Ian concluded his letter stating that streamlining is taking hold and we will monitor the progress going forward.

Almost all management teams say their top priority is to create value for shareholders. Not all managers take effective steps to that end. We applaud MFI for its actions to date. Although it has not yet reaped astonishing results, we feel that the steps taken by MFI's directors and management team during the last two and half years have been well intended with long term value creation in mind.

In October of 2011 MFI announced a revised, much concentrated restructuring strategy of approximately $560 million. Eight plants and distribution centres were to be closed with many of the remaining plants to be upgraded. A drastic reduction in the number of products offered was recommended. Unfortunately for many employees this overhaul would cost 1,500 workers their jobs. Work began shortly afterwards and continues today with a completion date planned sometime in 2015. A 385,000 square foot, $100 million, state of the art bakery has been built in Hamilton. With the capacity to produce 250,000 loaves of bread a day, it is the largest bakery in Canada. The focus now is on the protein division with record levels of investment happening this year.

Early in the restructuring process MFI stated that it would target a maximum debt level of three times debt to earnings before interest, taxes, depreciation and amortization (EBITDA). Earlier this year thin margins coupled with the restructuring toll caused MFI to breach this limit. This concerned us. As a result we sold part of our position to manage the increased risk. Just days after we finished the sale MFI announced that it would sell its meat rendering division, Rothsay, to Darling International out of Texas for $645 million. This action reiterated MFI's commitments to balance sheet targets and will get the debt to an acceptable level of slightly over two times EBITDA.

Important news for us came Monday morning when MFI announced the intended sale of its 90% stake in Canada Bread (CBY). CBY is a public company that produces and distributes bakery products under popular brands such as Dempster's, McGavins and Tenderflake. Both firms stand to become more streamlined and focused on what they do best. Today CBY's market cap is 1.7 billion and MFI's is 2.2 billion after double digit appreciation in both stock prices in the last week. An EV/EBITDA multiple of 11x's, a discount to comparable companies, would value CBY shares nearly 20% higher than today at $82. MFI's stake in CBY at this price is worth roughly the same as MFI's entire market cap before the announcement. This is a great example of a potential spin off that could unlock future hidden value from within the whole. We continue to hold shares of both MFI and CBY in various QV mandates.

We believe there is a good possibility of CBY finding a buyer given there has been significant consolidation in this space recently. CBY has hired RBC and Centerview Partners to help them find a buyer. Making it even more attractive, CBY just announced that it plans to sell its fresh pasta division, Olivieri Foods, to Ebro Foods of Spain for $120 million. This makes the company a pure play, which could be more appealing to potential buyers that are interested only in bakery assets. Proceeds from this sale would put MFI in an excellent financial position for a company in the midst of transforming its protein business.

Finance has all kinds of strange metaphors that do not actually explain what is happening but paint dramatic pictures. Examples include "keeping dry powder", investing in something "with hair on it" and my personal favourite the "dead cat bounce". Hopefully MFI doesn't experience the latter anytime soon. This is a rare instance where by selling its rendering business it actually did "cut the fat" and the value of its potential bakery sale is partially "baked in" to MFI's share price! It is comforting to see a management team, guided by its board, take steps to increase shareholder value. We expect a bountiful harvest, but will continue to scan the horizon for hailstorms.