the art of boring™

EP74 | Playing the plan: Mawer's Canadian equity portfolio

Disclaimer	00:25	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.
Andrew Johnson:	00:40	All right! A warm welcome to everyone listening. We have Mark Rutherford joining us today, he's an equity analyst on our research team. So, welcome to the podcast, Mark.
Mark Rutherford:	00:49	Thanks for having me, Andrew. Really great to be here.
Andrew Johnson:	00:51	Yeah well, we're happy to have you here. We've actually had a few first-time guests on the podcast in 2020, so, you're joining that list today. So, why don't we start there? Just give our listeners some background on yourself, maybe where you come from, and ultimately, how you ended up at Mawer.
Mark Rutherford:	01:05	A little bit of background is I grew up in Calgary, originally. So, lots of family in and around Calgary and Alberta. Growing up [I] was a competitive tennis player. And so that eventually led me down to the U.S. to go to university at Marquette and play NCAA tennis. And so that was a really great opportunity to get just...exposure, travel the U.S., [and] earn an education at the same time. And that's really where I dove into the markets, investing, and finance and really found that fascinating.
	01:38	From there, [I] had the opportunity to move out to Seattle to work with the family investment office for Bill and Melinda Gates. And so [I] took that opportunity after university and worked there for seven years, where [I] got a lot of experience working with very long-term focused investors; really, a platform where we can invest globally across asset classes. And just got some really great exposure to trading, private equity, venture capital, public markets, and worked with some great people.

Mark Rutherford: 02:17

And then after about seven years, was looking for some growth opportunities. From there [I] was actually back in Calgary one week, visiting, and was introduced just through a mutual connection in town (and we happened to be downtown) [with] Paul, Christian, and Vijay.

And looking at Mawer after I was introduced to the firm…there were a few things that really stuck out and attracted me. First: the fact that Mawer is independent and employee owned. The team here and the company just has a lot of skin in the game. So, not only investing in personal money within the funds, but also ownership of the firm. So that was a big factor for me.

03:01

Another factor that I really liked and that aligned my own experience was the generalist investment model that we have here at Mawer, where each analyst and member of the research team is really looking across industries and across countries at different companies. And that helps us make the best decisions with context.

And then in addition, just a nice attribute of Mawer is being located in Calgary; it provided an opportunity for me to come home and be closer to family after being in the U.S. for 11 years. So all that combined felt it was the right decision for me.

Andrew Johnson: 03:39

You mentioned working with the [Bill and Melinda Gates] family office and you highlighted some of the parallels that I think are between how we invest, and perhaps how they do as well. But I'm also curious—with your competitive sports background, [were] there any parallels that you can draw between your attraction [to] and competition in sports, and what brought you into finance, and eventually investing?

Mark Rutherford: 04:01

I think the thing that stands out for me is really just…that desire to win and be the best. And I think that resonated with me in sports and that made sports a lot of fun for me. But then also in investing, I mean, we are trying to make the best decisions for clients and allocate capital to the best opportunities in the market. And we're competing with other firms that are also trying to do that. And so every day, every year we're being measured by how we're doing. And that aspect to me, keeps me motivated and working hard every day to make really good decisions, create unique insights…And I think it drives a lot of the people on the team here who also have that internal competitiveness. You see it through their work. And many of them, too, have athletic or sports backgrounds.

Andrew Johnson: **04:52** Couldn't agree more. Now you mentioned that fast and furious introduction to Mawer and eventually landing the gig here. As part of that, when you joined the team (on the Research team), you will typically spend anywhere between 12, maybe 24 months kind of rotating around working with different people. So we call it our analyst rotation process, but maybe from your words, just for our listeners, can you describe it? Why we do that? And ultimately, why did you end up joining the Canadian equity team?

Mark Rutherford: **05:18** The analyst rotation for me lasted about a year and a half. And just maybe for context, one of the things that really attracted me to Mawer was the fact that the investment team here does have a generalist model where we will look at (I and others on the team) securities across industries and across geographies. And that really helps us make the best decisions so that we're not investing with blinders on.

05:48 Every new analyst that joins the team rotates around. For me, it was a great opportunity to just work with, really, almost all the team members on a daily basis for periods of time, learn from each of them, [and] just to get exposure to the uniqueness of each asset class.

And then within Canad[ian Equity], really enjoyed my time working with Vijay, Jim, Justin. Combined, they have obviously decades of experience. In Canada, [they] really know industries, management teams, and have context for making decisions.

06:24 And a few other things within Canada that really stuck out to me during my rotation: one, they were very open to new ideas. Both new ideas on the investment process side, as well as new securities to add to the portfolio, or things that we owned that we maybe didn't want to own. [I] thought the team had a lot of autonomy and trust in one another and were very candid. If someone brought up an idea and the other person disagreed, then people presented both sides of the investment case. I thought that was very refreshing.

06:59 And then kind of outside of that—the cultural component within Canadian Equity Fund—I think our scale in Canada's just also a nice benefit here at Mawer, where we do have great access to resources. We have very good access to management teams if we want to speak with senior management or board members and other resources just throughout investing in Canada; sources that we can draw upon.

So, those combine, and the combination of working with Vijay, Jim, Justin, [I] thought it was just a really good fit to work with the team.

Andrew Johnson: **07:32** Okay, so you're on the Canadian Equity team. You're clearly contributing to the construction of the portfolio. I wanted to spend most of our time today talking about the holdings within the portfolio. In particular, some relatively new holdings. So, if you're up for it, I'd like to talk about three of them. And those three that I had in mind were Stella-Jones, Ritchie Bros., as well as Granite Real Estate Investment Trust. I would say that all three are definitely within the realm of "boring" business models, but why don't we start with Stella-Jones?

Mark Rutherford: **08:03** First with Stella, that's a company that we've owned in our Canadian small cap portfolio for a number of years. Jeff and Samir know the company very well. As we came into this pandemic in 2020, [we] saw just markets grappling with incredible uncertainty. And while we were looking across the board and the existing portfolio of what changes we needed to make, if any, we also looked outside of the portfolio. And Stella rose as one of the names that we ranked pretty highly in terms of our matrix rankings for quality of the business, as well as return potential. We thought that it could provide incredible stability and a unique market exposure for the Canadian large cap portfolio, [which it] did not [at the time] have.

08:53 And so, just for background on Stella and their business model—Stella is a manufacturer and distributor of wood products and lumber products across North America. The end markets...there's really three different segments to the business: one third of the business is driven by railway ties, another third is driven by utility poles, and the last third is really residential and industrial lumber products.

09:20 Historically, the business earns a low, double-digit return on invested capital. The industry has largely been consolidated by Brian McManus and his team. So, if we look at the market share positions for Stella, they're number one and ties with 50% market share approximately in North America. And most of the demand for railway ties, approximately 70%, is replacement demand. So, regardless of whether the economy is doing well or doing poorly, they have relatively resilient demand in that end market. And then in poles, they're number one position with roughly 40% market share. There is fairly low degree of substitution risk because other products like metal poles or composite products are higher cost.

10:10 And there, because of aging infrastructure, Stella has seen mid to high single-digit growth rates. And they continue to expect those growth rates to continue for the foreseeable future. In addition, there are some barriers to entry because of regulation and industry—it's hard to add new wood-treating facilities.

Mark Rutherford: And then, in terms of growth going forward, another nice attribute is there are a few tuck-in acquisitions that Stella could potentially make. And that's an area where they have historically added value. And, during the second quarter, as we looked across the markets and just a lot of uncertainty, we thought Stella was trading at a reasonable valuation and provided a unique end market exposure that we didn't already have in the Canadian Equity Fund. And so that's why we thought it made sense to add to the portfolio.

Andrew Johnson: 11:02 So, certainly sounds like a wealth-creating business and hits on one of the more appealing parts of businesses that we invest in, which is that recurring revenue stream. Just before we move on to the other holdings, you mentioned it briefly there—I just want you to give a quick refresher for our listeners on what the Matrix means. You mentioned "matrix rankings" when talking about Stella-Jones, so perhaps maybe just give us a quick overview of that.

Mark Rutherford: 11:25 Just for background, we use a tool internally called "the Matrix," and that's where we will rank our securities in our portfolio on two axes. And really, the Y-axis is quality of the business model and X-axis is return potential. So, we will do that for internal holdings, as well as things that we don't own in the portfolio. And if we come across a name where we think it plots very well in this matrix, then we really ask ourselves, and it's a tool that helps us identify, "okay, should we be reconsidering whether we add this or not?" and/or, "should we consider repositioning the weight of different securities within our portfolio?" So that's just a brief overview of how we utilize the Matrix.

Andrew Johnson: 12:17 Just another tool in the toolbox in that goal to trying to make the best decisions with our clients' capital. Let's move on to the other names, Ritchie Bros. and Granite, whichever one you want to go with.

Mark Rutherford: 12:27 Great, with Ritchie Bros., that was another security that we added in the second quarter. Justin Anderson did the update on that. And that was a company that the Canadian Equity Fund has known about for quite a long time; we had looked at it previously in 2018, 2019, and at that point, they were still looking for a new chief executive officer. So, that was a little bit uncertain as to how that would play out.

Mark Rutherford: **12:56** Going into this year, they had hired a new CEO, Ann Fandozzi. And the business model, just as a reminder, is really an auction business. So, Ritchie Bros. has over 40 auction sites around the globe, they have online marketplaces, and they also have services that they'll sell with the auction. So, that could be appraisal, listing, insurance, or logistical services. And Richie had made an acquisition previously that we had identified with IronPlanet that was going to help them really get into online auctions and try to grow the business that way.

13:39 And so we thought that was [a] potentially transformative acquisition. And then coming into the second quarter, again, facing quite a bit of uncertainty, we looked at the business. We thought the competitive position had been enhanced by the IronPlanet acquisition; [it] has a very clean balance sheet, almost no debt. So, if the situation did get worse with the economy, we thought it would hold up very well. And then, even if the situation improved, we thought they would still benefit because machinery, equipment—those are really always changing hands. Richie has quite dominant local market positions, where they're connecting a highly fragmented base of buyers and sellers. That allows them to create value by giving their customers liquidity when they need it on the south side, or finding the right piece of equipment very efficiently for the buyers.

And so, when we put all those facts together, we thought it did make sense to add Ritchie Bros. to the portfolio and [we're] happy that it's in there now.

Andrew Johnson: **14:45** So, hitting on another, again, wealth-creating business, but also elements of the types of businesses that we'd like to invest in. In this case, very low, next-to-zero debt on the balance sheet is always an attractive part of any investment that we're looking at. How about Granite?

Mark Rutherford: **15:00** Sure. So, Granite [REIT] is another company that we had done quite a bit of homework on in previous years. It was one where we know the management team very well. Kevan Gorrie is the CEO, and he previously ran Pure Industrial Real Estate Trust and eventually sold that to Blackstone.

15:22 And Granite, first of all, just what do they do? Granite owns and operates industrial real estate across North America and also in Europe. And what we've seen is that there's been a massive trend with consuming more goods online, and that is really driving all sorts of consumer products companies to really increase and improve their distribution footwork across North America and across Europe so that they can enable one- or two-day shipping.

Mark Rutherford: **15:58** And Kevan has really assembled a portfolio that is trying to take advantage of those themes with high-quality assets in the U.S. Midwest, some in the U.S. South and Texas. And he's able to do that at fairly attractive prices and receive just a long tailwind for him to continue to execute well. And I think the resiliency of the business model has shown through in the last few quarters, as they've seen 99% rent collection on their assets, where a lot of areas in real estate are struggling right now, particularly [with] concerns [around] office and apartments and retail, but industrial has held up just because we're seeing the sustained demand from e-commerce.

16:48 And so, a very large percentage of their facilities can really distribute more than half of the U.S. population within a day. These assets are strategically located, and Kevan has done a very good job, historically, allocating capital.

I should also mention that the risk with industrial is that industrial assets are generally easier to build and so supply can come online easier than office or apartment buildings. And so that is one of the risks that Granite faces.

17:19 In addition, Granite has just under 40% of the portfolio tied to Magna [International], which is an auto manufacturing business. And the strategy that Kevan has really developed is to redeploy new capital continuously into new assets, reduce the Magna exposure, and then eventually, he will look to release those assets. And then, in addition to that, he's maintained just a relatively reasonable amount of debt on the balance sheet, relative to the potential debt that he could take on. So, we think that also helps mitigate risks for the business.

Andrew Johnson: **18:01** Well, I think all three of those are just in general, great Canadian stories, and you just gave I think, great overviews of each company and how they fit within our philosophy. And that's important because that is our first focus. When we're looking at potential investments for our clients' capital, we're first and foremost looking to ensure that we're investing in those wealth-creating businesses, we're assessing those management teams that run those businesses, and then we're trying not to pay too much for them.

Andrew Johnson: 18:26 One of the other major elements of constructing a portfolio for our clients is putting these holdings together in a way that allows the portfolio to be resilient. So, for example, holding a variety of businesses with maybe different end markets like you've outlined here, different growth profiles. Just in general, different risks associated with them, allows the portfolio to perform through various realities that could unfold in the future. And, as you stated, all three of these currently pass our test when it comes to holding it up against our investment philosophy.

But maybe just using these holdings, or any of the other holdings in the portfolio, can you illustrate how they fit within the entire context of the portfolio and what that means in terms of diversification?

Mark Rutherford: 19:09 I think all three of these really add just a unique element to the portfolio that we didn't have significant exposure to before. So, just comparing the end markets: Ritchie does provide a nice contradiction in the portfolio. We currently own Finning and Toromont, which distribute heavy equipment and are large Caterpillar dealers in Canada. And, if there is an economic contraction, or if it's a sustained downturn in demand for new equipment, declines in businesses across mining, oil and gas, construction are looking to buy used equipment instead. They may choose a company like Ritchie Bros. and buy equipment at their auctions, or, if they're looking to downsize their fleet, they will also tend to use Ritchie's auction or listing services to help rightsize their cost structure.

20:05 And so, that really helps just provide a nice natural contradiction in the portfolio.

In addition, on Stella, you have very steady utility end markets and rail end markets where, the railways really have to spend every year to maintain their network to high-quality standards. And with Granite, it provides a little bit more offense, but it's also a nice contradiction to this low-rate environment where we're seeing low interest rates, tremendous demand for high-quality assets, especially with good tenants. And Granite can benefit from that where other securities in the portfolio—maybe the banks—will have a harder time in a lower interest rate environment. And so that provides us a nice offset to the portfolio. And I think there are really three unique end markets where we didn't have a tremendous amount of exposure before.

Andrew Johnson: 21:03 That's great. And just to come back to Ritchie Bros. for a second, you mentioned, and I think probably from an absolute level, there's cyclicality to the business. When you hold it up against the economy, is there an element of counter-cyclicality there?

Mark Rutherford:	**21:15**	Definitely, I think it goes both ways. There's an element where, if you have periods of volatility, say for instance, in the energy sector right now—there could be a lot of changing hands of assets, particularly if oil and gas service companies are having trouble. And so, Ritchie is a potential beneficiary as those assets trade hands. And then if the market recovers in a few years, new capital comes into the space and there's more projects going on, people will likely trade those assets again. And so, there is a degree of counter-cyclicality with Ritchie that benefits. And then even if they're outside of volatility in a depressed trading environment, Ritchie still has potential to benefit and grow market share as more of these auctions move online longer-term. So that's a potential just…longer-term tailwind for them.
Andrew Johnson:	**22:15**	Yeah, it feels similar in nature to owning a stock exchange, for example, just when, in times of volatility, there's a bit of a tax on that volatility. This whole discussion is really summed up, I think, by a common phrase that we use a lot around the firm, and we use it in talking with clients, and that's that we're "trying to win by not losing." And for our listeners, I can see their faces kind of contorting, and they're probably saying, "huh?" Because admittedly, it doesn't sound like a very aspiring goal. So maybe you can tell us your take on it: what it means for you and what it means for building the Canadian Equity Portfolio.
Mark Rutherford:	**22:49**	Yeah, so it's a mental model that I like to think about. And it gets back to probably my days playing tennis, where I was trying to just get the ball over the net one more time than the opponent. May not have [had] very many winners or aces, but if I could just keep rallying and keep the point going, eventually the opponent was going to make a mistake. And really in Canada, that's one thing where I think we can focus on and avoid some of the "dirty shirts" in the index and try to just own the high-quality companies that are well-managed and manage our valuation risk and let those companies run. And that should shift the odds in our favour over the long term. And so that's a mental model that we think about as we look across the portfolio.
Andrew Johnson:	**23:38**	I'm just going to keep this rolling because that brings to mind two other topics just based on your comments that you just had. And they are two other topics that often come up and speaking with our Canadian clients in particular. The first is the energy sector—and you touched it briefly with your comments on Ritchie Bros. This is an area historically where we've held a relatively lower weight than what's represented in the index. Can you speak to the reasons why we've done that or why we've made that decision?

Mark Rutherford: 24:03 Yeah, it's a very intentional decision. It really starts with the bottom-up process of just looking at the business models and their fundamental ability over the very long-term to earn sustainable returns above their cost of capital and assessing whether or not they have a competitive advantage. And when we look across the energy landscape, there are a couple of names that meet that criteria, but it's quite limited.

24:32 And so that is really a function of the underweight. And why are there exceptions? Really, the exceptions that we have would be Canadian Natural Resources, Suncor, and Enbridge. And those…it's really driven by unique assets. Canadian Natural has very long base of reserves. We think that reduces the reinvestment risk that is very challenging for energy companies as they operate through the cycle. And then that low production costs really helps companies like CNQ and Suncor in very challenging environments. And so, despite oil futures literally going negative earlier this year, CNQ and Suncor continue to generate strong cash flow and [if] they can manage through this and be one of the survivors, then ultimately potentially pick up assets at very depressed prices to come out stronger.

Andrew Johnson: 25:33 Yeah. And I think you hit the nail on the head with the low production cost comment, because when you're trying to be a wealth-creating business, there's really two levers that you can pull. You can either charge more for the product that you're producing or manufacturing, or you can control your costs on the other side. And with an oil and gas and energy in particular, you're at the mercy of a global market price for your product that you're pulling out of the ground and ultimately refining or producing.

25:56 So that is key in particular when we're looking at oil and gas companies—is that production cost. Thanks for explaining that. Another much hotter topic, at least in the past few years, has been the rise…well, and the fall, I guess in some cases, of companies related to the production of processing cannabis. And so we've spoken briefly in the past with others on the podcast about this, but perhaps you can share our current views on the industry and the risks and opportunities with the companies that currently operate within it.

Mark Rutherford: 26:26 Yeah, so cannabis has been a wild industry to watch evolve over the last few years. It's gone from being in the headlines almost every day in Canada a few years ago when it was just legalized to now—some of the challenges that we've seen and even some of the consolidation that we've seen in the industry.

And so, to start maybe just looking at the value chain, there's really three areas in Canada for the value chain.

Mark Rutherford:

26:53 First, there's the producers that grow cannabis products; there's the wholesale distribution. And that's really done by the provincial governments where producers are forced to sell to the governments. They take a distribution margin or profit. And then there's retail outlets in many provinces where private corporations are allowed to set up retail distributions arms, and they have to buy from provincial governments and sell those products to the public.

27:23 One of the things that we noticed looking at both the producer side and the retail side was we didn't find that the barriers to entry were massive. And so that's one challenge in this industry—that there may be some companies that come out where they do have scale advantages over competitors, but for now, it seems like there are a lot of these companies popping up. For now, there doesn't seem to be a tremendous degree of differentiation amongst the products that's leading towards very high sustained profit margins.

27:57 Another thing that we saw on the retail side is that there's really no limit to the amount of licenses that provincial governments may issue. So, if you're the only cannabis retailer in a city, you might have a nice monopoly. But if government decides to issue 100, 200, or 500 retail licenses, the profits that you may earn from one of those retail outlets would likely decline over the long term.

28:24 And then, in addition on the product side, because of regulations in Canada, it's very difficult to brand products. You can't really market them publicly. And then even as these products are displayed, there's very limited opportunity for branding. And so we thought: could there be a "Coca-Cola" type company emerge in this industry? For now, it really seems too early to tell, and [we] haven't really seen evidence of that. But we'll continue to monitor to see if that develops.

28:57 Also, because the industry is so new, looking through some of the companies that are publicly traded, a lot of the management teams do not have a very long public company track record that we could bank on where they'd added significant value through other companies that we're familiar with. There may be some really great executives in the industry that are running companies right now, but for us, it just increases the uncertainty because you don't know those individuals as well, relative to other companies in our portfolio.

Mark Rutherford:	**29:33**	In addition, what's changed from really a couple of years ago to today, is valuations. And valuations at the time, were very, very high and they still appear to be quite high from our perspective. So, putting all those factors together: uncertainty around management teams, the governments are really set up to be the taker of economic rents in the industry, low barriers to entry, limited ability to brand...[for those reasons we] decided it's not the right fit for the Canadian Equity Fund. But we'll continue to monitor the industry and see how it evolves over time as it's still very early days.
Andrew Johnson:	**30:13**	It may be very difficult for the provinces to let go of that distribution control and the revenue that comes with it. And ultimately that might stymie the opening up of this industry to an emerging of "winners" out of this. Mark, this was tremendous. Thanks for joining us for the first time, and hopefully not the last. I think our listeners learned a lot today, so, thanks again.
Mark Rutherford:	**30:36**	Thanks very much for having me, Andrew.