QV UPDATE

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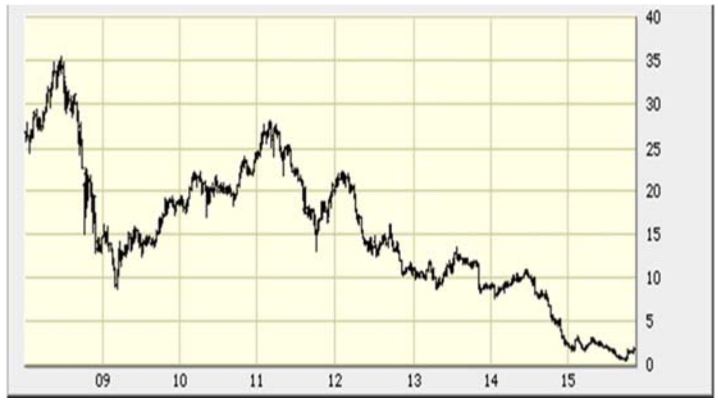
Darren Dansereau, CFA

What doesn't the "Q" mean?

In a recent meeting with one of our clients, we were asked how we define quality, the "Q" in our name. We typically discuss the high profitability of the companies in our portfolio, the reasonable and logical actions of management, and the company's franchise, which is often difficult to replicate.

Reviewing the history of a certain Canadian energy producer can shed light on what types of companies in which we are <u>not</u> interested. This firm decided in the last few months to take its dividend payment to zero. This was a good decision, but much too late. If we look at this company's record over the last seven years, there were only four years where operating cash was enough to support capital expenditures (capex). Capex is the amount reinvested back in the business for growth and to maintain production. Even when the capex was covered, there wasn't a single year in the last seven where the cash flow was high enough to pay for both capex and dividends. As a result, the company has had to resort to debt issues, equity issues, and asset sales to stay afloat. In the last seven years, $4.6 billion of assets have been sold, which has raised cash but also reduced future cash flow. The result is the cash flow on a per share basis has declined by over 70% to the end of 2014 before even factoring in the lower oil price over the last ten months. The company is within its debt covenants, but it is getting very close to the limit. A lot of drastic actions are being taken now such as salary cuts and layoffs, but it may not be enough. The stock price is down 94% since 2008 as shown in the graph below.

It seems basic, but this reminds me of the lesson my wife and I are trying to teach our kids with their newly instituted allowance. The idea of an allowance at the Dansereau house is teach each child to spend within their cash flow. There are no loans. Whether it is at my house or in QV's investing, the motto is if you don't have the money for something then it shouldn't be purchased, nor should you pay out money that isn't available (dividends).



What does the "Q" mean?

It is interesting to see the difference in actions between management teams within the same industry. Canadian Natural Resources (CNRL), which is owned in the large cap and balanced strategies, took a different approach. Although capital expenditures have been slashed, salaries cut, and jobs reduced to preserve cash and try to protect the business in the event that the downturn is much longer than expected, the debt level is still reasonable.

CNRL pays a dividend, but it is at a much lower payout ratio versus our other example. It has also done a much better job of living within its means. In the early years of our period under study, CNRL earned significant cash flow which allowed it to continue to build its projects without taking on too much debt. In the past few years, CNRL has been steadily investing to increase its production from the Horizon oil sands project. The company has stated that by continuing to build in this tough oil environment it has been able to achieve better productivity with the best crews on the job. Also, the costs have been declining as the competition for workers and services has diminished. The spending has occurred, but we will not see the cash flow until 2017. If we look over the next few years, the production will increase while capex will decline providing strong cash flow to either bump the dividend, pay down debt or buy back shares. The cash flow growth on a per share basis has been impressive and it will continue to increase, meaning it will add further to the value of the business.