QV UPDATE
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Desperate Transactions

Desperation and market transactions, whether to buy or sell are rarely a profitable combination. When transacting in stocks, real estate, or vehicles, desperation is more likely to lead to overpayment on purchases and receiving less than fair value when selling. While the rationale for owning growth is clear-cut, it should not be bought at any price. Growth in many advanced economies has been a scarce commodity since the great recession. The Bank of Canada recently highlighted annual growth in advanced economies has been 1.4% during 2010 to 2014 in comparison to the 3.6% growth between 1985 and 2007. The annual growth has also been disappointingly lower than projected by the start of year forecasts in each of the past seven years.

Investors have taken note and segments of meaningful growth have been bid up. According to CIBC's quantitative research team, expensive 'growth' and momentum have been among the best performing factors year to date in the Canadian stock market. As highlighted in last week's letter, the average valuation level of Facebook and Amazon at 90x+ price-to-earnings could easily be interpreted as overeager for growth, or at a minimum a strong hope for exemplary execution over multiple years.

The scarcity of growth is further reflected from a general bottom-up earnings perspective in Canada. Many of Canada’s largest companies and sectors are generally expected to have muted earnings outlooks for this current calendar year. Canadian financials are anticipated to post 3% growth, due in part to slowing consumer loan growth. Telecommunication services, in battling increased competition and maturing markets, are also anticipated to post 3% growth. The resource sector has been battered by declining commodity prices, as earnings are expected to decline ~49%. With these sectors comprising ~63% of the TSX Composite, it is clear why TSX earnings are projected to be down 11% in calendar 2015. This earnings outlook could be a potential explanation for investors’ declining appetite for Canadian or energy investments. In our opinion, indiscriminate selling of all exposed companies, regardless of company specific fundamentals in tough times, could be characterized as desperate selling.

As quality growth companies are bid up and resource stocks are experiencing selling pressure, we have been cognizant of desperation. As a result, stock selection and even deselection have become more crucial to preserving risk adjusted returns. Throughout this market of overbought growth and oversold resource businesses, we are finding reasonable opportunities with strong balance sheets, attractive market positions and respectable valuations.

Over the past year we have invested in Labrador Iron Ore Royalty (LIF) in the QV small cap strategy. The company’s share price has been impacted by multi-year lows for iron ore prices and has resulted in hasty investor exits. LIF offers an attractive 7.5% dividend yield, while taking zero capital expenditure risk, and maintains no net debt. LIF’s conservative capital structure supplements the resilient business model which collects a royalty on revenue generated by Canada’s largest iron ore mine. With a record of operating over the past 50 years, we anticipate a similar multi-decade asset life. Although commodity prices could continue to be pressured, the operator of the underlying assets is targeting a further 24% cost reduction in 2016 to provide flexibility and additional cash flow.

A QV holding with attractive growth but respectable valuation is BC based Ritchie Brothers Auctioneers (RBA). CEO Ravi Saligram has shown signs of early success in developing its underpenetrated US business. RBA has posted 19% organic growth (constant currency) in the year to date. Management is targeting high single digit to low double digit revenue growth. With minimal investment required to grow and a geographically diverse and counter-cyclical revenue stream, RBA provides portfolio enhancement. Importantly, RBA trades below its average valuation levels over the past decade.

Wary of overgeneralizations, we believe one instance of an acceptable desperate transaction is when purchasing presents for loved ones. We note this risk can be mitigated by proactive planning and searching!