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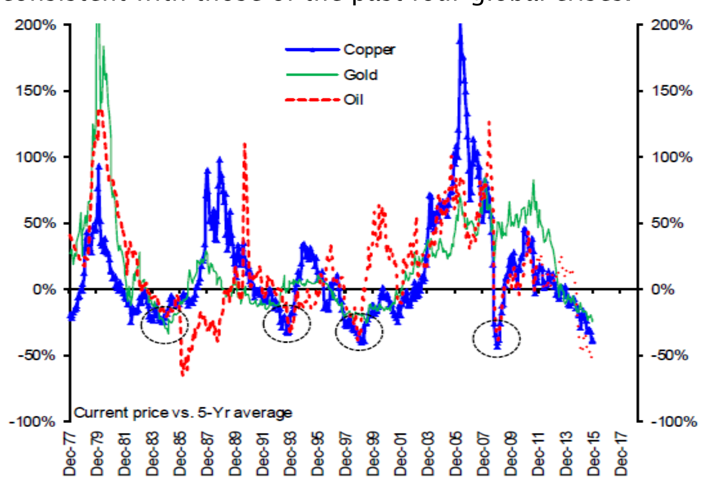
QV Investors Inc.

Keep On Digging

In discussing the lessons learned through this cycle, the CEO at one of our resource companies indicated how a downturn had been planned for, but when it arrived the impact was much greater than anticipated. This was the comment from a business with no debt and no capital spending requirements. We have to believe that weaker financed energy and mining operators are feeling much more of a pinch from this downturn.

The headlines and outlook are gloomy for the resource industry. This week one of the world's biggest diversified mining companies, Anglo American PLC, announced it would sell off assets, eliminate its dividend, and shed north of 80,000 employees! Compare this to the 35,000 jobs lost year-to-date in the Alberta energy patch to appreciate the magnitude. Due to the supply of base and bulk metals continuing to exceed demand, and the high costs associated with shutting down a mine, we do not believe another resource supercycle is on the horizon.

However, this should not deter us from digging for gems in the unloved energy and materials sectors. We have suggested to our clients for some time that valuations in the resource space are increasingly attractive. This remains the case today. The chart below shows the current prices of copper, gold, and oil are between 25 and 50 percent below their respective five-year average prices. Simply put, the price discounts today are consistent with those of the past four global crises.



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

Despite this, the Canadian equity strategy's exposure to resources has not changed drastically over the past year. The issue we encounter with most of these businesses can be summed up in three stages resulting from the commodities boom that began in 2004.

First, cash flow to the companies rapidly improved due to a surge in global resource demand. Next, double-digit dividend increases followed what was perceived to be sustainable cash flow growth. Finally, debt levels accelerated as we moved deeper into the cycle. This was generally a function of rising operational costs, lower quality resource grades, some bad investment decisions, and low interest rates. The situation worsened as commodity prices continued to slip, forcing many businesses to make severe cost cuts and shore up cash through dividend suspensions.

Few base metals or bulk commodities franchises have allocated capital strongly enough to endure an extended period of low resource prices. Typically this has led QV to invest instead in service providers to the resource industry, like Toromont and Ritchie Brothers Auctioneers, which have greater customer diversification and lower capital intensity. Though recently, the Canadian equity strategy initiated a small position in Potash Corporation of Saskatchewan. It is among the lowest cost producers of potash, and has at least 50 years in reserves of mines that are expensive and difficult to replicate. PotashCorp holds comfortable leverage ratios and pays a dividend that yields in excess of eight percent. Its valuation is at a level not seen since the start of the commodities boom, but it now generates three times more free cash flow.

Resource producers are entering a big adjustment period, which could involve further pressure on their share prices. Given the excesses of the past cycle and the perception of a never ending slump, the shares of commodity producers will likely be slow to recover. Yet in reality, inherent to the word "cycle" is an eventual reversal. We cannot pinpoint when this will happen. But we will use the current environment to identify and purchase some unique assets at what appear to be crisis-level discounts.