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Go West or Sell West?

In the midst of reporting season, 2015 results of firms exposed to Western Canada are showing continued pressure. If valuation multiples and share price declines are a decent proxy, economic weakness and economists advocating “avoid anything Western Canadian” has shifted sentiment to historic lows. Although the environment has impacted some of QV's holdings, this “sell Western Canada” trade is opening up select opportunities. We believe this short-term and potentially lazy approach is conducive to finding bargains.

We readily admit that timing the peaks and troughs for maximum returns is not our strong suit. Focusing on the three to five year time horizon and business evolution however, is. Calling a bottom is something few or none can consistently do. Rather, we advocate for a balanced focus on the reality of the outlook not only for today but also the next three to five years.

In the past, we have cited stock performance exceeding operating results as a factor in reducing exposure to expensive businesses. While we have been early in some instances, we maintain that being disciplined on value is paramount to preserving capital. More recently, we are seeing a number of companies exhibiting operating performance outpacing stock performance. To our chagrin, we have been early in some of our purchasing. Despite this, resilience within a select few Western Canadian businesses is beginning to emerge.

With the share price down 26% in this past year, QV holding AltaGas sounds like and its share price acts like a commodity stock. The reported 2015 business performance reflects a different reality however. AltaGas posted a 7% increase in normalized cash flow, and a 12% increase in the dividend. Management is targeting a 20% growth in cash flow for 2016 generated by prior investments. Recent per share growth has been below expectation, but this should begin to improve in 2016. With ~75% of cash flows generated by utility and power generation assets, AltaGas has a stable cash flow base to develop further. Longer-term, organic utility and power investments will support double digit growth. Value wise, AltaGas trades at an attractive 6.0% dividend yield relative to its 5 year average of 4.5% and the TSX Composite at 3.4%. As incoming CEO David Harris takes the helm from Mr. David Cornhill, AltaGas shareholders continue to be in able hands. Mr. Harris has spearheaded a transformational six year $1.1 billion run-of-river hydro construction project, which significantly has been on time and on budget.

Canadian Western Bank (CWB) also sounds exactly like the exposure strategists are touting to avoid. In the near-term, they could be right. But despite a 13% share price decline over the past year, in Q1 2016 book value per share grew 13% from $19.99 to $20.53. Loan growth was 12%, with two thirds of growth sourced in Ontario and BC. Although earnings will likely be flat for 2016, key investments in tough times will support the franchise going forward. CEO Chris Fowler tackles the operating environment head on, saying "we would not be who we are or where we are without an enduring commitment to a culture that puts risk management first. The foundational principles of our lending policies have stood through a number of economic and commodity price cycles". Facts support this. In the past decade, at 0.18% of total loans CWB has maintained lower provisions for losses than the big six banks at 0.40%. Management is currently implementing a core banking system upgrade, which will be a drag on earnings in 2016. However, the system will enable the bank to enhance its value proposition by offering further value-add services and increasing share of wallet. CWB trades at 9x forward earnings, a 30% discount to its 10 year average price-to-earnings ratio of 13x.

Balance sheets can either make or break businesses when plans go sideways. Both businesses maintain conservative balance sheets. Most importantly, should the business environment deteriorate further, the earnings power from these businesses is likely to be supportive of stable balance sheets. Although 2016 looks to be another difficult year for the Canadian economy, we remain focused on being long-term shareowners of attractively priced businesses that can compound in good and bad times.