

QV UPDATE

Weekly Commentary | April 29, 2016
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Bumper Bowling

At least once a year, one of my kids is invited to a bowling birthday party. The bowling party is perfect because it allows the kids to release energy. Another positive aspect is the side bumpers they put up on the lane to eliminate gutter balls. The bumpers also significantly improve my score!

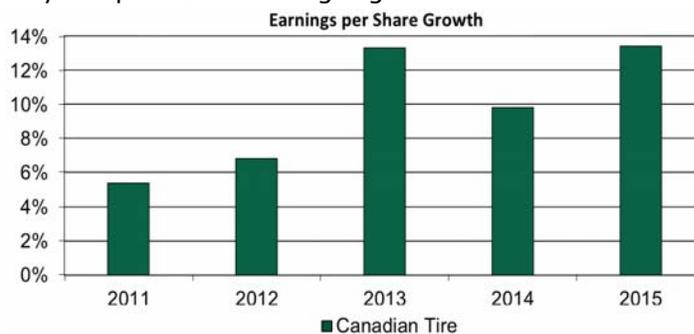
QV's investment process also uses bumpers to protect our portfolios from gutter balls. The bumpers are the tests or characteristics we look for when picking individual companies.

Ensign Energy Services, which is an oil and gas drilling services company, is a business we hold in a number of our Canadian strategies. Ensign's commodity exposure results in cyclical cash flows that move with the activity in the energy business. Our business analysis begins with a review of the company's financial record (bumper). When we do this, we spend more time looking at what happens in difficult environments rather than in strong markets. As we all know, when the oil price is \$150/barrel every energy company can do well. In the 2008/2009 financial crisis, we applauded as Ensign was able to avoid raising expensive debt, issuing equity or cutting its dividend. Ensign has consistently been positioned for a difficult environment whenever it may come. If we fast forward to today, the company had a strong balance sheet that was again positioned to withstand a downdraft in commodity prices. This is the result of a strong management team (bumper) that had seen this depressed environment many times before. Bob Geddes, Ensign's CEO, came into the drilling business in the early 80s, so he has witnessed the impact that price volatility has had on the sector. This experience assisted Bob and the team in swiftly taking action to right size the business. Two and half years ago Ensign implemented a hiring freeze. Since that period, it has reduced staff and other costs. 2015 revenues were down 40% from the prior year as were cash flows, but gross margins were up. This is very unusual for a business. Typically, we see weak margins when sales decline this quickly because it takes time to reduce costs. As many out there, we did not anticipate the magnitude of this decline in energy prices so we have not been immune to the price slump. However, the declines in our holdings were less severe than other companies in the

sector. In some cases, these businesses will never get the chance to recover because they were pushed into bankruptcy. These companies did not have protection from the gutter.

Franchise – Another Bumper

A durable franchise can provide strong growth, profitability and defence against competitors. Can you name a retail company that has locations within 15 minutes of 90% of the Canadian population? How about a company that has an advertising flyer that is read every week by two out of three Canadian men? Canadian Tire's nameplate store has grown its strong franchise over its 90 year existence. Over these years Canadian Tire, the corporation, expanded to acquire Mark's Work Warehouse (Mark's) in 2001 and more recently FGL Sports. FGL Sports has a significant presence in sports with its Sport Check and Sport Expert banners. Even after running these businesses for many years, there is still very respectable earnings growth as shown below.



Source: Capital IQ & QV Investors

The sales growth in Mark's has recently slowed due to its high exposure to Alberta and to the decline in highly profitable industrial work wear sales. However, since Canadian Tire acquired Mark's in 2001, sales and profits have more than doubled.

There was a lot of competition concern to Canadian Tire's business when US based Wal-Mart and Target entered Canada. This risk did not materialize and the franchise strengthened as Canadian Tire focused on products that did not overlap with these competitors. Most people think of the retail operations of Canadian Tire, but a more recent focus has been on promoting its auto servicing business that has 5,500 service bays across Canada. This is a business that is hard to replicate and provides a safeguard against falling in the gutter.