QV UPDATE

Weekly Commentary | June 17, 2016

Ryan Watson, CFA

Resist the Urge to Pay More

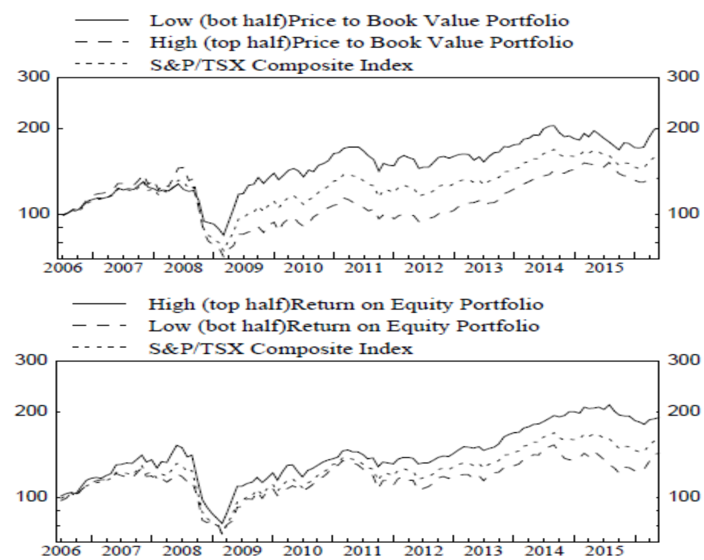
What comes to mind if you were asked to name a high quality business? We have posed this question several times in meetings, and we hear many of the same companies mentioned each time, including "Starbucks," "Apple," and "CN Railway." There's nothing wrong with this outcome, nor is there just one good answer. I like this question and the responses it collects because they make me reflect on the best companies and why QV may, or may not, own them. Let me share an example.

I believe one of the highest quality businesses in Canada to be Dollarama, the nation's largest dollar store operator. The company has delivered consecutive years of double-digit earnings growth since its October 2009 initial public offering (IPO). Impressively, this accomplishment has been achieved entirely through reinvestment in new stores, as opposed to acquisitions. The cost to open a store is the same today as it was seven years ago, while the average sales per store has improved by 8.0%. Talk about efficiency! Dollarama is amongst the top five businesses on the TSX with a five-year average return on capital in excess of 15.0%, and its balance sheet remains healthy.

How come QV has never held a position in this wonderful business? We initially underestimated the strength of this company and the organic growth opportunities that laid ahead. Now, with a store network nearly twice as large, and price points that extend up to $4.00 from an initial maximum of $2.00, the runway is more muted. Yet, Dollarama's business keeps pressing on and its stock price continues to defy gravity, having appreciated 837% since the IPO. The valuation multiple for owning this business has expanded for seven years from 18.0x earnings to 26.0x. Interestingly, the valuation rising to new highs has coincided with the highest volatility we have seen in its share price.

When do you abandon value and pay up to own the best businesses? Buying the best businesses without an adequate margin of safety diminishes the power of compounding earnings. The reality of today's somewhat expensive market is that it is costlier to seek safety in companies with the highest quality earnings. Record low interest rates have led investors to pay more for today's earnings, and also for growth well into the future. This has stretched valuations and pushed out the timeline to generate a meaningful return. Perversely, investing in a high quality company today may reduce the defensiveness we typically seek from additions to our portfolio.

So, "value" as a discipline isn't broken? Good value, in our minds, does not necessarily mean "deeply discounted." Rather, it is a level where we can earn an above-average risk-adjusted return over a reasonable period of time. Market conditions have become quite challenging in which to find value opportunities, but they do exist. Keeping with a strategy for the long haul is tough, especially when it falls out of favor. But studies, like the one below, support how the construction of a portfolio with below-average valuation (top, solid line) and above-average profitability (bottom, solid line) can lead to long-run outperformance.



Source: BMO Capital Markets

Many great companies do not meet our criteria for investment today. However, like a time tested investment strategy, great businesses can also temporarily fall out of favor. Using history as a guide, the best businesses eventually go on sale after investors lower their safeguards. For now, resist the urge to chase high quality at any cost, and instead, focus on the long term benefits of a sensible strategy.