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Remember to look under the hood

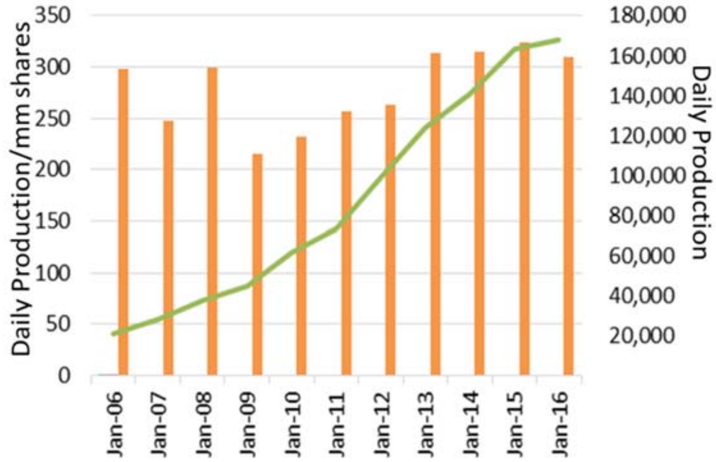
Buying a stock can be similar to buying a used car. You see that cherry red coupe, and right away you think it's the one for you. But the more disciplined part of your brain knows that an inspection is necessary. It may look shiny and fun on the outside, but that engine growl might be the car's call for help.

I have seen shiny charts in presentations where the growth has been tremendous and management's pitch is it will continue indefinitely. One specific commodity producer, which we will name Company ABC, fits this profile. If we review its ten-year history, ABC has increased its production at a 23.3% compound annual growth rate (CAGR)! This is shown as the green line in the chart to the right. A more relevant metric, in our view, is the production per share (PPS), shown by the orange bars in the graph. Growing PPS means more value is being created because each share has more production associated with it. In a stable commodity environment, this would also lead to improved cash flow. A fantastic way to grow PPS is using internally generated cash flow to fund exploration programs or acquisitions. When we examine the PPS growth of ABC, we see it has a CAGR of 0.4% over the same ten-year period. Not a very good record. Upon further inspection, we can see that the production has grown as a result of many acquisitions where share issuance has been the source of funding.

Furthermore, ABC's balance sheet has been managed with a higher than average debt level compared to its peers, which has resulted in more volatility in the share price, and dividend cuts when commodity prices have declined. The production is concentrated in one area of North America, which carries less political risk, but could present difficulties with moving the commodity to market. This could pose a risk to cash flow. The management are shareholders, but they are compensated more from salary than from share ownership, suggesting incentives may not be aligned. The quick check of the paint does not show some of the rust under the hood.

The best car my wife and I owned was a Honda Civic Hatchback. It was cherry red. It wasn't a sports car, but it was inexpensive, and it only sipped gas. It reminds me of another commodity producer (Company XYZ) that we have owned in the past, which is almost the polar opposite of ABC. Not that polished, but it sure runs well.

Company ABC



Source: Company Documents, Capital IQ & QV Investors

XYZ has commodity production on three continents. This reduces the correlation of product prices and usually provides more stable cash flows. The ten-year growth rate on its production is 11%, basically half that of Company ABC. The difference is when we look at the PPS growth for XYZ, which has a CAGR of 5.9% versus 0.4% for ABC. We could stop at our analysis here and say that it has better PPS growth, but there is more when we look at how the cash has been used. For one, XYZ used cash flow to maintain a well-financed balance sheet. From 2003 to 2013, it kept debt at less than 1.2X cash flow, which is at the lower end of most producers. It also provided XYZ with flexibility when the commodity price dropped. XYZ did not have to raise equity, sell off assets, or cut the dividend. XYZ has actually grown its dividend over the last ten years. XYZ's lowest dividend yield was 3.2% over this period while ABC cut its dividend three times!

In terms of returns, what has this Honda Civic of the market given you? If you invested $100 in XYZ on February 28, 2007 and reinvested dividends in new shares, your investment would be worth $292.10 today. For ABC, it would be $178.57. What initially looked like a "shiny" investment opportunity in ABC was revealed to be a lemon upon a detailed inspection. On the other hand, XYZ passed the inspection with flying colors.