QV UPDATE

Weekly Commentary | July 14, 2017

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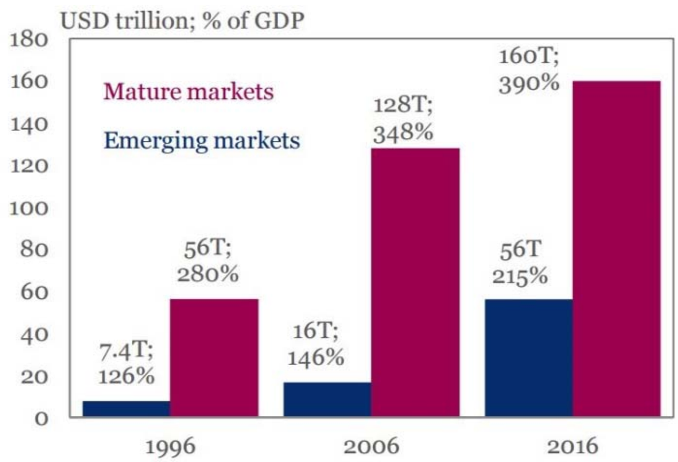
Sitting (& Staying) in the Driver's seat

Overextended retailers such as Sears and Neiman Marcus have been in the news recently as they reinvent themselves to deal with accelerating industry changes while managing sizable debt loads. Such examples highlight the altered margin of safety that investors must account for when companies utilize debt to magnify financial returns.

Debt related risks are not isolated to corporates, as there has been a substantial increase in leverage within the global economy over the past two decades. In 2016, combined government, corporate and household debt hit a new record of US $215 Trillion. This trend has progressed in Canada as well with record consumer debt levels that have been well publicized. While it continues to be unclear if debt levels are a harbinger of a financial shock, at a minimum, repayment of debt will apply downward pressure on future spending domestically and abroad.



Source: Business Insider (Institute of International Finance, BIS, Haver)

The recent rate hike in Canada also highlights growing constraints on cash available to repay debt and the heightened vulnerability of borrowers to rapid unexpected changes. From both a company specific and financial market perspective, the widespread use of low-cost debt has increased risk.

We view these developments with caution, as equity investors' claims on businesses are typically the last in line to be compensated if difficulty arises, behind senior debt, subordinated debt, convertible debt and preferred equity holders. More often than not, equity holders are also first in line to bear capital losses. Among other losses, the forfeiture of control also magnifies downside for equity holders. During financial distress, courts and creditors are able to take the steering wheel to find solutions which prioritize creditors' rights.

While a company's Debt/Equity and Debt/Cashflow metrics can look benign in healthy times, they are fundamentally trailing metrics. Significant changes can and do occur in shorter than anticipated periods across many industries. Industry developments such as accelerating online sales growth and changes in the price of oil since early 2016 have increased risks for companies in these sectors. These examples highlight the pace at which a seemingly solid credit position can change by an inherently unpredictable factor. Pengrowth Energy's aborted asset sale earlier this week is a timely illustration. The sale was intended to improve Pengrowth's balance sheet, but when the agreed counter-party reportedly could not secure financing, the firm was left suddenly exposed.

It is not a desirable outcome, whether driving a vehicle or operating a business, for the back seat driver to wrest control of the final destination. We believe the risk of levered balance sheets and loss of control to equity shareowners can be underappreciated, principally as the loss of control can result in value destruction for business owners. A creditor's right to dictate asset sales to recover exposures (which can be a fraction of the asset's market value), or forcing assets to work to cover interest and principal payments with no regard for replacement costs, are instances of a business owner's equity held captive.

We are not adverse to effective use of debt by companies' management teams, or as part of a sound business case to augment returns and minimize shareowner dilution. However, respecting the difficulty in forecasting, we strive to manage balance sheet and loss of control risk for an unpredictable tomorrow within our clients' portfolios. As a result, in an area like the technology sector, which is often susceptible to rapid transformation, the management discipline and debt free balance sheet positions of QV holdings like Evertz Technologies and Solium Capital are important investment attributes. Across our mandates we continue to be focussed on preserving a margin of safety, by striving to ensure creditors and back seat drivers are where they should be (strapped in safely), or even better, not in the vehicle at all.