

QV UPDATE

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Risks and Consolidation

As the bull market continues to age, we are now seeing a relatively lower risk appetite from investors around the world. Recently, one of our trusted partners sent us a graph of bond yields for China Evergrande. The company is one of the largest real estate developers in China and issued a five-year bond yielding 4.3% in February and less than a year later the yield has doubled. If the largest property developer in China is going to have a significantly higher cost of capital down the road, it does make you wonder what will happen to its competitors with less scale and resources. Consider also the negative consequences to the recent bondholders.



Source: Bloomberg

Consolidation Throughout the World

Another aspect of the cycle that has become more prevalent in the recent past is that companies are focusing on mergers and acquisitions (M&A) to grow their businesses as organic reinvestment opportunities have been, to an extent, exhausted. In an August 2017 paper by Grullon, Larkin and Michaely, they highlight the increasing levels of market share of leading firms in many US markets over the past two decades. They also note that leading firms often tend to have higher profit margins and more success with M&A. In some cases, we have seen industries consolidate through M&A while in other cases organic growth has led to steady gains in market share.

We have often found consolidation to be a positive for a company's return on investment going forward. In many cases it appears that more consolidation drives higher utilization rates, a better pricing environment and

stronger negotiating power over suppliers. Furthermore, firms that have operated with fewer rivals have tended to be less sensitive to macroeconomic shocks than firms operating in a more competitive environment.

AutoZone, an auto parts retailer and QV Global Equity Strategy holding, is a company that has benefitted from similar industry changes. Through a combination of M&A in the industry and market share gains from independently owned and operated auto parts retailers, the top 4 companies have grown their market share from ~20% in 2011 to ~25% in 2017. Over time, this has resulted in better credit terms and pricing from auto parts manufacturers and improving margins over much of the past 10 years. We continue to believe AutoZone is attractively priced given its reinvestment opportunities and long-term growth prospects.

Samsung Electronics is also a QV Global Equity Strategy holding and another example that has benefitted from consolidation. The company is a leading manufacturer of Dynamic Random-Access Memory (DRAM), a market that has historically been very fragmented with over 15 players involved and industry profitability has typically been depressed. Over the past 10 years, consolidation in the industry has reduced the number of competitors to just 3 core companies operating in the market. This has resulted in more muted market cycles and higher profitability at both peaks and troughs in the DRAM market. We believe Samsung remains attractively valued given its industry leading market position along with a forward P/E multiple of ~5x.

While we have seen consolidation in some markets around the world, this isn't the case for all sectors and industries. In Canada, we saw a relatively high influx of new entrants into the marijuana industry ahead of changing regulations. In the USA, we continue to see an influx of new television streaming apps as old mediums of consuming TV lose market share. Quality characteristics can quickly be eroded when a new entrant aggressively enters a market and perceived value may be just that. At QV, we try to keep a close eye on competitive dynamics to manage this risk in our portfolios.