QV UPDATE

Weekly Commentary | March 15, 2019

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Not All Headwinds are Bad

Following a tough year for global equities in 2018, rebounding stock markets seem to be shrugging off prior concerns. Strong year to date equity returns in Canada have been in-line or better than international benchmarks, despite negative sentiment related to investing in Canada and the energy complex. Headlines on the Canadian housing cycle, high debt levels and the demise of the energy sector have been common in international and domestic press coverage. We won't recount them all, but recent headlines include Bloomberg's "Pipeline Delays Stymie New Growth in Canada's Oil Sands" and Reuters' "Norway's Wealth Fund to Drop Oil and Gas Stocks."

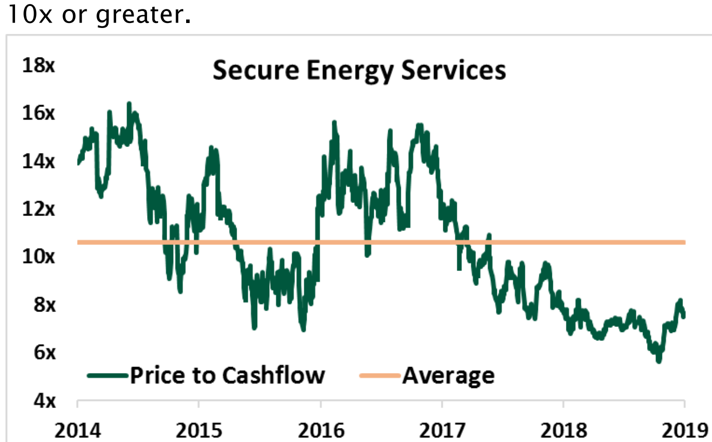
In late 2018, a sizable US-based investor penned a letter to the Canadian government citing lack of competitiveness as a key factor for investors shifting to international jurisdictions. This highlights a trend and a headwind, as both domestic and international investors shift focus and/or assets to international markets. We believe diversification should be a consistent investing priority and, indeed, gradually increasing exposure to global equities within QV's balanced strategies remains a goal.

However, despite the headwinds, we also believe good opportunities can sometimes be presented when real and perceived challenges abound in a country or industry. While we cannot predict resolutions for all of the issues Canada's economy faces, we strive to capitalize on individual businesses that may be on sale at a time when expectations are excessively low. Given the headlines, the Canadian energy space may very well provide some of these select opportunities.

Take Secure Energy Services, for example. Although it is never easy to experience an annual share price decline of ~21% from any QV holding, the company's key operating performance metrics were satisfactory over the year. Secure's recently reported annual results demonstrated 14% growth in cash generation from $0.96 per share to $1.09 per share. Additionally, over the past two years, Secure has expanded its number of midstream facilities from 39 to 51, an average annual growth rate of 14%. Demand for these services should be favorable as Secure provides important recycling, treatment and disposal services amongst other logistics and marketing services.

Commodity price declines and drilling activity are going to bounce around and, to be sure, companies like Secure will have to manage throughout the cycle. However, under the hood, there appeared to be incremental reductions in risk in 2018 as well. Operationally, Secure's cashflows have become increasingly related to recurring production, which provides some mitigation from swings in new drilling activity. From a balance sheet standpoint, despite the asset growth, the firm's leverage has been stable. Importantly, we expect it to remain stable, as the ~$120mm capital program for 2019 should be predominantly funded through internal cash generation, which amounted to ~$174mm in 2018.

Although Secure's share price was disappointing over the year, we believe companies' share prices should converge with their operating performance over time. At a current price to cashflow (P/CF) multiple of ~7.5x, valuation risk is in-line or better than at this time last year. Additionally, Secure trades at a discount to both global oilfield service providers and Canadian midstream companies, which trade at a P/CF of approximately 9x to 10x or greater.



Source: Capital IQ

When negative sentiment and headwinds arise, we focus on company-specific opportunities by drawing back to fundamentals. We continue to focus on allocating capital as guided by our risk management process, deploying capital in businesses where we believe there to be attractive return potential in relation to the risks taken.