QV UPDATE

Weekly Commentary | April 12, 2019

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The Seven Tests Framework

What a difference three months can make! The S&P/TSX Composite Index went from bottom to top performer amongst major global indices in the three months ending March 31st, 2019. Many of the same macro level issues are yet to be resolved, but investors found comfort in central banks' decisions to sustain accommodative policies for the time being. Once again, yield hungry investors were quick to respond by pushing up equity valuations from their December lows. With the P/E ratio of the TSX back up to its long-term average of 15.9x (or higher, considering the financials sector pulls this ratio down by three turns), we need to search a bit harder for areas to deploy cash.

With Canada's energy sector starved for capital, a high level of uncertainty around Brexit, and slowing global growth projected by various economic organizations, we believe there is an opportunity to invest [again] in Finning International. Finning operates a network of heavy equipment dealerships in Western Canada, the UK, and South America. It is best known for its sales, rentals, and servicing of machinery under the Caterpillar brand. Due to the geographies it serves, Finning's business tends to be more cyclical compared to its Eastern Canadian peer, Toromont Industries. (Toromont is currently held in QV's Small Cap and SMID strategies at a below-average weight).

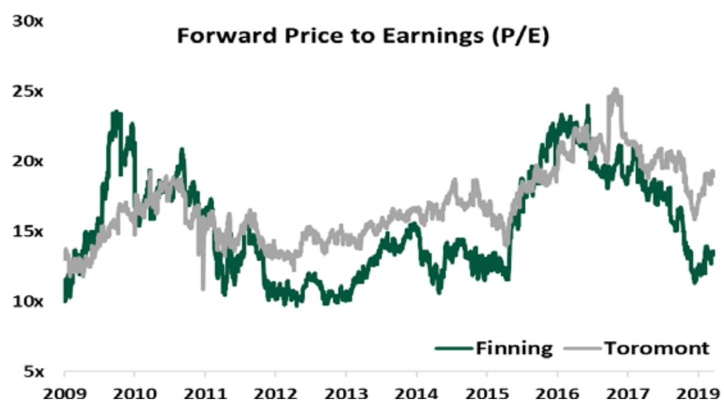
	Jun-17	Jan-19	Direction
Management	✓	✓	↑
Financial Record	≈	✓	↔
Franchise & Outlook	✓	≈	↔
Balance Sheet Strength	✓	✓	↑
Valuation	X	≈	↑
Capital Allocation & Dividend	✓	✓	↑
Portfolio Enhancement	≈	✓	↑
Portfolio Weight	*0.0%*	*1.5%*	

✓/≈/X: pass/fair/fail; ↑/↔/↓: improve/neutral/weaken

To overcome biases formed when a business was originally bought or sold, and to review changes to the business that may have developed since, QV employs its seven tests framework. The snapshot above illustrates our assessment of Finning when we exited in June 2017 and when interest was renewed in January 2019. In addition to how a company fairs in the listed categories, the analysis evaluates how these criteria evolve over time ("Direction").

Finning's management team has delivered on dealership network efficiencies, and through systems and technology we believe this should continue. While its financial record has displayed some short-term strength, we fully expect the long-term record to show cyclicality – it's the nature of this business. The franchise has proven its durability, having been established in the 1930s, but this is offset by a subdued near-term outlook caused by slowing economic growth and reduced spending by customers. The company's leverage ratios remain at reasonable levels when we stress on the downside, and as the business has improved, the dividend has grown.

Finning's valuation is below-average on several measures, but we know it can get cheaper as global growth wanes. Though we believe Finning's shares should trade at a discount to Toromont's over time, it is difficult to ignore how wide the valuation spread has become. Over the past decade, this spread has tended to converge – whether by Finning's multiple moving up, Toromont's moving down, or the two meeting somewhere in between.



Source: Capital IQ

It is least apparent in a broad-based equity rebound like we've just had, but investors can and will overlook certain areas of the market at any point in the cycle. This is where value can be found. All things considered, as we run through QV's seven tests, we believe it is a reasonable time to be owners of Finning.