QV UPDATE

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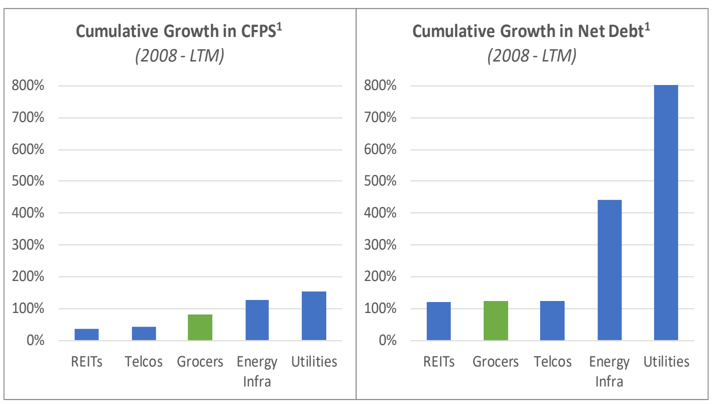
Diana Chaw, CFA I Darren Dansereau, CFA

QV Investors Inc.

On Independence

In the era of ultra low to negative interest rates, you might think the idea of a self-reliant business that generates excess capital is an outdated concept. After all, why bother generating cash flows in excess of what you need when money is so cheap? Low interest rates aside, we have seen valuations expand for companies that demonstrate an ability to grow without too much reliance on external debt and equity markets, even in the case of slower growing businesses. We also concur that the ability to be independent and self-funding holds value in all market environments.

While we hold many non-cyclical names in our portfolios, we hold a meaningfully larger-than-index weight in several grocers, including Empire, Metro and Loblaws, depending on the fund. Admittedly, the growth record of grocers isn't particularly exciting. Cash flow per share (CFPS) growth has averaged 80% since 2008 (see chart below), well below the growth of energy infrastructure and utilities.



Source: Capital IQ

Despite the relatively slower growth record, we have continued to see grocer valuations expand in the last year. This is partly due to a flight to stability, but also because we believe the grocers are in the envious position of having largely "self-funding" business models. For example, from 2008 through mid-year 2019, growth in the grocers' debt levels averaged 120% compared to 80% growth in cash flow per share metrics – that is, debt outpaced earnings, but arguably not by too much. Contrast this profile with energy infrastructure, for example. Cash flow per share has grown a healthy 126% since 2008, but debt has grown by over 400%. On the other hand, over the same period, Metro, whom we believe to be the strongest grocery operator of the group, has shrunk its share count by 24% and grown its debt by 162%, while doubling its cash flow per share.

The desire for lower reliance on debt and equity has been a theme that continues to extend to different industries. For example, in the QV Canadian Large Cap Equity Strategy, we hold both TC Energy and Enbridge. Both companies have grown rapidly since the financial crisis, funded with significant amounts of share and debt issuances. 2018 marked a pivoting year for Enbridge as the company completed asset sales, paid down debt and guided to a more moderate long-term pace of growth. That is, growth that can be achieved with less reliance on equity and debt – a "self-funding" model. TC Energy is proceeding down a similar path this year and has announced several major divestitures to pay down debt while pursuing good, but moderating, growth into the future. Admittedly, the term "self-funding" is somewhat misleading for Enbridge and TC Energy – both companies will still be regular issuers of debt to fund future growth since cash flow from operations will remain insufficient to fund all their capital projects. However, the ability to become less dependent on external markets is still important regardless of the availability of capital. We believe a company's ability to generate enough capital to fund its growth without much reliance on external markets is a positive competitive advantage.

The need for external capital is by no means a deal breaker for us – we still hold sizeable weights in many other non-cyclicals, including those that continue to rely on external markets to fund growth. But, overall, we are encouraged by the improving levels of "financial independence" amongst several of our portfolio holdings. We believe this model for growth is more sustainable and defensive over the long term.

[1]Growth calculated as a simple average of the three largest names by market cap in each segment. Energy Infrastructure: ENB, TRP, PPL Utilities: FTS, EMA and BEP.UN; REIT: REI.UN, CAR.UN, HR.UN; Telco: BCE, RCI.b, T