QV UPDATE

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The Stories We Tell

"There's nothing in the world more powerful than a good story. Nothing can stop it. No enemy can defeat it." – Tyrion Lannister (Game of Thrones)

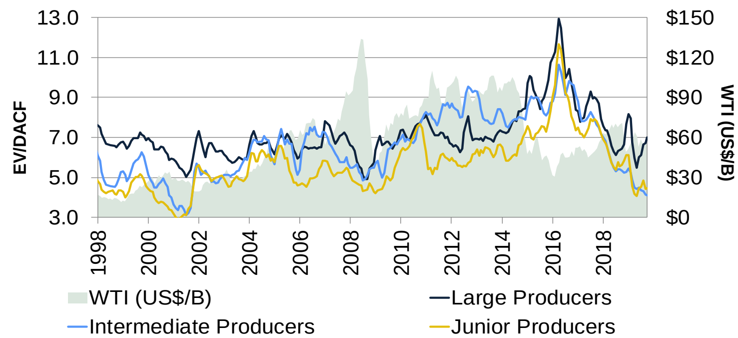
Just like in Westeros[1], in the world of investing, nothing is more powerful than a good story. Company X is a "growth" story; Company Y is an "acquisition" story; Company Z is particularly unique, a true "turnaround" story. We too, invest in companies with good stories to tell – stories about competitive moats, cost advantages or the ability to turn a mediocre business into a better one.

But what about stories that *are* just that – narratives not based in reality? In late 2017, Canopy Growth's (WEED) shares traded at $20 and the story of exponential growth that would last for years, maybe decades, was exciting. Two years later, WEED shares have made a round trip, peaking at $60+ before losing 2/3 of their value to wind up at approximately the same price ($23).

If the story of investing in the cannabis industry was the happy and optimistic tale everyone liked to talk about, the story of Canadian energy in the last five years rivals that of a classic Stephen King horror novel. The world has gone from an era of hydrocarbon scarcity to an era of abundance – there are even talks that we may be entering an era of hydrocarbon irrelevance. Canadian energy producers have all been painted with the same brush – terrible allocators of capital, poor stewards of the environment and owners of increasingly uncompetitive or irrelevant asset bases. Just like the too-rosy story of cannabis, we believe the overly cynical story of Canadian energy is also not tethered to reality.

It's true that many Canadian energy producers have historically been empire builders rather than wealth creators. However, we believe the largest producers in the Western Canadian Sedimentary Basin are well-managed companies with management teams that share similar philosophies with us. A common valuation measure is an energy producer's total enterprise value (value of market cap and debt) divided by its projected annual cash flow. The industry average of this multiple is back to 1998 levels (see chart at right) – a time when market sentiment towards "old industries" was also extremely poor. Our criteria for Canadian energy investments do not differ from other investments – we look for management teams that are focused on profitability and maintaining appropriate levels of debt for a cyclical business. We are not macro forecasters – we don't have an internal "price deck" for oil in our modelling, but we seek to invest in competitive assets and capable management teams.

Large, Intermediate, and Junior Producers
EV/DACF – Fwd Year Est (3 Mo Avg)



Source: Peters & Co. Limited estimates.

In the QV Canadian Equity Strategy, we own Suncor, an integrated oil sands producer. While the world is now apparently in an era of hydrocarbon abundance, we note that Suncor's oil sands assets are some of the most cost competitive in the world, with cash flow break-evens at an oil price in the low $20s (WTI). Organic growth in production has been anemic on account of the lack of pipelines, but lack of growth opportunities has meant abundant cash generation, which Suncor has been returning to shareholders. In the last twelve months, Suncor has increased production by 2%, bought back 4% of its shares, paid out a dividend yield of 4% and repaid $1.2 billion of debt (equivalent to ~1.8% of market capitalization). In a time where growth valuations are stretched and investors are willing to commit capital to stories that consume rather than generate cash, the fact that Suncor can generate over 10% of its market capitalization in free cash flow each year is something we find attractive. We also note that Suncor's dividend yield is at record high levels while cash flow valuation metrics are 13% below long-term median levels. Oil sands are greenhouse gas intensive operations and certainly there is more work to be done on this front. We are happy that Suncor (and many of its peers) has committed concrete efforts to lower its carbon intensity over time – Suncor specifically has a goal to reduce its emissions intensity by 30% by 2030[2].

Stories are powerful, but not always accurate. Where reality and storytelling diverge in the market, we see opportunities.

1. Westeros is the fictional country in the novel *Game of Thrones;* 2. https://sustainability.suncor.com/en/climate-change/ghg-goal