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QV Investors Inc.

Capital Preservation - Again

A new year usually brings with it new goals and resolutions. For most a universally common goal is to get more fit, or to lose weight. At QV, one unchanging goal is capital preservation. Unfortunately, capital losses come much easier than weight loss. Regardless of an individual investor's estimate of long-term equity returns, regaining lost ground is a prolonged struggle. For example, a 20% decline in a portfolio requires a 25% return to reach break-even. A larger loss of 50% would require 100% appreciation.

Given the difficulty of regaining lost capital, measures to avoid investment losses are paramount to QV's investment philosophy. An important way to measure risk in a company is through the balance sheet. More specifically, the risks associated with debt levels in relation to equity and cash flows. The downside to equity investors when a company uses debt can come in a number of different ways. Firms that are dependent on debt for growth are subject to a creditor's willingness to lend. As many can attest, banks are happy to provide access in good times. However in tough times, not only is the funding tap closed but repayment may be demanded. With limited access to funding, growth initiatives are often put on hold resulting in lower expected earnings and potentially investment losses.

Reduced growth is only one potential outcome. Debt repayment obligations can put pressure on cash flows and change capital allocation priorities to benefit credit holders at the expense of equity holders. Management teams may be forced into decisions that can impair long-term value creation. These include selling assets at depressed values, diluting shareholders through equity raises, and cutting staff or dividends to meet interest payments. When times are good, the probabilities of these dire scenarios are often discounted by the market. As seen recently, circumstances can change quickly. Due to commodity price levels, the energy sector's revenue and cash flow expectations for the upcoming year continue to decline. Canadian GDP growth projections have followed suit, as energy focussed provinces suffer.

The surprise Bank of Canada rate reduction, on the premise of a weaker economy due to lower oil prices, highlights how tenuous budgets can be. This is even more so for oil patch related firms, where investments are forecasted to see a 33% reduction. QV's energy holdings consist of firms with balance sheets that we believe will be strong enough to weather this downturn. Many of our businesses have either net cash positions or reasonable cash flow support at lower commodity prices to avoid having lenders force inopportune corporate actions.

Despite the dangers, debt can be an effective funding source for business improvement. Thus teams that respect the downsides of debt are sought after. We have found that management teams, who invest alongside equity investors, are often motivated to temporarily employ debt for longer-term value creation. QV holding, Empire Company, issued $3.3 Billion (Bn) in debt to help fund their $5.8 Bn acquisition of Canada Safeway in November 2013. The economic rationale for the deal was strong; it would add scale, quality Western Canadian locations, and cost reductions. A pathway to reduce debt with the growth in cash flows and management's willingness to repay was also clear. As of November 2014, good execution has allowed Empire to repay close to $1.2 Bn of debt, through realization of greater than $100mm of synergies and rationalizing its assets. We recently met with the team at Empire and they reiterated their goals. The company is committed to achieving their targeted $200mm in cost savings and reducing debt further. These goals seem attainable, as plans to improve distribution and logistics and reduce marketing and administrative costs are in place.

Each QV equity mandate maintains better balance sheets than their respective benchmark. Along with ensuring a valuation discount and better growth metrics, our risk management and investment process is driven by the end goal, to preserve and grow capital over time for our clients. While this doesn't ensure share price performance, it does speak to reduced probability of permanent capital loss.