QV UPDATE

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Small Caps – More than meets the eye

Sector diversification is not the first theme that comes to an investor's mind when thinking about Canadian small caps. This is an understandable assessment with close to half of the market concentrated in junior energy and materials companies. In addition, smaller cap stocks have historically felt amplified pain/benefits from the changes in oil prices and global demand for materials. This view is further entrenched by the relative underperformance of resource Canadian small caps against their larger counterparts in the past six months and year. However, the Canadian small cap market is deeper than simply highly volatile, resource related investments. Two prime examples of sector diversity in the small cap space are recently reporting QV holdings, Information Services Corporation and WSP Group.

Classified as a financial sector holding, Information Services Corp (ISV) is a high quality non-resource Cdn small cap investment. ISV derives its revenues from providing registry services to one province, Saskatchewan. While the geographic concentration could be a concern, ISV's operating model mitigates this risk through two key factors. ISV runs Saskatchewan's land title, corporate, and personal property registries, generating flat and value based fees on transactions. While transaction levels can change, the underlying services are essential, regardless of economic times. Secondly, ISV is the exclusive provider of these services for the next two decades. Despite its largely captive market, management's focus on customer service is refreshing. As is their high profitability at 23% net profit margins versus the BMO Small Cap benchmark in the 3% range, and the S&P/TSX at close to 8%. With its growing net cash, at 8% of its market cap, and well supported 4.5% dividend yield, ISV is poised to weather any downturn and capitalize on any opportunities that might arise. ISV also enjoys some built-in inflation protection, given its ability to pass on CPI increases.

Part of the industrial sector, in 2006 WSP (formerly Genivar), led by CEO Pierre Shoiry, was a Quebec based engineering firm generating $167mm in revenue. While not the typical Cdn small cap company deriving cash flows from commodity prices, it also had a very geographically concentrated business. The company went public in 2006 with an ambitious plan to diversify its revenue base, primarily through acquisition. Throughout the past 8 years, Mr. Shoiry and his team have far surpassed their initial plan to grow Canada wide. WSP has grown from a Quebec centric firm of roughly 1,800 employees to a global engineering firm employing 32,000 people. At year-end 2014, the run rate revenue for WSP was $5.2bn, including the results of its most recent US focussed acquisition, Parsons Brinkerhoff. Debt has been held in check with a 39% Debt to Equity ratio at year end, despite strong growth. WSP has grown EBITDA per share (a cash flow proxy) from $1.37 in 2006 to $3.96 in 2014, a 14% annual growth rate over the past 8 years.

Although the financial results have been exceptional, the path hasn't been easy. The team has also navigated a very challenging environment in Quebec and Ontario the past few years. Rebranded as WSP, the firm's diversity will pay dividends in 2015. WSP's western Canadian operation faces declining activity from its energy focussed customers, as the rest of the business progresses. Eastern Canada is improving and more importantly, close to 80% of its revenues are generated outside of Canada. Going forward, WSP could be hard pressed to match its historic growth rates, but we believe it continues to be a solid investment. Irrespective of the sector diversity it offers, WSP maintains a strong balance sheet, excellent business model, and well supported dividend yield of 3.6%.

Sector diversity continues to be an important risk management tool at QV. However, merely rotating into hot and avoiding cold sectors is a losing proposition for an investor. Our investment decisions are driven by an evaluation of each company's individual risks/rewards prospects within the context of the current portfolio's return profile and existing sector exposures. More than simply resource stocks, we believe the Canadian small cap universe continues to offer opportunities to own a portfolio of diverse businesses that can compound through the ups and downs of ensuing cycles.