QV UPDATE

Weekly Commentary | February 28, 2014

Darren Dansereau, CFA

QV Investors Inc.

Paint Drying

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas" - Paul Samuelson, Economist.

In a recent meeting with a market strategist, we were discussing the market's desire for earnings growth. With muted inflation and slower economic growth around the world, revenue growth has been challenged. Earnings growth has been propped up by one of or the combination of mergers and acquisitions, share buybacks, or cost cutting.

An example of a classic growth company is Valeant Pharmaceuticals. Valeant has been on a tear spending $15 billion on twenty acquisitions over the past two years. This has resulted in the revenues growing by 236% over this two year period and earnings growing by 213%. Management has stated they want to be one of the top five pharmaceutical companies by market capitalization in the world by 2016. In our opinion, this is a yellow flag. Profitability should be the focus, not size. There is no doubt these are impressive growth rates and the stock has surged over 110% in 2013 and 32% year to date.

The only problem with companies like Valeant is how this growth is achieved. Valeant has used debt to acquire and has amassed a huge debt position of $17 billion, which corresponds to a debt to expected 2014 cash flow level of 7x. The D/CF of the TSX Composite as a comparison is 2.5x. In terms of valuation, Valeant trades at a price/cash flow on 2014 guidance of 18x, which is significantly higher than the TSX at 8x.

Watching this company in action is the opposite of watching paint dry! If there is any hiccup in the growth rate, if one of the acquisitions does not deliver the results that are anticipated, or if it becomes harder or more expensive to borrow in the bond market, the downside on this business could be significant. The rewards have been great, but they come with considerable risk.

On the flipside, most people would say watching Canadian Tire operate is like watching grass grow. As a shareholder, when we see how well the team has executed their growth plan, we get pretty excited.

The one year anniversary of Target entering Canada is next week. It was heralded as a significant blow to Canadian Tire because there was 30% product overlap in the two businesses. Many analysts and portfolio managers were predicting declines in the Canadian Tire business. This was the same incorrect concern expressed when Wal-Mart entered in 1994.

Looking at what Canadian Tire has done has been impressive. In meetings with the management team, they outlined how they went product by product to determine the overlap with Target. If the company didn't feel they had an advantage, they removed the product. However, if Canadian Tire decided to be in the product category, they adjusted their offering to have different price points than Target. This was not accomplished over night, but methodically.

Canadian Tire had been targeting growth in the sporting goods category and acquired the Forzani Group. This gave Canadian Tire the opportunity to improve its volume of buying in the sports categories (lowering costs), and provided them with the ability to offer sports gear to the beginner at Canadian Tire and then more advanced sports enthusiasts at Sport Chek.

Canadian Tire recently released 2013 numbers and it would be hard to notice the effect of Target's entry. Canadian Tire stores open for at least one year increased sales by 2%, while Sport Chek stores increased by 10%! The earnings for Canadian Tire were up 9% for the year, and in the third quarter the dividend was increased 25%. Now the stock did not return 110% in 2013 like Valeant, but it did return 43% without taking nearly as much risk. The 2014 P/CF of Canadian Tire is 7x, lower than the TSX and much lower than Valeant. Debt to cash flow is 3x, a reasonable level and it pays a dividend of 2%. A market focused on growth may result in our companies underperforming the fastest growing companies. Our goal is to find companies with a sustainable growth model. We find this in businesses with prudent management, well-financed balance sheets and valuations that limit the potential downside.