QV Investors

QV Update

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Cash (Flow) is King

Repeatable performance over the business cycle is an emphasis of security analysis at QV. Questions on business performance in past downturns, and most importantly, business performance over the next cycle are important considerations.

Interestingly, along with our clients, we ask ourselves similar questions. Our aim is to preserve and grow client assets via a repeatable process. As a result, drivers of past portfolio performance need to be contemplated. In the past year, the top performing investments in the QV Small Cap portfolio have engaged in corporate activity. Businesses have either made significant acquisitions or in the case of E-L Financial, sold an underperforming division. Recently, two of our holdings received acquisition offers at big premiums to their trading prices. The stocks of both Paladin Labs and Aastra Technologies have increased over 50% during this period.

We know we cannot depend on future take-outs and acquisitions to drive performance. However, we can control the investment process and the price paid for investments. The security selection process and emphasis on cash flow generating capability, key elements of the thesis for owning both Paladin and Aastra, will persist indefinitely. The challenge in today's market, is not overpaying for these opportunities.

Mr. Buffet, a great investing mind of our time, coined the term 'owner's earnings'. 'Owner's earnings' is defined as the annual cash available to owners, after factoring out the annual cash outlay required to maintain production levels and competitive position. Both Paladin Labs and Aastra Technologies have generated strong 'owner's earnings' over time, albeit in different ways.

In early 2007, Paladin's market cap was about $160mm. Six years later in 2012, the cash and short term investments had grown to $265mm from $36mm. We have not been owners since 2007, but shareholders smart enough to hang on have been rewarded. Just over $38mm in cash per annum has been returned in 'owner's earnings', or 24% of the investment per year. The team at Paladin has leveraged their unique position in the healthcare space by developing, manufacturing, and marketing late stage niche drugs. Management should be commended for managing the risks of a potentially declining pipeline of assets, while generating such impressive 'owner's earnings'. Any investor would be hard pressed to identify a team that has generated such strong cash returns, while expending such little capital. With 34% insider ownership and very little debt utilized, we are sorry to see this cash generating company go.

In comparison to Paladin's enviable record, Aastra's cash generation through cost control and allocating capital is equally impressive.

Source: StockCharts.com

In late 2008, the market cap of Aastra plummeted and traded as low as $140mm, despite $70mm in net cash. Aastra's exposure to Europe proved to be a headwind. Between 2009 and 2012 revenue declined 27%. Despite the decline, management cut costs and maintained 40%+ gross margins. Our calculation of Aastra's cumulative 'owner's earnings' generated from 2009 to 2012 is $163mm. Implying a $41mm in cash per annum return, or 29% return in 'owner's earnings'. In contrast to Paladin's growth, Aastra's leadership faced a difficult business cycle but has been similarly disciplined. Over this period, the Shen brothers, who own 14% of Aastra, paid down debt and returned $98mm in capital to owners, buying back stock and issuing dividends. In Q3 2013, Aastra provided a $85mm special dividend, returning a total of $183mm to owners in the past four years. Recently the market had valued the entire company at $140mm, reflecting how wrong the market can be.

While Paladin and Aastra were attractive assets, in looking ahead, we cannot control the prices others will be willing to pay for investments. Nor can we predict acquisitions by or take-outs of our investments. But sustainable and repeatable performance will be the outcome of controlling the investment process, seeking out cash generating assets led by aligned and disciplined management teams, and controlling the prices we pay.