QV Investors

QV Update

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Darren Dansereau, CFA

Quality Please

The firm's name was QVGD Investors Inc. when I first started here. In many meetings, people would ask Leigh Pullen what the letters meant and why he chose them. His response was he selected a name that reflected our process so that when we came into work there would be no doubt what we were looking for every day. QVGD stands for Quality, Value, Growth and Diversification. When we moved to our new office in 2007, we shortened our name to QV Investors. We did not dismiss growth and diversification, but we have incorporated them into our definition of a quality company.

Quality can mean different things, but we would agree with the Merriam-Webster definition as "superiority in kind." In reviewing a company, superiority can be viewed by reviewing its franchise value, its culture and management, and its ability to meet the needs of its customers. Quality companies are attractive to us because they typically generate a return on equity (ROE), or profitability, above that of the average company.

It is generally taught in business school that if a company has high profitability, competitors will enter the market and try to replicate the company's offering. Although a patent or other 'moat' may repel direct competition, the belief is profitability will decline as more competitors enter the arena. A study completed by asset manager GMO provided evidence against this conclusion by studying 1000 companies in the United States over a 45 year period. Companies were ranked by their ROE and separated into four groups. The group of companies with the lowest ROE were compared to the group with the highest ROE. The conclusion was that on average the most profitable companies had an 8% ROE advantage over this time period. The ROEs did not decline and those with advantages continued to be the most profitable.

There are many businesses with sustainably high ROEs; however, the opportunity to find these businesses at the right valuation is limited resulting in our concentrated portfolios.

Inside the Funds

"Quality is the result of a carefully constructed cultural environment. It has to be the fabric of the organization, not part of the fabric."

– Phil Crosby (businessman and management consultant)

We had the opportunity to meet with Mike Roach, President and CEO, of CGI Group this week. CGI is the fifth largest independent IT consulting, systems integration, and business process outsourcing company in the world. They have customers ranging from the US government to organizations such as Royal Dutch Shell and TELUS.

We originally assessed the company in 2008, but were concerned in the downturn that as companies cut expenses they would reduce their spending in CGI's niche. Many companies in an effort to reduce costs actually increased their spending on IT. As an example, they outsourced some of their systems to CGI and reduced their workforce. As a result, CGI was more stable than we originally thought maintaining its 15% ROE. We entered a position in 2009.

We believe CGI is a high quality business for several reasons. CGI culture is one area that stands out because of the intense focus on running each part of the business with its stakeholders in mind. According to Mr. Roach, monthly meetings are held to discuss two of the three stakeholders identified by management: employees and customers. At these meetings employee surveys are reviewed to measure their engagement in their roles. Engagement is typically high since 85% of employees are shareholders.

Face-to-face customer surveys are also reviewed to ensure satisfaction. Mr. Roach's idea is "to fix a problem when I see it." The challenge could be due to the contract being over budget or late, or the customer is not satisfied. Potential scenarios are reviewed and can be as drastic as trying to get out of the contract or trying to renegotiate the terms. The focus is always on trying to reduce the number of problem contracts and increase the profitability of the overall business.

CGI has acquired many businesses successfully over the years. The strategy has always been to find the right acquisition, at the right price, at the right time. In 2012, CGI purchased Logica, a UK based IT services business, which doubled the size of CGI in terms of people and revenues. Logica was also acquisitive; however, it never fully integrated its acquired companies. This resulted in selling, general and administrative costs that were 50% higher than those at CGI. Furthermore, Logica's sales people focused on generating sales only and did not consider profitability. CGI has revamped the incentive plan for sales people to focus on profitability and it has aligned costs by converting Logica to its operating model. CGI has been able to take Logica from a good business to a great business where the margins in Europe are best in class.

CGI's focus on its customers, employees and its third stakeholders, shareholders, has been a result of the strong culture of focusing on the little things. CGI makes sure its contracts are profitable, its operations are efficient, and employees are engaged.