QV Update

July 19th, 2013 Ian Cooke, CFA

We Bid Adieu to a (Shoppers) Optimum Investment

In a February QV Update we espoused the virtues of the Shoppers brand, the financial record and the opportunity for growth through increased pharmaceutical volumes in conjunction with an aging Canadian population. We made it the largest holding in the QV Large Cap Fund after initially investing in early 2011.

Our timing was fortunate. On Monday, Loblaw's announced that they will pay a near 30% premium to last Friday's closing share price to acquire Canada's largest pharmacy chain. In today's low interest rate environment, the deal should be immediately accretive. From a strategic perspective, leveraging off of each other's distribution will be difficult. Grocery volumes are almost entirely distributed by case load while drug stores, which typically have much smaller footprints and less back of store inventory, require distribution primarily on a per unit basis. We believe Loblaw's will benefit from diversifying its business into this higher growth, high free cash flow business but we do not know if combining the two will result in stronger operations.

We have reduced our investment in Shoppers Drug Mart. We have maintained some exposure, recognizing that there is potential for competing bids from others. However, our expected return today is much less than what it was in February. This leaves a bit of a dilemma for us. How do we reinvest the proceeds? Our simple answer in one word: Prudently.

Shoppers Drug Mart: 3 Year Stock Chart

Source: StockCharts.com

Do Opportunities Exist in Today's Market?

We recognize that the current bull market is now over four years old. We are aware that investor optimism is the highest it has been in years. We know broad market valuation measures are average, at best. We believe profit margins are too high compared to the historic record. Despite this backdrop, we believe there are still pockets of opportunity for equity investors. As mentioned in last week's letter, we like numerous energy companies that have attractive growth opportunities and stewardship prepared for cyclical risk.

We also feel that Canadian banks offer attractive value relative to most opportunities in the market place today. Canadian bank share prices have oscillated around break even for over two years despite both book value and earnings growing at above market rates. One of the main reasons for pause has been related towards concern for the financially stretched Canadian consumer. Like most of the market, we are also concerned about excessive household leverage but we aren't as concerned about Canadian banks.

For one, a lot of concern appears to be priced into bank stocks already. The six largest banks in Canada as a group are trading at approximately 10.0x forward year earnings. This is near the low end of their valuation range, which has averaged approximately 11.2x forward earnings since 2000. Current bank valuations also look attractive compared to the overall market place with the S&P/TSX trading at an estimated 12.2x forward earnings. Even if valuations for the banks stay supressed, with an average dividend yield of 4.1% and earnings growth in expected to be in excess of 5.0% we get paid to wait. Saying all this, valuation is only relevant if the franchises can remain strong in a difficult environment.

Consumer loan growth has slowed which has been a headwind for Canadian banks. But these are diverse businesses with strong competitive moats. Despite a slowdown in consumer loans, TD Bank (now QV's biggest weight in our Large Cap Fund), has been able to grow net income to shareholders by more than $1.7 billion over the past two years, equating to over 30% growth on a per share basis.

A recent discussion with distinguished Financial Services Analyst, John Reucassel of BMO Capital Markets has reiterated our conviction. Mr. Reucassel calls the banks underappreciated total return vehicles. He is quick to point out that half of Canadian bank assets are residential mortgages of which 2/3rds are government insured. In the worst recessions going back over 30 years, the most provisioning that has ever been required for bank mortgage portfolios has been 12 basis points (0.12%). He has run a housing crisis scenario which identifies approximately $40 billion in uninsured Canadian condominium mortgages. If provisions for credit losses reached 10% for these condos (almost 10,000 times higher than previous peak provisioning in the early 1980's), that would represent an earnings hiccup of approximately $4 billion. Not a small number, but a manageable number, in the context of an industry that generates close to $30 billion in net income per annum.

Numbers like these suggest to us that the Canadian banks are well positioned to manage through a severe housing crisis if that transpired. We have significant investments in what we believe to be Canada's strongest banks. In the QV Large Cap Fund, this includes TD Bank, Bank of Nova Scotia and National Bank. We believe these Canadian banks offer prudent opportunity for investment in today's market.