QV Update

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High Quality Assets can be Risky

The 'Q' in our name stands for Quality. The most common misperception is that the quality of a company determines its riskiness. However, it is really the price paid for a particular asset that determines its risk level and the success of that investment. Therefore, a high quality company bought at too high of a valuation can result in a risky investment with low return potential.

Let's look at a high quality company like TELUS Corporation as an example of how a change in valuation can result in a change in the potential return and risk level. TELUS has consistently focused on growing its business and returning cash to shareholders. In the downturn of 2008 and 2009, it traded at a price to cash flow of under 4.0 times. Like many companies in that period, TELUS traded at one of its lowest valuation levels ever. During this period, QV held TELUS as a top ten weight within its large cap and balanced portfolios. If we fast forward to today, we still have the same excellent company that has committed to returning cash to shareholders with a yield of 3.7%. The difference now is the valuation. TELUS' price to cash flow ratio of 7.2 times is at a slight discount to the S&P/TSX Composite Index, but is much higher relative to its historic levels. We recognize that the business has not changed, however; the higher valuation, increased regulatory scrutiny, and slowing growth have reduced the opportunity for return.

The theme of higher valuations for dividend paying companies, which are typically considered high quality, is one we have seen throughout the Canadian market and globally. With extremely low interest rates, the demand and valuations for high yielding securities have moved to above average levels. Thus creating more risk in these businesses if sentiment shifts. With speculation of rising interest rates, we have witnessed negative price reactions in interest sensitive stocks. As the spread between bond yields and dividend yields narrows, the demand for dividend paying stocks will decline and so will the multiples the market pays. With a higher probability of increased rates, we believe there is more risk associated with these high dividend payers with high valuation. We reduced our weight in TELUS and other exposures to these types of stocks. If valuations increase higher, we will need to further pare our positions.

Empire Performs a Stealth Extraction

Empire Companies Limited, the owner of Sobey's and IGA, announced an agreement to buy Canada Safeway for $5.8 billion. Canada Safeway's assets are some of the best retail locations in Western Canada and were desired by many industry players. Empire was able to swoop in and extract this leading Western Canadian operation in a deal expected to close in the third quarter subject to Competition Bureau approval.

We have owned Empire for approximately ten years and it is one of the largest holdings across QV's Funds. We are the largest holder of Empire stock after the Sobey's family, which has a significant investment of approximately $2.6 billion. We continue to hold this business because of its history of creating shareholder value. Empire has increased its dividend each year over the past 17 years and quadrupled its earnings per share over the same period.

With this transformational acquisition, Empire will become the second largest grocery operator in Canada with over 1,400 stores across the country and hold a leading market position in Western Canada. Canada Safeway's assets were purchased for 11.4 times EV/EBITDA, which is expensive relative to Empire which trades at 5.6 times. However, when synergies and sale transactions are accounted for, the multiple is a more attractive 7.4 times. Empire has stated the deal will increase earnings by 25% after all the synergies are realized. We believe this could be a conservative estimate of the true potential of this deal. As we have seen with some of our other companies in the portfolio, strong businesses such as Empire are able to find more synergies through the integration process.

We are usually concerned when a large acquisition is financed primarily with debt. However, we have comfort with Empire's discipline in reducing leverage following an acquisition. For instance, the debt of Empire peaked when it bought the Oshawa Group, a leading Ontario supermarket, at the end of 1998. The debt to equity ratio moved up to 220%, but it was quickly brought down over the next two years as Oshawa was successfully integrated. Empire may have been able to finance the Safeway deal entirely with debt, but they showed prudence by deciding to issue equity of approximately $1.5 billion. We estimate the debt to equity will be around 67% after the deal. We calculate the debt to equity level could improve to its previous level in less than five years, or sooner if the company sells some non-core assets like manufacturing plants and excess real estate.

Empire's valuation has moved up like other defence areas in the market, but not to the same extent as high dividend paying stocks. Empire pays a yield of 1.4%. The Safeway acquisition will expand the balance sheet, but Empire's large insider ownership ensures the company is focused on reducing debt rapidly. The valuation remains attractive and we are confident that Empire can pull the same levers at Safeway that has used to make Sobey's the successful franchise that it is today.