Wednesday June 4th, 2014

At Sionna Investment Manager's 2014 Market Review, Portfolio Manager, Dave Britton, CFA, discussed our detailed investment process by illustrating how one company went from a potential idea to a portfolio addition.

Dave began his presentation by emphasizing the importance of the two key parts to Sionna's process.

The first step is to screen the investment universe for potential ideas. The team begins by turning to Sionna's proprietary Intrinsic Value Model (IVM) to rank the entire universe of Canadian stocks based on their expected return. This ranking helps to identify any potentially interesting opportunities in the market that deserve a much more extensive look.

We then move on to the second step in our process, which involves an in-depth, fundamental analysis of the business under consideration. A key component that guides the rigour of our process is Sionna's Research Questionnaire.
Dave took us through a summary of the methodology that resulted in one Sionna investment.

Step One – Idea Generation
During 2013, Sionna's IVM highlighted that a number of equipment dealers began to show attractive expected returns. In particular, Finning International traded at attractive valuation multiples. The company, which historically tended to trade at a premium to the market, was now available at a discount – suggesting additional research might be warranted.

Finning was not a new or unfamiliar name to us – a full research report had been written on the company in 2006, and we continued to follow the name over the years, including a visit to Finning's oil sands operation in 2007 and multiple meetings with management.

For a variety of reasons, the company was never deemed an appropriate investment during that time frame – but last year our evaluation suggested that things might be different.

Dave Britton, 2007
Finning Operation
Fort McMurray, Alberta

Step Two – Idea Evaluation and Fundamental Analysis
As mentioned previously, Sionna spends a vast majority of its time conducting qualitative analysis to really understand a company and determine if an investment is warranted. Using Finning as an example, Dave highlighted some select parts of Sionna's Research Questionnaire to illustrate how we viewed the company as a potential investment.

Does the company have any competitive advantage?[1]

Finning is the world's largest dealer of Caterpillar (CAT) equipment. In addition to its market dominance, the company also has the benefit of a significant barrier to entry: exclusive rights to operate as the only authorized CAT dealer in key geographic regions of Alberta and Chile, both of which represent some of the highest-growing and mining-intensive jurisdictions in the world.

One of the attractive aspects of Finning's business model is its multiple revenue streams, including new and used equipment sales and rentals. However, the real gem of the business is its high margin parts and service "annuity" – a particularly attractive business when you are dealing with large mining equipment that is operating in some of the harshest climates in the world. Along with high demand for parts and service, this revenue stream is also much less cyclical than the others. As long as oil sands are being extracted in Alberta, and copper is being mined in the low-cost mines of Chile, this annuity will exist.

Because Finning has such a dominant market share, their extensive revenue base allows them to make significant investment in service facilities. Since 2008, the company has invested over $200 million in oil sands service infrastructure (e.g. facilities to rebuild equipment). Capital expenditures of this magnitude are not something that smaller competitors can easily contemplate, since they don't have a large enough revenue base across which to spread the costs. Customers want to work with companies that offer the best parts and service infrastructure because downtime equates to lost revenues. For Finning, their enhanced service offering meets this crucial customer requirement and in turn further solidifies their dominance in the market.

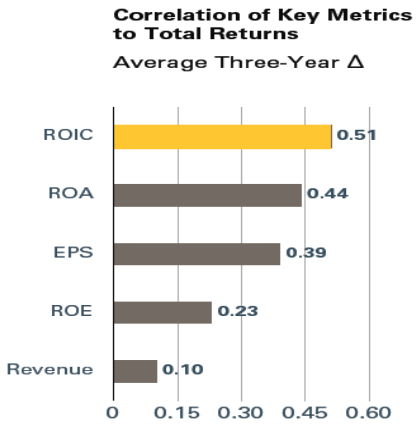
Our research therefore concluded that, on this aspect, Finning has an excellent competitive position that is anchored by its dominance in Alberta's oil sands and Chile's copper mines.

What is the revenue and earnings history of the company?[1]

Despite the fact that Finning has exclusive territorial rights and an incredible service infrastructure, the company had not historically generated returns that reflected this strong competitive position. In the past, management focused most of its resources on growing the top line and not on earning an acceptable return on invested capital (ROIC). In addition, the company faced some operational issues. Finning's poor execution and revenue focus were among the reasons we didn't previously invest in the company. More recently, we saw evidence that positive strategic changes were underway, which further piqued our interest in the business.

Does the company have good management whose reward is tied to the firm's prosperity? [1]

Does the company have a clearly articulated, simple and focused corporate strategy? [1]



In mid-2013, Finning's board decided to hire a new CEO. The hire came from outside the organization, which indicated to us a desire and willingness to change its pattern of underperformance. Finning's new strategy involves improving the company's ROIC. Sionna has always believed in this measure as a sound way to assess management's capability. The chart to the left also reinforces our focus on this measure; it illustrates that among the key metrics that impact a stock's total return, ROIC is the most correlated. It's no surprise that Sionna views Finning's strategic refocus on ROIC (instead of its historically revenue-driven approach) as more value-creating to shareholders over the long term.
Four of Finning's main priorities are directly tied to improving ROIC – and have correspondingly aligned management's compensation targets. Since incentives tend to drive behaviour, Sionna's investment team views the changes very positively and anticipates that Finning will see ROIC rise as a consequence. In fact, we are encouraged to have identified improvements that are already underway.

Are the shares trading at discount to intrinsic value? [1]
Finally, one of the last items Sionna looks at is the valuation of a stock. As discussed earlier, our research identified that Finning traded at attractive multiples. Following the qualitative portion of our research we determined what we thought the business was actually worth to arrive at a conservative estimate of its intrinsic value. Based on those calculations, we believe that the company is undervalued and also offers an asymmetric return profile. While there could be downside from here, we believe it is reasonably limited. Instead, we think that there is greater likelihood of a 40-60% upside from these levels.

Conclusion
Finning is a business that Sionna has closely followed for years. It has a strong competitive position and its current management team has put in place a credible and detailed plan to improve profitability. But partly thanks to some unforced errors on Finning's part, and partly because the sector is out of favour, the stock is currently available at an attractive discount to intrinsic value. We believe that the stock offers a compelling upside and that this is an opportunity for us to build a position in the investment. Finning International provides an example of Sionna's patient and rigorous

approach to research and investing in a stock; no matter how many years it takes to get there.

The Sionna Team

[1] *Questions From Sionna's Research Questionnaire*

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