Sionna Investment Managers

SOUNDBITE

August, 2015

Discovering Value in Obvious – But Overlooked – Places

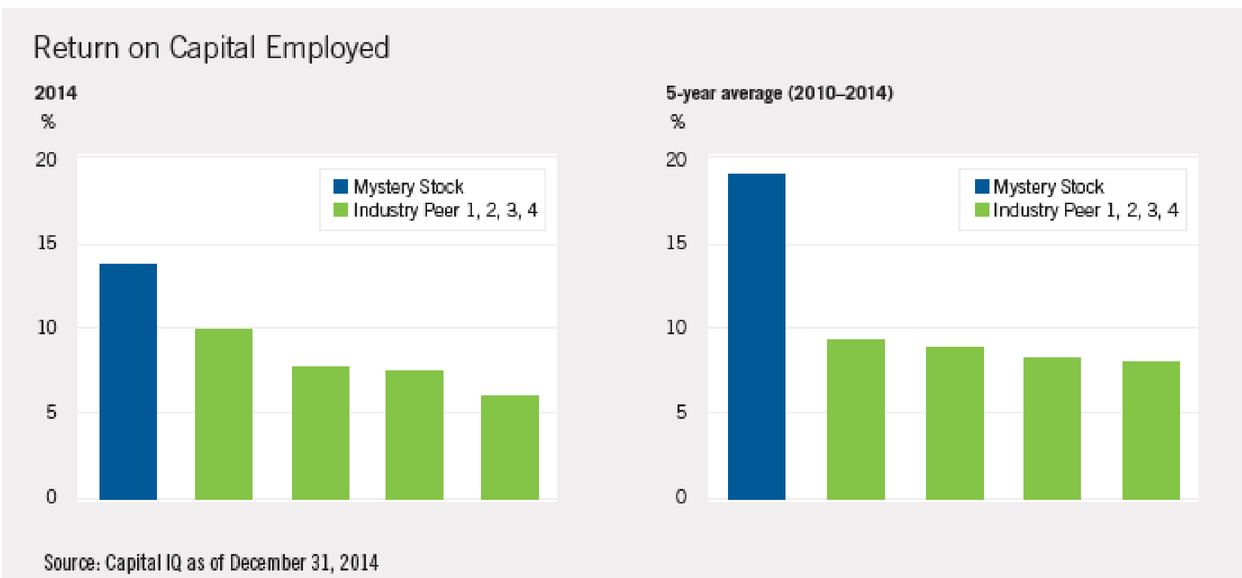
Have you ever looked all over your house for your sunglasses in an effort to find where you last left them? Finally, after searching everywhere two or three times, you enlist the help of your entire family only to be informed your glasses were on your head the whole time. You forgot to look in the most obvious place!

Recently, I was asked to participate in a mystery stock presentation for a group of investment professionals where I would slowly reveal the name of one of my favorite investments by providing more and more information as we went along. After struggling to choose a unique and exotic name to present I realized that my best choice was right in front of me the whole time.

If you heard the name of this company, you would immediately nod in recognition. It was incorporated in 1880 in south west Ontario and is currently a member of both the S&P/TSX Composite Index and the S&P/TSX 60 Index.

Well Run Business

This is a well-run business that funds growth projects the old fashioned way with operating cash flow. Over the last several years it poured much of its sizable cash flows into capital expenditures, building a major new capability and despite the drag this imposed on its returns – because earnings haven't been realized from the investment – it still managed to generate a return on capital employed better than most of its peers.

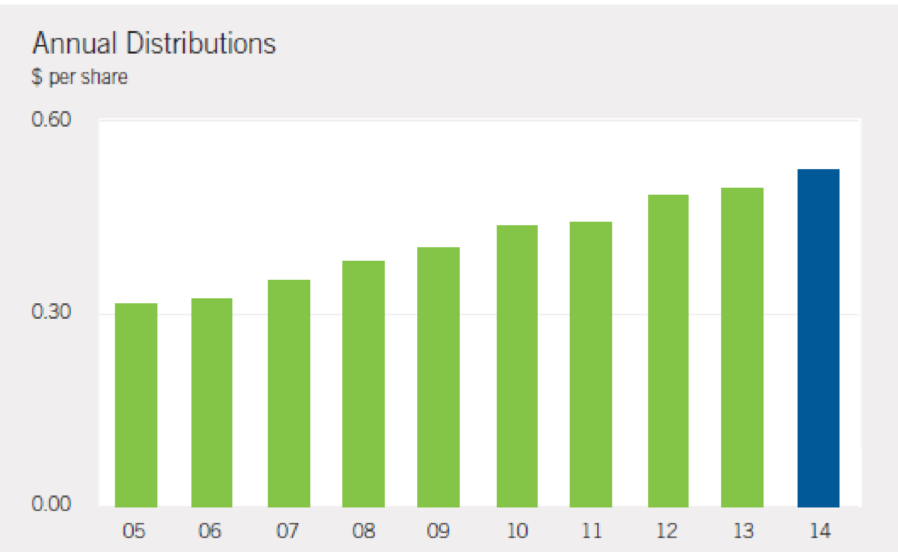


Low Financial Risk

In our view, companies always face three major forms of risk: cyclical, operational and financial. Cyclical and operational risks are beautiful forms of risk as they will allow you to buy great companies at reasonable prices. A company with a strong management team and a strong culture should be able to weather the storm, solve a temporary problem and ultimately get back to business as usual. Financial risk, however, is the most troubling risk. Virtually all bankruptcies occur because of too much debt, and therefore at Sionna we actively avoid companies that fall into this camp and seek out those with low financial risk. My mystery stock is no exception since it has one of the lowest debt burdens in its peer group and is the only AAA rated Canadian company within its sector. *(Source: Capital IQ and company financial statements as of Dec 31, 2014)*

Modest But Growing Dividends

My mystery stock has a modest per share dividend and the lowest yield of its peer group at slightly better than 1%. That is a bold move in today's market where most new equity dollars have been going into yield orientated strategies with investors scrolling for stocks with at minimum a market type of yield in the 3% range. While the low yield probably adds to it being overlooked by yield hungry investors today I would note that this company has paid a dividend for 100+ consecutive years and has grown its dividend for the past 24 years.



Source: Capital IQ as of December 31, 2014

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Strong Culture

Typically the name of a CEO of any larger company is a dead giveaway. Are you familiar with Richard Kruger, the President, CEO and Chair of this company? Odds are, you have not heard this name. The CEO of a competitor in the same sector once told me that he always made a point of meeting the newly appointed CEOs of his peers but he realized that it really didn't matter for this company because it has such a firmly entrenched culture that the results do just as well in spite of whoever is ultimately in charge. This company fits the discussion as outlined in Jim Collins book *Good to Great* a few years back where his research showed that companies with strong cultures and teams created more long term shareholder value than companies with highly visible and larger than life CEO's whose firms often stumbled after the leader retired.

Cloak of Invisibility
This business is clearly not run by former investment bankers. It focuses on being a solid low cost operator and eschews mergers, debt issuance and secondary offerings. Thus it doesn't need vibrant investment banking relationships which supports its cloak of invisibility. Behavioural psychology suggests that stocks are often traded due to the recency effect. If a company is mentioned a lot, it is top of mind, and therefore investors think about whether the stock is worth purchasing. This company doesn't engage in investment banking relationships, so there is less incentive for it to be featured in write-ups. As a result it doesn't really appear on daily ideas lists, potentially making it fly under the radar.

Foreign Parent
Now for a real clue, this company has a foreign parent! Remember 20 to 30 years ago there were lots of branch plant stocks in the Canadian landscape (Rothman's, Dominion Textiles, Shell Canada, to name a few) all with ownership by a foreign parent. The parent, aware that some day it may buy back the outstanding shares had little incentive to promote or support the share price. Often the CEO's were up and comers for the parent and were groomed for a period in the Canadian entity before being promoted to grander positions back home. And one of the main reasons stocks like this get overlooked is because of their float. Lower free float pushes the stock down in size and scale in the mind of investors making it more easily underestimated.

The Big Reveal
If you haven't guessed it by now…

My mystery stock selection is: Imperial Oil (IMO).

Imperial Oil is 70% owned by Exxon Mobil who's stake is worth approximately $28 billion CAD at current prices and the free float is worth approximately $12 billion CAD. Exxon currently has a market cap north of $345 billion USD. *(Source: Capital IQ as of July 20, 2015)*

Having a small free float really impacts a stock's relative perception in an index influenced world. For example, Suncor is the 9th highest weighted stock on the TSX and the highest weighted Energy stock. IMO, which has a slightly higher market cap than Suncor, ranks as the 37th largest stock on the TSX and ties with Power Corporation in terms of index weight. This weighting belies the formidable economies of scale that IMO enjoys and the benefits of drawing from the vast pool of resources and knowledge in Exxon. (*Source: Bloomberg as of July 20, 2015)*

So, why buy a commodity stock now? At Sionna we are a value shop, preferring to act in a contrarian manner, buying when more momentum orientated investors have fled. When buying a commodity stock we like to see three things in place before we begin assessing the business itself:

1. The commodity trades below its marginal cost of supply
2. The sector is cheap relative to its history
3. Stocks themselves are cheap relative to their history

When it comes to oil we believe all three are in place today and the energy sector is rich with opportunities (please see our January 2015 thought piece for more details "*The Unsustainability of $50 Oil"*).

We believe this sector is a rich opportunity set in which Imperial Oil is a standout with a low risk and high reward potential today given its positive attributes:

- One of the highest current (15%) and normalized return on equity of its peers
- Low financial risk
- Conservatively managed
- Low cost producer
- Broadly diversified; Upstream, downstream, oil, gas, conventional, unconventional
- Fastest production growth of majors as Kearl (oil sands) continues to come on line with overall production company-wide expected to double from 2013 to 2020
- Attractive price-to-earnings ratio at 13x trailing
  (Source: Capital IQ as of July 20, 2015)

Earlier this year Exxon raised $8 billion in debt issuance (keep in mind IMO's free float is only $12 billion) and the CEO of Exxon was quoted as saying he was keen to take advantage of good opportunities if they emerged and implied that it was cheaper to drill in capital markets today than in the ground.

At Sionna we believe oil will eventually revert back to its marginal cost of supply around $85 dollars per barrel and in that environment we anticipate greater than 50% capital gains from the current share price of IMO. And if we are wrong in our assessment of oil prices and the sector stays weak then Exxon just might take the rest of the company private at a very opportune time again providing the backstop for a profitable return from current share prices. Recall that Royal Dutch Shell paid a 45% premium to buy Shell Canada.

Sometimes, just like your sunglasses on your head, the best investments are overlooked because they seem too obvious.

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