July, 2015

Searching Beneath the Surface

Traditionally, value investors are perceived as focusing on companies that trade at low price-to-earnings (PE) and price-to-book (PB) multiples. At Sionna, we believe these traditional methods are best married with extensive fundamental analysis and a healthy dose of skepticism since multiples can be misleading in some cases. There are many ways valuation metrics can be tricked, and investing requires judgement to determine when these multiples are accurate estimates of intrinsic value and, more importantly, when they are not. Our goal is to identify companies that we believe are truly trading below their intrinsic value, and not simply accept the reported metrics. To accomplish this goal, it is important that we constantly search for companies using various methods, to ensure we capture as many undervalued opportunities as possible. Examples of common valuation methods we use include our proprietary intrinsic value model, net asset-based valuations, and free cash flow-based valuations, along with traditional multiples of price metrics.

One example where traditional valuation methods require adjustment is in cyclical industries, because the stage of the business cycle can dramatically impact a stock's current PE or PB. Cyclical businesses will often have low, seemingly attractive PE multiples at precisely the time you should be avoiding them; and conversely, reflect high, unattractive PE multiples at times when we believe investors should be buying the shares. At the bottom of the cycle, earnings are depressed, so the PE ratio will be high – reflecting the low level of earnings (E). On the other hand, when earnings are near peak levels or close to the top of the cycle, the PE ratio will correspondingly be low since the E is high. As value investors, we believe the bottom of the cycle is an excellent time to be investing in quality companies that are temporarily out of favour. Energy services provides an illustration of such an opportunity. Many energy services companies are currently reflecting extremely high PE multiples, and look unattractive based on traditional metrics. However, the sector's current earnings are depressed given the low oil-price environment. Earnings are not expected to stay at these levels forever. As long-term investors, it would be short-sighted to value the company based on this one point in time. We believe these companies will increase their earnings over time, and the PE multiple will come down. At Sionna, we attempt to normalize for these differences and determine an intrinsic value for the business that should apply over a full cycle. For energy services, this is done by normalizing the PE multiple to account for the true earnings power of the business.

Differences in accounting conventions can also dramatically impact stock valuations. Ideally, accounting rules reflect the true economics of the business, and earnings generally match cash flows over time. This is often the case, but not always. There are businesses that generate substantially more cash flow than their earnings reflect. Differences can include higher accounting depreciation compared to the true

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maintenance capital spent, or high levels of intangible depreciation that do not represent the true cash costs to the business. In these situations, we believe free cash flow is a better measure to estimate intrinsic value.

Accounting rules can also affect businesses that must report one-time gains or losses through the income statement, which can dramatically impact reported earnings. While some of these gains (losses) properly reflect the ongoing business, others do not. Consider the real estate subsector as an example. The move from Canadian GAAP to IFRS reporting has made PE multiples less accurate estimates of intrinsic value. Under GAAP, companies held their real estate on the books at historical cost. While this method did not account for increases in property values, there were no large swings in the income statement and the properties often represented hidden assets. Under IFRS, investment properties are typically revalued to reflect fair market value and the changes flow through the income statement as gains or losses. This reporting requirement results in very volatile earnings that, in our opinion, do not reflect the true earnings capacity of the business. In the real estate space, we prefer to look at a company’s net asset value (NAV) or adjusted funds from operation (AFFO) to estimate the business’ intrinsic value.

We are not suggesting that multiples are never an appropriate measure of intrinsic value. One sector where we believe traditional metrics are more consistently a good gauge of intrinsic value is consumer staples. Grocery stores, for example, tend to be very stable businesses with steadily growing earnings. We therefore believe that traditional PE multiples are, for the most part, appropriate measures of intrinsic value for those businesses.

Determining an estimate of intrinsic value requires thorough analysis of the business, its historical performance, competitive advantages, industry economics, management’s capital allocation abilities and many other fundamental factors. There is no standardized valuation metric that could possibly encompass all of these factors accurately. Investing requires analysis of all of these factors in rigor. Value investing requires the patience, long-term focus and emotional intelligence to believe in your analysis and stick with it. At Sionna, we are advocates of contrarian thinking and believe digging deep into business fundamentals is the key to uncovering opportunities that might have been missed by those simply looking at the surface.

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