Sionna Investment Managers®

SOUNDBITE

March, 2017

A Contrarian Value Opportunity Revealed

As a value manager, we know that value picks don't always perform right away; the best returns tend to be seen over the long term. The contrarian value opportunities are in stocks that are either overlooked, underfollowed or in some kind of trouble.

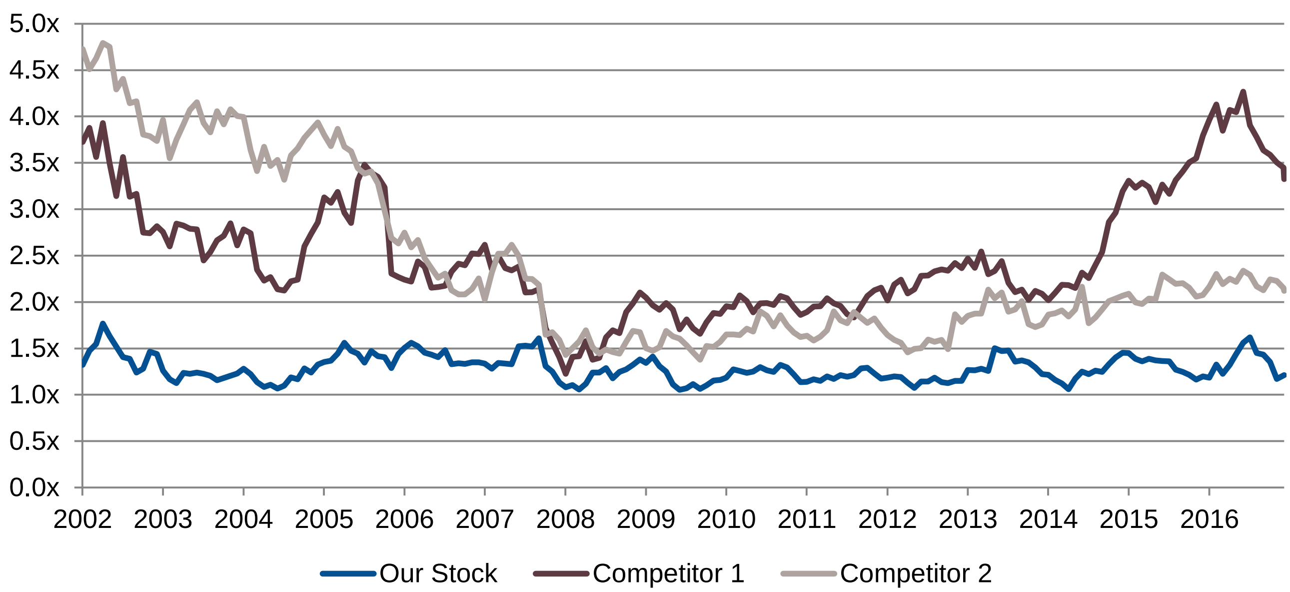
One company that presents an opportunity for value investors is a large-cap Canadian name; it is not overlooked, it is not underfollowed, but it is currently in some trouble. Rather than tell you up front what this stock is, let's look at the facts first.

Until two years ago, the stock had performed quite well. Over the past 20 years it has had an annualized return of 9.8%, versus the Index's return of 4.7%. But, when you shorten the time horizon to five years, the S&P/TSX returned 4.1% while this stock delivered -2.9%.

When compared to two of its primary competitors, this stock is the cheapest on a price-to-cash-flow basis. It also looks attractive when looking at the stock's normalized price-to-earnings, and is as cheap as it's ever been with regards to its price-to-sales ratio.

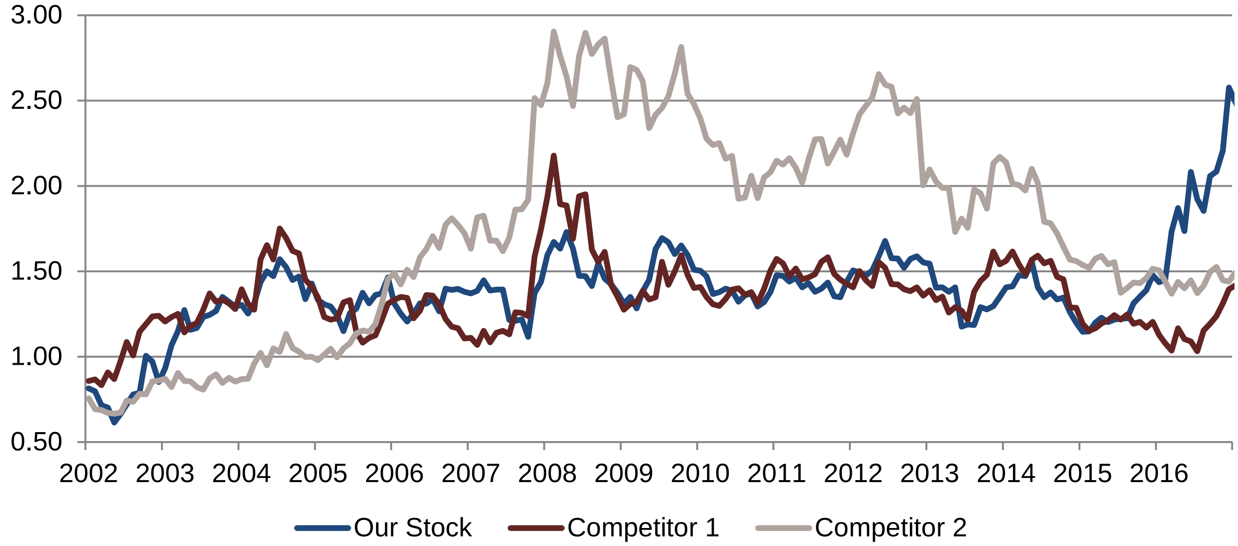
Price-to-Book Ratio

Next up is the old value classic, price-to-book ratio. On this measure, our selected stock is cheap relative to its peers and to its own history.



Dividend Yield

Looking at dividend yield, our selected stock currently offers the best yield of the group at 2.5%. It is not quite as high as the S&P/TSX (at 2.7%), but with 10-year Canadian government bonds at 1.7%, this stock will pay you to wait.



This stock's market share is the second-largest among its competitors, but it has the smallest market cap. The company made a significant acquisition two-and-a-half years ago, at the time paying C$5.8 billion for what was considered to be a prized asset; today, its total market cap is C$4.4 billion, we therefore believe that it's not getting appropriate credit for the assets.

The next big question to ask is: what is the risk?

Companies face three major forms of risk: cyclical, operational and financial. Cyclical and operational risks are beautiful for value managers, but we seek to avoid financial risk. In our opinion, this company does not have excessive levels of financial risk. If you take all of the operating cash flow of the business, and look at the amount of debt outstanding, it would take the company approximately three years to pay off all of its debt.

So, what is this classic contrarian stock that we've been talking about?

Empire Company Limited – a holding company that operates conventional grocer Sobeys, Canada's second-largest grocery retailer. In addition to the challenging environment for conventional grocery retailing, the company has faced execution issues with regards to its acquisition of Canada Safeway, resulting in the departure of the CEO, write-downs and weak results. One complication of this acquisition came from Safeway's Western Canadian base, which suffered from the economic downturn stemming from the fall in energy prices. Given the economic troubles in Western Canada, consumers have been moving more towards the discount banners, and since Safeway never had a discount banner, it hasn't been able to benefit from this change in purchasing behaviour. In addition, it has been a challenging environment for grocers in general because of price deflation. We believe these risks are primarily cyclical, and should revert back over time.

It was no secret that other players in the industry, like Metro, had stated interest in Canada Safeway, but Empire beat them to it. Acquisitions are a common challenge in the grocery industry. There are a number of products and SKUs and it can be difficult to integrate different technology systems. Metro, for example, experienced difficulties when it integrated with A&P in 2005, and Loblaw's struggled for years with the implementation of its SAP software. That being said, both companies recovered, demonstrating that these integration issues are fixable. The Safeway acquisition provides Empire with strong assets with good locations, so in time we believe the company should recover as well.

Empire is a classic case of a good company that has fallen on hard times. The company is controlled by the Sobey family, and has a long history of strong financial performance and a focus on long-term value creation. The company has brought in a new CEO, Michael Medline from Canadian Tire, who is considered to be a strong leader. With consumers moving towards less-expensive options, the company is discussing possible strategic implementation of its discount banner outside of Ontario. The company is being methodical about its decision and considering its development options, while prioritizing fixing its core business first. With patience, we believe that this stock can revert back to more normalized valuations and presents an opportunity for long-term investors.

The Sionna Team

Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please email Kelly Battle at kelly.battle@sionna.ca or call (416) 203-2732