

Return on Equity

We often speak of financial return and quality interchangeably around the hallowed halls of the QV campus. Speaking of our campus, we are about 60,000 square feet, sorry make that 6,000 square feet, of comfortable office space attained during the peak of the Calgary real estate bubble. Commercial real estate timers, we are not. We may not be as large as some of our competitors but we do offer coffee, tea, or water to all of our guests. If you want a pop or juice, you'll have to buy it yourself; come on, you know we are value based investors.

We have two paintings on our walls, both courtesy of bids at charitable events. There was no chance we were going to spend any "real" money on art. Nor were we ever collectively able to decide what to buy. The hallowed halls consist of one corridor from the four meeting rooms to the open area where we all sit, elbows to noses. This ensures no one falls asleep on the job (you try reading some of the exciting investment analysis that comes out day after day).

We did buy a TV to watch the financial news, but we generally find it annoying and keep it on mute. Quite occasionally we laugh and do it with vigor. We greet good news by the shake of a Maraca or two, and a filled candy bowl (in the shape of Shamu the whale) keeps us energized throughout the day.

Oh yes, as you can tell we often have a tough time focusing on the subject at hand. Back to return on equity. Return on equity is defined as net earnings divided by shareholders equity (book value) expressed as a percentage.

Let us use Toromont Industries as an example. We do not currently hold shares of Toromont in the small cap Fund but do in other pools. The company is an "engineering" firm that makes or supplies refrigeration equipment (hockey rinks) and gas compression equipment (natural gas pipelines).

In 2008, Toromont showed net income per share of \$2.16. The closing book value for 2007 was \$10.08. The book value represents all the funds re-invested in the company net of dividends and taxes. Thus the ROE for Toromont last year, 2008, was $\$2.16/\$10.08 \times 100 = 21.4\%$. Toromont's ROE is pretty impressive knowing for the last 15 years or so the average ROE in Canada was about 10%.

For the last 10 years Toromont has earned an average return on equity of 17.2%. By Canadian standards that is an excellent number. Of importance is that Toromont did this with very little debt. They have consistently driven down their debt to equity ratio from 0.76 eight years ago to 0.22 today. It is harder to make a high return without debt it is also harder to go bankrupt without debt. We like that.

Why is the ROE important? It is the fundamental compounding rate on this company and our job is to determine if the management can keep the number rolling on behalf of shareholders. If they can, we can put our feet up and have Chinese food for lunch.

It is valid to compare the 17.2% ROE to the 3.5% you can get today on 10 year Canada's. Why would you bother with Canada's given that alongside the high ROE you get paid a 2.5% dividend yield? You would only bother with the Canada bond if you thought the 17% ROE might turn into 0% or turn negative. Or...if the price you paid for the 17% was too high. Well today you have to pay 2 times book value, so it is reasonable to cut the 17% in half, 8.5%, to identify the rate of return the portfolio is actually earning. That is today's compounding rate on Toromont, still a heck of a lot better than the 3.5% bond rate. If on the other hand we had to pay 4-5 times book value for its ROE, we'd look elsewhere.

But let us say the outlook for hockey rinks and gas compression is poor and consider the downside. Global warming will crush the demand for hockey rinks, too hot to play, and we will not need natural gas because we will not have to warm our houses. So let us say Toromont's historical ROE goes to 10% and we get 5% at two times book (10% ROE / 2 times book value). It is still better than 3.5% on Canada's.

Two years ago the compounding rate earned and expected in the markets was unsupportable. In the past six months, the price/book on the TSX has been cut in half. The BMO Small Cap Index traded at a discount to book. The madness of the past has turned to fear. Interest rates pay little and represent a great risk. We are not overly optimistic for a V-shaped return in corporate profitability. But, many quality companies will continue to generate positive ROE's, pay a competitive dividend yield and have the balance sheet to sustain their franchises.

Have a good weekend; we're off for our Chinese lunch.