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EP 131 | Canadian Small Caps, Energy, Risk Management, and Assessing Management Teams

Anum Siddiqui (00:00):

Hi everyone. On this episode of the podcast, I sit down with Jeff Mo, lead manager of our Canadian small cap strategy. In our conversation, we had the opportunity to dive into how we think about and apply certain elements of both our philosophy and process.

For instance, Jeff speaks to how our thoughts on energy businesses ties back to our required investment criteria. Furthermore, given that investing in excellent management teams is a key tenet of our philosophy, Jeff goes through the framework that the team follows in assessing whether, in fact, a management team demonstrates the excellence that we're looking for.

We also take the time to unpack the multiple layers of risk management. I hope you enjoy the conversation.

Disclaimer (01:10):

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Anum Siddiqui (01:27):

Hi everyone, welcome to the podcast. With me today is our lead manager of the [Mawer] Canadian Small Cap strategy, Jeff Mo. Jeff, thanks for joining us today.

Jeff Mo (01:37):

Thanks for having me, Anum.

Anum Siddiqui (01:39):

I thought we could start off with a topic that's been on the mind of many different investors, and that topic is energy. Different factors over the last few years have led to the increase in oil prices, with many energy companies benefitting from that increase. And as a result, the sector has done quite well within in the broader market.

I know we're very much bottom-up investors, but I was interested in getting your thoughts on the sector in general and how we think about companies in the space.

Jeff Mo (02:07):

Very fair. And what probably many longtime listeners know, is that the index that we follow—the [S&P/TSX SmallCap Index]—also has energy as its top weighted sector. Most of the time, it's often a mix between materials and energy. Primarily oil and gas [are] what we're referring to today when we talk about the GICS sector energy.

It's a very interesting part of the market. Because the companies often are extractive in nature, meaning they have a business model where they invest a lot of capital upfront to try to extract either oil or gas, we find it quite difficult to invest in with our investment philosophy.

The reason for that is it's very difficult to find a sustainable competitive advantage in energy. Let me break that down for you. The first thought is they're producing a commodity. The definition of companies that maybe don't have a product or service that is differentiated [are] companies that literally produce a commodity. So that makes it more difficult.

Jeff Mo (03:15):

Commodity companies can still have a competitive advantage. They can have a cost competitive advantage. However, those cost competitive advantages tend to be more ephemeral and less so (not always), but less so based on what the company has under its control, and more so based on perhaps the historical luck or the positioning that that company may have had in securing its particular assets.

And often, you probably have heard some adage like it: "when you have a hundred potential oil and gas well locations, you'll drill your best well," and I think there's many variations of that idea in business. And so what happens is a company might drill their first 10 best locations and the numbers look wonderful and it looks highly wealth creating; it looks like they have a clear cost advantage. But then you get to well 30 and you're like, oh, okay, maybe the economics weren't as great as we thought.

Jeff Mo (04:09):

And then the final issue with energy is the commodity prices are highly volatile. And as I was saying earlier, the business model is spending a lot of capital upfront and then hoping for a return from the oil and gas that you produce over a number of years. And of course, if you drilled your well when oil and gas was trading, say, $100 a barrel, and then two years later it's at $50 a barrel, the return framework or the model that you had when you were drilling that well may no longer apply. And again, you're not a wealth-creating company.

So there [are] all these issues that energy companies have that have made it harder for us to invest in historically. Not to say that we haven't, and in fact you're probably alluding to this, we bought a couple in 2022 in the strategy.

Anum Siddiqui (05:00):

Actually, that would be a great place to move on to. So, you mentioned that there aren't as many competitive advantages—assuming if we did in fact, and which we did, invest in a company over 2022. Presumably those companies that we invested in have competitive advantages. Could you speak to what those are and how those companies met our criteria?

Jeff Mo (05:23):

So we invested in two oil and gas producers in 2022. We had other companies in the energy sector prior to that. None of them were actually resource extraction companies. So the two that we invested in are [Parex Resources] and [International Petroleum Corporation].

So, Parex is Calgary-based, but they have the majority of their operations in Columbia. The first thought is, well, Columbia—wasn't that where a lot of the narcotics consumed in North America perhaps were produced until maybe recent years when the government was able to take on more security control over larger parts of the country? And I think that precisely is the point.

Whereas in the '80s and '90s, most of the rest of the world was targeting these easy-to-find and easy-to-extract oil resources using more primitive 2D seismic technology and other techniques that were developed during that time period, Columbia unfortunately was undergoing civil war and having lots of issues. In other words, it was almost impossible for oil and gas companies to go and access these resources in the foothills of Columbia.

Jeff Mo (06:32):

Fast-forward to probably 10 years ago, companies like Parex and other western companies like them went into Columbia and they started going after these 1980s-style resources with today's technologies. Whereas we've heard comments like how [multi-stage hydraulic fracturing] has really opened up access to resources in many parts of North America—in the Permian Basin in Texas, for example—Columbia doesn't even need that because they're still using what's called "conventional technologies" or older technologies.

And as you could probably imagine, conventional technologies are cheaper because you just drill the well. You don't have to go and do multi-stage hydraulic fracturing after you drill the well. Obviously there's a cost to that. And so that's what makes Parex uniquely low cost—because of their ability to access these areas. Even today, Columbia still has some security concerns, but Parex has done a really good job being in the community for over a decade building relationships and also working with government.

Jeff Mo (07:38):

The largest oil and gas company in Columbia is a company called Ecopetrol. They are the national oil and gas company owned by the government. And Parex has developed a very strong relationship with them. The owner of oil and gas mineral rights in Columbia, actually even larger than Ecopetrol (the government), and by far larger than the third-largest player. And I think that's just a testament to [the] on-the-ground advantage they've had being there a decade building up their operations.

Whereas many other companies…they didn't focus just on Columbia. They were in many parts of the region. They came in and out of the country and lost some of that relationship that they had with the government. Hence [Parex's] competitive advantage to go after an area of the world that is still under-exploited in terms of oil and gas exploration.

Anum Siddiqui (08:25):

Your comment on Parex having Columbian operations makes me think about a lot of companies—regardless of where they're enlisted—can have international or global revenues. I'm curious to know how does this broader Canadian small cap portfolio look in respect to the geographic diversification, and is it something that the team considers when they're assessing a company?

Jeff Mo (08:49):

Definitely the profile of the revenues is something we think about. I wouldn't say we target it specifically, but it's something we're aware of first and foremost because when we do a discounted cash flow analysis, we actually take the risk-free yield curves for each country that the company has material revenues in. So, there is a technical aspect for why we care.

But from a broader perspective, we think about it on a standpoint of diversification. And so—I'm just checking my notes here—I believe the [Mawer] Canadian small cap portfolio, I think we last ran this about a month ago, had just over half its revenues actually outside of Canada or a Canadian dollar source.

I say Canadian dollar source because sometimes we might have a Canadian company producing a product that's only sold in U.S. dollars, for example. Fully a third of the revenues of the companies in the portfolio are generated in U.S. dollars. And then you have a smattering of the rest of the world, 5% in euro, 4% in various emerging market currencies, and so on and so forth.

Anum Siddiqui (09:48):

Are there any specific companies in the portfolio that come to mind that are more international in nature than one would expect?

Jeff Mo (09:55):

Maybe a company like Jamieson [Wellness Inc.], the vitamin and supplements manufacturer. They are obviously a household brand here in Canada. They have the largest market share in what's called the "mass market" or the "food, drug, and mass market" that they define. But fully 35% of their revenues are outside Canada, probably closer to 40%; Proforma, their latest acquisition, of which of that I'd say two-thirds of the international revenues is in the U.S., which is not a surprise.

Lots of Canadian companies are operating in the U.S. But the other one-third is actually a smattering across, I think over 30 countries, 20 to 30 countries—I forget the exact number they're in now. And in many cases, they've been in those countries for many, many years. I didn't know this until I started researching Jamieson as a company, but apparently they're the best-selling vitamin in Trinidad and Tobago, in Hong Kong, in a few eastern European countries as well.

Jeff Mo (10:49):

And what has created some excitement in the market in recent quarters is their push into China, where, given that they are a Western brand and the Chinese consumers tend to prefer that for their supplements manufacturers, they have gained a toe hold and is growing quite rapidly there.

Anum Siddiqui (11:08):

Listeners of our podcast will know that one element of our investment philosophy is to invest alongside excellent management teams. What I wanted to dig in with you a little bit was just, well, it's easy to say we invest alongside excellent management teams, but what exactly does that entail in terms of assessing whether a management team is, in fact, excellent? Is there a certain approach that the team takes and certain elements that you're looking for?

Jeff Mo (11:36):

We ask them. Sometimes they say that they are. But of course more scientifically, we've been analyzing management teams for probably as long as we've been investing. And in smaller cap equities, it's quite important because management teams have a disproportionate impact on the companies and how they ultimately play out in terms of strategy.

I would say that in recent years we've really honed it in to something more systematic. We've always had, I'd say, four or five planks that we covered in our internal reports. We've since expanded it to what we call the "management assessment framework." And we have seven points in the MAF, as we call it (the management assessment framework).

Jeff Mo (12:19):

And in the MAF, things we care about would be, how strong is the company's historical track record of execution? That's probably the most key one that we focus on. And we would look at the historical both inductive evidence (historical numbers), as well as the deductive evidence—what are they saying in terms of how they achieved the results they did? Is it just luck? Or does there seem to be logical structure to how they're executing their strategies?

Other aspects of the MAF would include things like capital allocation. That's probably I'd say number two/number three, in terms of our focus. Probably number two in Canadian small cap because companies tend to be growing faster and therefore allocating more of their capital that they're retaining. And certainly their ability to deploy capital at very high rates of return, either internally or acquisitively, is a very important factor for us when we assess a management team.

Jeff Mo (13:19):

Some other aspects that could be very important would be their strategy and vision. We would often analyze a company and what management is saying about a strategy alongside what we think is their competitive advantage. So, if a company has cost as their main competitive advantage and scale—so, Stella-Jones might be an example in our portfolio where they are North America's largest producer of treated lumber—what we don't like to see in that case is for them to come on and say, "We are going to start selling highly differentiated treated wood products."

[Such as,] maybe—I'm just making this up—carved wooden animals that are then treated with weatherproofing chemicals that they do. Because they have no expertise in the artistic side of producing low volume, high price treated lumber. They are in the game of producing high volume, low price treated lumber. And so the strategy there would be something that we would really assess to see if management is doing the right thing.

Jeff Mo (14:21):

We also care a lot about culture at a company. So on the culture front, we would look for both inductive and deductive evidence that the company cares about its people and is thinking about how to manage their employees and their teams in the right way. So, some inductive pieces of evidence we might look for are employee surveys, either things like external review websites or if the company produces internal surveys. Sometimes we'll ask management team about how those trends are trending. There's something called an employee net promoter score that we sometimes also ask about and care about.

And then we also look at the leadership team. So, this is a concept of, "are the right people on the bus?" And so, if this is a company that is highly acquisitive, do they have a strong CFO? Do they have a strong mergers and acquisitions team? If the company is really operationally intensive and they're an industry where they're really trying to grind out margins and try to be operationally the best, we would like to see lots of strong operational backgrounds—people with Six Sigma Black Belts and other kind of lean manufacturing backgrounds.

Jeff Mo (15:37):

And then the final two pieces we look for in the management assessment framework, one of the final pieces is alignment. So, we would like the management team to be aligned with shareholders, both from a compensation structure standpoint as well as just a simple point of, do they own shares? Do they think like owners? Even if they don't own a lot of shares because, perhaps, they aren't that independently wealthy, or they haven't been CEO that long, so they haven't accrued a lot of equity-based compensation, but do they think like owners? Are they thinking like a hired gun?

And then finally, risk management. I left it last not because it's least important, but because it's sort of a category on its own that we really have to dig into and understand. Do they manage that effectively? And it could be very different depending on the industry. It could be a subset of capital allocation in certain industries, it could be just how they manage the operations in other situations, but certainly a track record of both thinking about risks when we have a management interview. Do they talk through how they are mitigating risks in their business as well as can we see that in their track record execution historically?

Jeff Mo (16:45):

So that would be kind of how we assess management teams. And certainly not every management team scores perfectly in all seven in our portfolio, but we find that manager teams that generally do well on many of these points tend to make it to the portfolio and tend to also have stronger performance.

Anum Siddiqui (17:04):

When you are answering the last question that the right people need to be on the bus, inevitably, sometimes the people on the bus change. People step off, new people come on, new management [has] taken over. And obviously that is a significant change because if it's a notable part of your thesis that you've invested alongside a certain manager or executive and they've left, that it's going to impact your thesis.

Anum Siddiqui (17:30):

So, I'm curious to know—I know there's been a couple of companies in the portfolio where that's happened—how does the team go about navigating such change within the portfolio?

Jeff Mo (17:40):

It's something we think about a lot, especially when it's the driver on the bus, the CEO if you will, who's swapping out. That happens, as you alluded to, sometimes. Not all the time, but sometimes. Probably a couple a year, a few a year maybe in our portfolio. Maybe I'll touch on a couple that happened a few years ago because sometimes it takes a few years for the results to kind of play out.

So, one example would be Uni-Select, which is an auto parts or auto service company, aftermarket auto services company for U.S., Canada, and the UK. And this is actually a holding of our portfolio probably five or six years ago, and we held it for almost a decade. But in that time, especially near the end of our holding period, we got increasingly concerned about the execution of the management team. We thought it was poor, and eventually we chose to exit our position entirely. But of course, we kept an eye on it; it's obviously a company we knew well, given our long owning history of it.

Jeff Mo (18:38):

It was actually the former CEO of Stella-Jones, Brian McManus, who then became the CEO of Uni-Select. This would've been about two years ago now. And Brian had a very strong track record at Stella-Jones. I think in the tenure that he was CEO for almost 20 years, he actually increased the value of Stella-Jones' stock by a 100-fold over [that 20-year period]. It was one of the best performing stocks on the [S&P/TSX Composite Index] in that time period. So, certainly someone with a very strong track record of execution.

So, we kept an eye on Uni-Select once he came in. We met with him a couple of times. We tried to understand what were the issues that Uni-Select had. Was it structural? Is the business itself weak and not possessing of a competitive advantage? Or was it just temporary, the execution of previous management was not very strong?

Jeff Mo (19:27):

And increasingly, as we analyzed Brian, both what he said he was going to do in terms of tightening operations, changing incentive structures—there's a whole host of things that Brian and his team were going about doing at Uni-Select—we could also start to see it in the numbers as each quarter margins improved, and organic growth started to turn around as well. And eventually we felt comfortable enough to make an investment again in Uni-Select. It was unfortunate though, that shortly after we made our investment, they announced that they were selling themselves to a larger U.S. competitor, LKQ.

Anum Siddiqui (20:03):

Let's hear another example.

Jeff Mo (20:05):

One that's sort of in transition again, but this would be Element Fleet. So, Element Fleet was assembled via acquisition, and we owned the shares several years back as that previous management team was acquiring competitors and building the largest player in the industry. However, while they were good at the deal side of the business, they were not good at the integration and operational side of the business.

And so, the company had some stumbles. They left, and a new CEO, Jay Forbes, took over in 2018. He set out a plan to turn around the company. He had several essentially bullet points—literally bullet points—on a PowerPoint presentation of how he thought the company should be run and how a turnaround might happen. We went ahead and I guess held our shares and observed how this would play out. And sure enough, quarter after quarter, the numbers improved and all the points that Jay Forbes had outlined initially in his turnaround plan came to pass.

Jeff Mo (21:05):

So now it's five years later, he has decided to retire. But on a positive note, he actually increased the value of the shares from the very bottom—almost fivefold in his tenure over the last five years. So, [a] very successful time period that he was CEO of Element Fleet.

And now someone named Laura is coming in. She was head of retail banking at CIBC, which may sound a little bit different in terms of a background for someone coming in to lead an auto fleet leasing and services business, but we think there's certainly some connection with just serving retail clients, serving large clients in some cases, but also some differences.

So, this is another transition that we'll keep an eye on. So far, Laura has more so committed to staying the path, which makes sense because Element Fleet is doing quite well operating their business. And so there's probably not the need for drastic change as when Jay came in. But that's a double example: one example of a successful CEO coming in and doing a turnaround and then now moving on to someone who is not from the industry and it's more kind of a wait-and-see how she performs as the next CEO.

Anum Siddiqui (22:15):

Okay, great. When you were talking about the management assessment framework, you mentioned risk management and how that's top of mind for the management teams that you're assessing. Risk management is an important job for yourself, as well as the team as portfolio managers and investors. Can you speak a little bit to your own risk management approach that you apply when managing the portfolio and perhaps what risks are top of mind for you and the team at the moment?

Jeff Mo (22:46):

So, if we talk about risk management framework, I think there's a saying that very few ideas are original nowadays, and we all just copy the best ideas from everywhere else to create our own structure and frameworks. So in this case, I've shamelessly ripped off, call it the "Mawer Risk Management Framework" that probably Jim Hall, our current president and former chief investment officer created, and then currently Paul Moroz, our current chief investment officer, iterated and improved upon.

Jeff Mo (23:04):

We call it the "Risk Management Elevator," and at the ground floor, the foundational level, the floor that keeps the building up at Mawer, we would actually say it's nothing to do with the securities of portfolio, it's actually the decision-making environment. And longtime listeners to the podcast probably know what I'm talking about. It's really our culture.

So, how do we encourage a group of very talented people, smart people, all of them smarter than myself, to come and tell me as the lead manager of our Canadian small cap strategy that, "Hey, Jeff, you might not be thinking about this the right way." Or, "Hey Jeff, there's another piece of information over here. You really want to consider that when you make this final decision on company X, Y, Z."

And so that culture that we constantly work to maintain and improve, whether it's through foundational concepts like reading High Performance Investment Teams by a fellow named Jim Ware; whether it's constantly working on our language and lexicons and having behaviours of candour and curiosity, staying above the line, not below the line; these are all concepts that really help build a foundation of trust, therefore allowing us to have good communication across our team and sharing ideas that maybe won't be unearthed. So I would say that's actually the most fundamental aspect of risk management.

Jeff Mo (24:38):

Now, going from the abstract to the concrete, I'd say the second level of risk management for us is that security selection basis. So, these are things like our investment philosophy, honestly. If we pick companies with strong competitive advantages, it's just less likely for them to be dislodged and for their performance to change or be permanently impaired by changes in the world. But certainly, doing lots of work, making sure we follow our investment process, making sure we think about the world stochastically and probabilistically in our evaluation models, making sure we have a seven-point management assessment framework and ask the management teams who we are invested in how they manage risk—all of these aspects on a security-selection basis [form] that second level of the elevator.

Then, if we move up one level to the third level, we think about risk from a portfolio standpoint. And so here we really make sure we focus on diversification. And we are also focused within diversification on trying to have inherent contradictions. The best way I've found to explain that concept is, say, through where we started: oil and gas prices.

Jeff Mo (25:54):

A company like Parex Resources obviously would benefit when the price of oil goes up. We think they're a wealth-creating company through the entire economic cycle, but obviously during the time of the economic cycle when oil prices are high, they're creating a lot more wealth. On the flip side, we also own a company in the portfolio called Winpak. That stands for the old Winnipeg Packaging Company. They are a large plastics manufacturing company in Canada. They produce plastic manufacturing for things like your cheeses, your meats, lots of perishables that require very precise and complex plastic layers to ensure that the food doesn't spoil.

Jeff Mo (26:34):

So, for them, the biggest input cost into their manufacturing process is hydrocarbons. And so when the price of oil and gas goes up, their costs actually go up and their wealth creation goes down. But for them also, they create wealth over the economic cycle. And so what we are trying to do is when we own both of these companies in the portfolio, both will create wealth over the cycle, but at certain points in the cycle, Parex will create more wealth, Winpak will create less wealth. In other parts of the cycle, say in 2019, 2020 when the price of oil was low, Parex creates less wealth and Winpak creates more wealth.

Jeff Mo (27:06):

And so we can essentially, through diversification in the portfolio, smooth out the variability of a macroeconomic variable like the price of oil. And this is intentional, because—let me move now to the top level of the elevator, which is looking at risks systemically—what we are trying to do when we scan for risks across the spectrum that could impact the portfolio, is we are trying to find sharp edges in the portfolio. Meaning: if the price of oil suddenly moves up or down by a lot, is our portfolio unduly exposed to that situation? If interest rates move up or down very quickly, is the portfolio unduly exposed there? But what if the U.S. dollar and the Canadian dollar exchange rate changes rapidly? How will that impact the portfolio?

Jim Hall, our current president and former CIO, he leads our investment risk process, where twice a year myself and all the other asset class managers here at Mawer meet with him. And the goal there in that meeting is looking for what we call "sharp edges" in our portfolio. So, for example, could a particular move in currency between say the Canadian dollar and the U.S. dollar—could that impact the portfolio or the price of oil moving a lot? Could that impact the portfolio very negatively?

Anum Siddiqui (28:23):

You mentioned interest rates, and that brings me to my final question for you. Interest rates were top of mind for investors over 2022. It was one of the primary causes for the pullback that we experienced over the year. More recently, we've seen how a higher interest rate environment can lead to certain breakages, such as what we've seen with certain banks in the U.S. and Europe again more recently.

I know the team has talked about how the rising or the increased cost of capital impacts our underlying businesses in many different ways. If we're looking for wealth-creating companies and the cost of capital is higher, inevitably I would think that that eats into wealth creation. It could also impact how we value companies. So I'm interested in hearing how you and the team are thinking about analyzing companies in this environment where the cost of capital actually exists.

Jeff Mo (29:20):

There's probably a two-pronged question there. One is, how does valuation get impacted in an era of higher interest rates? And then the second question is, would that eat into the wealth creation of companies?

Jeff Mo (29:40):

I'll tackle the second one first. I think—I hope!—it's relatively simple, which is, if you truly have a sustainable and strong competitive advantage, if you truly have a value proposition that's very unique for your customers, if your costs go up, whether it's your cost of supplies or your cost of labour or your cost of capital, you should be able to pass that on to your customers and ultimately still maintain the same spread or margin over your cost of capital when you think about your returns. And we are seeing that. I think a lot of our companies with strong competitive advantages are showing their pricing power to their customers.

Jeff Mo (30:14):

The first one is, I guess also not too complicated. It's more mathematical. So, earlier in our conversation, Anum, I was referencing our discount-to-cash flow models we use here at Mawer, where for a discount rate, we don't just pick a single number, rather we build it up from the yield curve of each of the countries that that particular company we're analyzing generates revenues from.

For most of the Canadian companies, obviously it'll be the Canadian yield curve that matters most. Many of our listeners here know that we employ a 15-year, three stage discount-to-cash flow model. We explicitly model out cash flows for 15 years. And so we will take the yield curve or essentially what the risk-free rate of the government of Canada bonds is, the yield to maturity for each year of maturity from year one to year 15. Two years ago, that was probably 2%, or even under, depending on the term of the bond. Now it's 4% even 5%—depending on the time period. That mathematically causes our discount rates, all else being equal, to be higher by about 300 basis points. And so that is reflected in our valuation just from updating our models. And of course, we also get the impact of the pricing on the other side.

Jeff Mo (31:38):

So, that's not a mathematical update. It will actually require us to go into our models, do some thought and decide if revenue growth is also increasing because of that. I would say that those would be the two ways to, I guess, answer your question of interested impacts on the companies.

Maybe to also just add, it was the higher duration companies—so, companies that had high growth, low current cash flows in the next couple of years, but lots of future cash flow in years five, year 10—that mathematically get impacted more because as discount rates increase, it's the cash in the near-term years that is more valuable on a relative basis versus the cash flows that you're generating in year 14 or year 15 in that discounted cash flow model, which is probably why we've seen some of those higher duration or higher multiple stocks do relatively worse in the last 12 to 18 months.

Anum Siddiqui (32:32):

Okay, thanks Jeff. Well, I think that is a great conversation on a variety of different topics. We appreciate your time on the podcast today.

Jeff Mo (32:41):

Yeah, thanks again for having me, Anum. Appreciate the conversation as well.