Every big company was once a small one

GROWTH POTENTIAL

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IN 2005, THERE WAS US$160 billion in takeovers and mergers in Canada, according to Thomson Financial, up 53% from US$104 billion in 2004. The list of large-cap companies no longer available for investment includes CP Ships Ltd., Creo Inc., **Dofasco Inc.**, **Geac Computer Corp.**, Noranda Ltd., and **Falconbridge Ltd.** Not all of these takeovers have been consummated, but if you add in potential takeover targets **Sears Canada Inc.**, **Placer Dome Inc.**, and **Fairmont Hotels & Resorts Inc.**, a year from now there will be a host of major companies that perhaps won't be around as we know them today.

We have been going through a period when many of Canada's most established corporations have been afraid to expand. Perhaps they still fear the fallout from the overexpansion in the technology sector or perhaps they are reluctant to expand in case consumer spending falters. Instead they have chosen to focus on cutting costs and generating cash flow.

Better margins have led to earnings growth, greater cash flow, and improved balance sheets, but how much better can margins get? If we do finally get the oft-predicted slowdown that many suggest, then the only way major corporations might be able to grow is through acquisition. With better balance sheets, these companies will have the cash to find the candidates for their expansion.

As small-cap portfolio managers, we would like to be the beneficiary of this trend to grow by acquisition. First, we want to own the stocks before the takeover premium comes along. In the past year, companies we invested in that have been taken over include Canico Resource Corp., Wheaton River Minerals Ltd., Tesma Inc., and Geac. And second, we would at least like to own some of the replacement candidates for the companies that are taken over. When the current small-cap darlings are gobbled up, others will evolve to fill the gaps.

WHAT TO LOOK FOR

Trying to pinpoint a takeover candidate is a difficult process. One way is to focus on poorly managed companies, with low profitability, trading at low price-earnings ratios or low price-cash-flow ratios. Ideally, an acquirer would take control of the company, replace the existing management, and enhance the value by turning things around.

This has happened in the past with such firm as Moore Corp. and **Sherritt Inc.** More recently both the Creo and the Geac takeover offers came in the midst of outside shareholder attempts to change the companies' direction. While identifying potential takeover candidates may work, one of the key risks is timing — you never know for sure who will be acquired or when.

In our **Renaissance Canadian Small Cap Fund** and our **Talvest Small Cap Canadian Equity Fund**, we prefer to buy small caps that we believe can grow into large caps on their own merits. One of our criteria is to look for small companies with management that has a vision that will make them big companies, and with some unique product or service to carry out the vision.

Ideally these companies are operating in markets large and fragmented enough that the companies can increase their market share. However, rather than buying simply based on vision, we also look for signs of success such as order intake, order backlog, and margin improvement.

We prefer to give up some potential return rather than risk our investment. Another sign of success to us is a rising return on equity (ROE). A company with a consistent ROE of 10% that reinvests all of its earnings should double its earnings in about eight years. A company with a 20% ROE should double its earnings in less than four years. It's like getting compound interest at the bank.

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In the past we have had success from our holdings in **Alimentation Couche-Tard Inc.**, **RONA Inc.** (see David West's update on Page 1), and **Bonavista Energy Trust**, which have crossed the chasm from small-cap to large.

Couche-Tard changed the way convenience stores marketed their merchandise, RONA rolled a successful Quebec-based home improvement business across Canada, and Bonavista successfully reinvested its cash flow for growth. So who do we see as some up-and-coming candidates?

GROWING NOW

☛ ***Groupe Laperrière & Verreault Inc.*** (TSX: GLV.SV.A). The company designs and sells engineered industrial equipment used primarily for the separation of liquids and solids in a variety of commodity-related processes. It serves four key markets: mining, chemicals, and food industries from which it derives 38% of its revenue; pulp and paper, which gives it 33% of its revenue; water treatment, which returns 19%; and energy, where it gets 10% of revenue.

We consider investing in GLV as a way to participate in the recent upturn in the materials sector without taking the risk of buying any particular commodity company. GLV's quarterly sales began improving in 2004, and order bookings have risen from an average $95 million per quarter in 2002 to an average $160 million per quarter in 2005. At Dec. 31, 2005, the order backlog was $310 million compared with $279 million a year earlier. Consensus earnings per share estimates for 2006 and 2007 are $1.43 and $1.60 respectively. The GLV year-end is in March. While there is a risk that capital spending by resource companies will slow down, GLV's diversification and its replacement parts business will help alleviate the downside.

☛ ***Savanna Energy Services Corp.*** (TSX: SVY). The sales for Savanna have grown from about $30 million in 2002 to $200 million in 2005. Savanna provides proprietary coiled tubing drilling services as well as other well servicing and wireline services to the oil and gas industry. Savanna drills about 15% of the wells in Western Canada. Coiled tubing, essentially one continuous tube, offers time and cost advantages compared with connected pipe, and is particularly useful in shallow and coal bed methane applications.

Drilling activity in Western Canada has been very strong because oil and gas producers need to offset declines from new wells, and because strong cash flow has resulted from high commodity prices.

While there is always a risk of a slowdown, and many question when the number of new oil rigs will saturate the market, we are still seeing oil companies signing two- to three-year contracts for oil rig services. While oil and gas prices may soften in the near term, if global demand for energy keeps growing, Savanna should do very well over the next two years. Consensus earnings per share estimates for 2006 and 2007 are $1.80 and $2.26 respectively.

☛ ***Stantec Inc.*** (TSX: STN). Stantec provides infrastructure and facilities services to public and private buildings, performing functions such as planning, engineering, design, and project management, mainly on a fee-for-service basis. Stantec's sales have grown from $265 million in 2000 to over $500 million in 2005, with an ROE of 14% to 17% over that time period.

Stantec has expanded its geographic footprint into the United States, where there are over 100,000 firms, with a market worth over US$50 billion annually. In our view the main risks for Stantec lie in the timing of projects, slowdowns or cancellations, and the general state of the economy. The consensus estimates for 2006 and 2007 are $2.30 and $2.60, respectively.

☛ ***Imaging Dynamics Company Ltd.*** (TSX: IDL). Imaging Dynamics develops digital radiology systems for the healthcare industry, based on a patented process using Charge Couple Device (CCD) technology. Traditional film x-ray still represents 70% of the market, but there is a definite trend to digital. While IDL's competitors, **General Electric Co.**, **Philips Electronics NV**, and **Seimens AG**, are recognized brands, their equipment costs hundreds of thousands of dollars more than IDL's.

IDL's devices use less expensive components, so its market can include hospitals, chiropractors, veterinarians, and other end users that can't afford the high-end devices. IDL's success so far can be measured not only in its rising order intake rate, but also in its agreements with major equipment distributors in both North America and Asia.

There are risks, such as growing pains, maintaining adequate working capital, and competitive reaction, but IDL appears to have an opportunity to grow in the foreseeable future. Consensus estimates project sales at about $50 million (with earnings per share at about $0.19) for the 2005 fiscal year ending in March. Sales are expected to climb to $100 million in 2006, with earnings per share rising to between $0.25 and $0.33.

All of these companies have growth as an objective and all have shown signs of success in achieving that objective. Certainly some have a longer track record than others, but we expect all four to be able to cross the $1 billion market cap threshold in the near future.▼

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