ValueInvestor INSIGHT

The Leading Authority on Value Investing

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# Investing in Crisis

Warren Buffett captures an essential truth about investing when he says, “It's only when the tide goes out that you learn who's been swimming naked.” The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they're navigating the roiling seas.

**INVESTOR INSIGHT**

**Whitney George**
Sprott Asset Management

## Hard Assets

*As both a portfolio manager and the president of an asset-management firm, Sprott Inc.'s Whitney George has done plenty of thinking about how well his portfolio and his firm are positioned for what he expects to be a rocky economic road ahead. Here he describes some of his key conclusions.*

**Like many value investors, your cash balance had grown coming into 2020 and you put it to work fairly quickly as the market collapsed. Can you generalize about your priorities in doing that?**

**Whitney George:** I'm an active value investor trying to understand what businesses are worth and trying to buy them at reasonable prices. I always stress companies with high returns on capital, strong balance sheets and that are trading at significantly out-of-favor valuations. As you say, the pickings with that combination of attributes were getting very slim as 2019 went on and into the new year.

As we essentially got a global margin call, almost everything got hit. Correlations went to one on nearly everything. This is something investors like me and many of the people you probably regularly talk to have been thinking about for a long time. You never know what's going to trip it – it wasn't the trade wars, it wasn't the impeachment proceedings, it ended up being a virus. But it did deflate the debt-fueled bubble that existed in many assets globally, and as a value investor that should be your time to shine.

What did we do? We put money in precious metals mining companies, which now represent more than 15% of my fund. We've been investing in high-quality energy companies, which we were doing before this crisis and before the price war between Saudi Arabia and Russia. I've also been adding to active asset managers. They are often punished the hardest in a decline because of their exposure to the markets, but asset managers have some of the strongest balance sheets and provide real leverage to a recovery.

**It sounds like you might be pretty high on the shares of your own parent company, Sprott Inc. [Toronto: SII].**

**WG:** Thank you for asking. In addition to managing money, I am also the President of Sprott Inc., where I have been for the past five years after leaving Royce & Associates. The company's stock is my most significant personal holding.

Sprott has three primary businesses, all tied to precious metals. The biggest business, with about $7 billion in assets, is managing physical bullion trusts that trade on the New York Stock Exchange and that allow investors to buy claims on physical gold, silver, platinum and palladium. The metal is stored at the Royal Canadian Mint and the shares of these trusts are exchangeable into that metal for delivery. The second business, with about $2 billion in assets, we purchased last year from Tocqueville Asset Management and now consists primarily of the renamed Sprott Gold Equity Fund. The portfolio is managed by John Hathaway, one of the longest-tenured and most successful active equity investors in gold and silver mining companies. We also have a well-established private-lending business that makes and facilitates high-interest collateralized loans to a range of mining-industry players in search of capital.

We expect all of these businesses to benefit considerably from the macroeconomic environment we see coming. In a world of seemingly limitless money printing, we think that it's only a matter of time before the inflation that central banks seem to seek so desperately will arrive – and that it will come on faster and increase more dramatically than people can imagine. We also believe the debt build-up we're seeing will significantly dampen economic recovery and that the debt load being taken on won't be manageable without debasing currencies. If we're right about this, hard assets will once again play an essential part in wealth preservation during what looks to us like an inevitable period of stagflation required to restore balance. I admit that's not a particularly optimistic picture, but it's what we're positioning our company for.

**Turning from that cheery note, describe why Pason Systems [Toronto: PSI] is one of your favorite ideas in the decimated energy sector.**

**WG:** Energy is an area I started to find increasingly interesting over the last six to 12 months as I cycled out of names like Apple and was looking at more out-of-favor ideas. The stocks in the sector were already re-rating before both COVID-19 and the Saudis and Russians picked one of the worst possible times to start a massive price war. Part of it was due to flagging global economic growth, but at the same time all things ESG [Environmental, Social and Governance] were turning the perception of energy into the next tobacco industry. The negativity was already high, and then it got much worse.

I've owned Pason since 2004 at various times and in varying quantities. It's one of the more interesting energy-related companies I've ever seen – it's actually more of a technology company. It provides technology and electronics that collect, transmit, manage and analyze oil and gas drilling data that is used to help optimize the performance of drilling operations. For example, it has developed rig sensors that direct horizontal-well operators to the optimal site in a formation to position a drill bit, arrived at by essentially sniffing the gases the drill bit is penetrating.

The company's market shares are high – 85-90% in Canada and 65% and growing in the U.S. Like any good technology company, it spends heavily on R&D and also earns technology-like margins, frequently 50% on revenue.

The business is driven both by the rig count in North America and the number of Pason products per rig that clients use. Rig counts are obviously way down and there's not a lot of visibility on when they will recover. But I am a big believer that the best cure for low prices is low prices, and that even a slow recovery in the oil price – at least back to $40-50 per barrel – will translate into significant upside for Pason. There's no reason in my view that its fundamentals can't come back to where they were before this crisis.

**Is the balance sheet a risk?**

**WG:** The company has C$170 million in cash and no debt. That's C$2 per share in net cash on a C$7-8 stock. I don't expect net profits this year, but there's a multi-year cushion in that level of net cash. I don't know if they'll do this or not, but with the annual dividend yield pushing 10%, they also have flexibility if necessary to save cash on that as well.

**If the fundamentals do come back to where they were, what upside do you see in the stock – now trading at about C$7.75 – from here?**

**WG:** Pason made C$1.50 in EPS in 2018 and just over C$1.30 last year. Those are far from its peak earnings levels earlier in the decade, but are reasonable levels to anchor on given where oil prices were in 2018 and 2019. The company also continues to increase its offerings, so it can grow

**INVESTMENT SNAPSHOT**

**Pason Systems**
(Toronto: PSI)

**Business**: Provider of technology and electronics that collect, transmit, manage and analyze oil and gas drilling data used to help optimize the performance of drilling operations.

**Share Information**
(@4/29/20, Exchange Rate: $1 =C$1.39):

| | |
|---|---|
| **Price** | **C$7.71** |
| 52-Week Range | C$5.81 – C$21.00 |
| Dividend Yield | 9.9% |
| Market Cap | C$596.6 million |

**Financials** (TTM):

| | |
|---|---|
| Revenue | C$295.6 million |
| Operating Profit Margin | 27.1% |
| Net Profit Margin | 18.3% |

**Valuation Metrics**
(@4/29/20):

| | PSI | S&P 500 |
|---|---|---|
| P/E (TTM) | 11.0 | 22.5 |
| Forward P/E (Est.) | 36.4 | 21.0 |

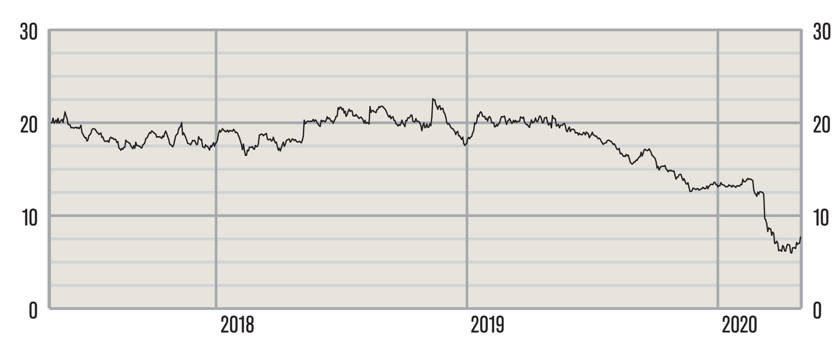
**Largest Institutional Owners**
(@12/31/19 or latest filing):

| Company | % Owned |
|---|---|
| Mackenzie Financial | 10.1% |
| Royce & Associates | 8.2% |
| Fidelity Mgmt & Research | 6.2% |
| Caisse de depot et placement du Quebec | 5.2% |
| Neuberger Berman | 4.8% |

**Short Interest** (as of 4/15/20):

| | |
|---|---|
| Shares Short/Float | n/a |

**PSI PRICE HISTORY**




**THE BOTTOM LINE**

As a service provider to the energy industry, the company's near-term outlook is predictably poor, says Whitney George, but he believes it can before too long return to earnings levels of 2018 and 2019, when its average EPS was C$1.40. Even assuming an unambitious multiple, he says, that would translate into an excellent return on the stock.

Sources: Company reports, other publicly available information even at a lower level of rig activity by increasing penetration per rig.

What kind of a multiple could you apply here? I could make the case that a company with this margin profile and balance sheet could go for 20x earnings. But if earnings get back in the next couple of years just to where they were one or two years ago, the multiple can be much lower and this would still generate an excellent return.

**You've been a long-time investor in Berkshire Hathaway [BRK-A]. What's your take on Warren Buffett's relative silence through all this?**

**WG:** I'd argue that there's no manager or company better proven to operate extraordinarily well in crises. Berkshire Hathaway is always a go-to name for me when there's a disorderly market environment, and after averaging in during the recent turmoil it's now the second-largest position in my fund.

I don't read much into Buffett's relative silence. Running a business with 400,000 employees in an economy that is shutting down is a challenging job. But still waters run deep and the environment over the past two months has improved for him. It's been almost trendy to ridicule Berkshire for having $128 billion in cash on its balance sheet, but I imagine that's been a pretty valuable asset of late – and probably will be for some time to come. VII

**Important Disclosure**

Whitney George serves as President of Sprott Inc., Chief Investment Officer of Sprott Asset Management LP and Chairman of Sprott U.S. Holdings, Inc. He is also a Senior Portfolio Manager at Sprott Asset Management USA. Mr. George is portfolio manager of Sprott Focus Trust (FUND), a closed-end equity investment fund that seeks to provide long-term growth of capital through a focused portfolio of value stocks of companies across all market capitalizations.

**Past performance is no guarantee of future results. As of March 31, 2020, Pason Systems represented 3.71% of Sprott Focus Trust's total net assets**. Sprott Focus Trust, Inc. (the "Fund") is a closed-end investment company whose shares of common stock trade on the Nasdaq Select Market. Closed-end funds, unlike open-end funds, are not continuously offered. After the initial public offering, shares of closed-end funds are sold on the open market through a stock exchange. For additional information, contact your financial advisor or call 1.203.656.2430. Investment policies, management fees and other matters of interest to prospective investors may be found in the fund's prospectus and shareholder reports. The Fund is a closed-end registered investment company whose shares of common stock may trade at a discount to their net asset value. Shares of the Fund's common stock are also subject to the market risks of investing in the underlying portfolio securities held by the Fund. Please visit https://sprott.com/investment-strategies/focus-trust for more information.

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