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# The overlooked value in GMP Capital

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One key to successful investing is staying within what Warren Buffett calls your circle of competence: the industries you know and understand.

For nearly a decade, I had the good fortune to work at an employee-owned investment bank in Toronto. Employees could purchase stock in the firm at book value – an attractive proposition since investment banks can earn very high returns on equity.

I had to sell my stock back to the firm at book value when I left to form a money-management firm. But while it was hard to let the stock go, it was only fair. The goal behind my former employer's stock policy is to maintain ownership with the current employees and keep them motivated.

Fortunately, the public markets have recently provided a way to buy into a similar business at an attractive price. It's GMP Capital Inc., the Toronto-based investment bank.

I know GMP well from my days on Bay Street. Back then, GMP and the Canadian bank-owned dealers were my main competitors.

At its core, GMP is an institutional equity investment bank. The firm acts as an underwriter on equity financings and provides advice on mergers and acquisitions for public companies. GMP also facilitates trades for its institutional clients by matching buyers and sellers for blocks of securities.

Most of the firm's revenue comes from two sectors: energy (oil and gas, in other words) and materials (metals and mining). GMP's business is highly cyclical given the volatile nature of these two resource sectors. Right now, both sectors are feeling the impact of lower commodity prices and investment banking activity has been depressed.

However, a well-run investment bank rarely loses money, even in difficult times. There are few hard assets in this business – just a few desks, computers and office space. The real assets are talented employees.

Beyond regulatory capital to support the firm's trading and underwriting activities, GMP's business does not require much incremental capital as revenue increases. As a result, it generates plenty of free cash flow in good markets.

In recent years, GMP has extended its core franchise to new territories – the United States, Britain and Australia. Expanding to jurisdictions where it can leverage its expertise in commodities is a smart strategy. In early 2011, the firm also raised $115-million of permanent capital via a preferred share issue on what I believe are attractive terms. I give it full marks for both initiatives.

Last summer, GMP's stock traded as low as $4.48 a share. I purchased the stock above that level and have watched it rise to around $7.14. I think there's still plenty of growth left. In better markets, I believe that the company is capable of earning over $1.50 a share and could easily trade over $10 a share.

My investment in GMP is not without risk. CEOs of businesses that generate excess free cash flow are tempted to use it to expand their business empire. Unfortunately, this usually leads them to take cash from the great business and invest it in one that is less so.

For example, in 2006, GMP purchased Edgestone – a private equity business – for $152-million. Over the ensuing years, the business was essentially written off. This is a sizable sum for a company of GMP's size.

There are a few promising signs that management has learned from past missteps and is not eager to repeat them. The divestiture of a small asset-management division was announced last month and GMP reduced head count to deal with the challenging operating environment. My interpretation of these announcements is that management recognizes that the core investment banking business should be, and will be, the focus going forward.

My investment thesis on GMP is straightforward. If the company focuses its efforts on its core institutional equity investment banking franchise and keeps a lid on costs when markets are soft, it should continue to prosper. Provided that it strikes the right balance between rewarding employees and shareholders, my investment should turn out quite well.

Whenever I hear my former partners complain about how tough things are in the industry, I tell them that I would be pleased to buy their stock from them. Not one of them has taken me up on my offer.

Like me, they know that the Canadian energy and materials sectors will turn around. They always do. And when that happens, my former partners, and their competitors at GMP, will absolutely mint it.