# Quarterly Market Commentary

September 2017

We are pleased to report that our managed portfolios continued to reflect strong results during the third quarter. Using the S&P/TSX Composite Index as a benchmark (which went positive in the third quarter), our managed portfolios are all doing very well year-to-date. We are pleased with how the portfolios are positioned and we remain to have a positive outlook for the balance of the year.

The macro theme through this past summer had been a re-acceleration in global growth versus what we viewed to be a deceleration in U.S. growth with a low inflationary backdrop. As a result, we saw a decline in U.S. interest rates and a weaker U.S. dollar versus most currencies. However, recent comments from the U.S. Federal Reserve (the Fed) along with the proposed changes to the U.S. tax structure have boosted the U.S. 30- year Treasury yield increase to 2.87% from 2.66%. This has also led to a recovery in the U.S. dollar, which had come under pressure since earlier this spring. As U.S. interest rates rise and the market discounts another Fed rate hike, we are now seeing a rotation back to cyclical value from secular growth. The sustainability of this rotation is still not clear. But given the extent of the relative outperformance of growth stocks over value stocks, we believe that the risk/reward favours value again. The macro rotation between value and growth not only has significant implications as to which sectors we overweight, but also affects specific stock performance. Throughout most of 2017 (excluding June), cyclical value has underperformed secular growth on declining interest rates and low inflation expectations. This rotation may be reversing on rising expectations of another Fed rate hike and higher oil prices.

It remains our view that U.S. and global growth will continue to re-accelerate in 2017, reaching a level of growth in 2018 which we expect will be the highest since 2010. Global growth fears, which dominated in 2015 and early 2016, have been replaced by confidence as the U.S. consumer has continued to spend, and inventory corrections have ended in the U.S. and most countries around the world.

During the third quarter, we added CIBC to the portfolio. Our views on CIBC are driven primarily by relative valuation. We also favour CIBC's recent approach to building franchises rather than building silos and entering into creative financing transactions.

We have long held the view that CIBC's business model, unlike most of its peers, is a set of silos (mortgage business, card business, etc.) rather than a set of interconnected franchises (e.g. consumer/ commercial banking). First-Line (mortgages) and Aeroplan (cards) are the best of examples of CIBC's more silo-based approach, and the sub-prime deals with the U.S.

Some of the names that we continue to hold and favour for 2017 include:

**ENERCARE**
Our overall outlook is relatively unchanged following the quarterly results and conference call, as EBITDA fell broadly in line with our forecast, customer aggregation trends remained consistent with recent quarters, and there were no new material developments accompanying the results.

We believe that Enercare remains an attractive long-term holding, as it is a well-run and stable company with a portfolio of rental assets that generate predictable and recurring cash flows supportive of the attractive dividend and good growth opportunities.

**CANADIAN NATIONAL RAILWAY**
CNR hosted an investor tour of the port of Prince Rupert. Prince Rupert has grown from 3% of CN's total revenue (~$230M) in 2006, before the construction of the container terminal, to 7% in 2016 (~$845M), and CN expects Prince Rupert to grow to more than 10% of its total revenue (medium term). We believe that this success/growth potential reflects Prince Rupert's natural advantages, combined with CN's distinctive business approach. Prince Rupert (1) the closest major North American port to Asia, (2) has the deepest natural harbour in North America, (3) has minimal terminal dwell time, (4) has connections to all major markets in Canada and many in the mid-west U.S., and (5) has ample space and strong workforce/local community support for expansion. CN's distinctive business approach includes collaborating with partners to create efficient, cost-advantaged, end-to-end supply chains.

We view CN as a relatively high-quality, low-risk industrial company, which should be a core holding.

**NEW FLYER INDUSTRIES INC.**
The past quarter was a record setter with EBITDA of $85M, above our estimate of $80M and consensus of $81M, reflecting all-time high margins from the bus division.

Robust coach and transit bus demand: 2017 guidance was increased for a second time to €3,800 (€3,750 previously and €3,650 originally), reflecting continued robust industry demand. These production levels are expected to remain stable through 2018, which bodes very well for continued margin improvements and cash generation, given the efficiency gains from operating at higher capacity.

Investments in R&D and facility upgrades: 2017 CapEx spending has been increased to $55 – $65M, compared with prior expectations for maintenance capex of $25 - $30M, reflecting planned facility upgrades and a new product development centre. Roughly half of the growth CapEx is being spent to expand the Alabama facility to allow for further in-sourcing of supply chain work (small parts and paint). We expect a relatively quick payback of 12 - 18 months on this investment through reduced input costs and improved margins.

New Flyer is generating strong free-cash-flow currently, with its capital-light business model, and we expect this to continue in the near term, given a strong industry outlook, record backlog, and continued opportunities for cost-rationalization and optimization as it consolidates its bus and coach operations. Furthermore, New Flyer has a demonstrated track record of creating value through disciplined M&A, and we expect this to continue being a part of the story going forward.

**MAGNA INTERNATIONAL**
We like Magna's current profile as it appears positioned to participate in the car of the future, is globally and operationally diversified, and is positioned to outgrow the industry, and has a financial position of strength that provides optionality with respect to capital allocation.

**EMERA INC**
We view the TECO acquisition positively as it is providing Emera with accretive regulated growth in earnings and cash flow, along with the potential to expand further in the U.S. It is also the company's first foray into natural gas distribution, and provides a new platform of growth. On a consolidated basis, TECO Energy has increased the regulated earnings in EMA's business mix and contributed to the company's geographic diversification.
We believe that EMA's investments in: (1) transmission, (2) reducing the carbon intensity of its portfolio, (3) gas generation and transportation, and (4) utilities will contribute to the company's ability to grow EPS and dividends by high single digits through to 2020. When coupled with a relatively low-risk business model and attractive dividend yield, we expect EMA to be appealing to investors looking for income and growth.

**ALGONQUIN POWER & UTILITIES CORP.**
In our view, Algonquin offers a balance of accretive expansion opportunities and transparent dividend growth potential (we believe that management's annual 10% dividend growth target is sustainable over our forecast horizon). Management has demonstrated an ability to navigate across multiple regulatory environments. We believe that Algonquin offers a compelling valuation in the context of an extensive growth pipeline (via development activity, acquisitions, and utility rate base investments), conservative payout ratio, and manageable leverage.

**ROYAL BANK**
We believe that Royal Bank represents a core holding in a Canadian equity portfolio. Royal Bank generates consistent, strong retail results and the shift to more predictable corporate lending, underwriting and M&A revenue from pure trading revenues will likely support a premium multiple. Royal Bank is known for its strong global presence and profitable capital markets presence. Royal Bank also has a track record of generating above-average industry growth. Investing in Royal Bank provides shareholders with exposure to Canada's largest bank with high-quality operating segments across all business lines.

**CANADIAN TIRE**
Canadian Tire reported a strong quarter that was well ahead of our estimates and consensus. We were most impressed with the retail performance, as it lapped a strong comparable period, had a revenue pull forward into Q1/17, and in general faced unfavourable weather. That said, retail sales and revenue growth performed well while the gross margin progression far exceeded our expectation. We believe that there remains further runway for gross margin improvement, including the sharing of efficiency gains at click-through rate cross the banners.

Canadian Tire remains a compelling risk/reward investment, in our view. We believe that the retail valuation remains attractive, Canadian Tire is on track to achieve our financial forecasts, there are additional real estate assets to monetize, and the retail balance sheet remains in a position of strength. It is our view that the active Normal Course Issuer Bid commitment provides a degree of downside protection to the share price, and that as Canadian Tire further surfaces value from underappreciated assets and achieves our financial forecast, the applied multiple to the retail division is poised to expand.

**PREMIUM BRANDS**
We are confident that Premium Brands is on pace to significantly exceed both its sales and margin guidance over our forecast horizon, given the following:

- AZ sandwich plant production is ~6 quarters ahead of our estimate due to production shifts between plants as well as new sales opportunities. We have pulled forward our sandwich sales estimate and increased our EBITDA margin assumption accordingly. As demand outstrips supply, we are confident that Premium Brands will need to build/acquire more capacity in the next two years.

- Specialty Foods (SF)'s organic revenue growth (outside of sandwiches) is far exceeding management's targeted 4 - 6% range, driven by new sales, product development initiatives, and leveraging investments made to expand capacity. Meanwhile, Premium Food Distribution (PFD) sales are poised to accelerate in second half on the back of greater retail network penetration, increased market share in Ontario (particularly once the new distribution centre pens in early 2018), greater market penetration in Quebec (i.e. C&C, an acquisition made roughly a year ago), and stabilization of the Alberta economy.
- SF gross margin expansion was impressive, and we expect it to continue, driven by improving efficiencies and product mix enhancement (i.e. exiting lower margin product categories and growth in higher-margin branded products).

**ALIMENTATION COUCHE-TARD INC.**

Couche-Tard shares have been under pressure amid concerns over recent lacklustre industry demand trends and several long-term headwinds (particularly electric vehicles). Sentiment on the shares has arguably hit a decade-low, although acquisition contribution and operational performance should improve as F2018 progresses, producing strong earnings growth that exceeds consensus and helping the share-price to rally. With a forward P/E under 17x, valuation remains attractive in relation to: 1) peer valuations (generally 20x or above), and 2) Couche-Tard's mid-20% EPS CAGR over the next two years.

**SUNCOR ENERGY**

With multiple production outages in the quarter, we knew that Suncor's headline numbers had the potential to miss the mark entirely. However, they were remarkably close to mean consensus estimates, with only a slight miss on production and funds from operation. Suncor also announced 2017 guidance revisions, largely as a result of the outages. Although production guidance is unchanged, this is offset by a 10% boost to CapEx to $5.5B (only some of which was expected). The near-term growth outlook is intact, with both Fort Hills and Hebron still tracking to first production by year-end.

**TRANSCANADA CORP**

TransCanada has a strong incumbency in the two most prolific natural gas basins in North America (the Marcellus/Utica and the Montney), combined with access to large markets, in our view. Growing connectivity over time should provide customers with increasing optionality as it moves approximately a quarter of North American natural gas demand. The company's 91,500 km. of pipelines have increasing value as new pipelines become more difficult to build, in our view. We believe that TransCanada's scale, energy infrastructure expertise, low-risk business model, and financial strength are competitive advantages when pursuing new assets. Big picture, strengthening oil and gas fundamentals should benefit TransCanada's growth outlook and mitigate any impact that rising interest rates might have on sector valuations.

**TORONTO DOMINION BANK**

TD delivered strong results in all respects, including margins, credit, and operating leverage in its two large retail banking segments. The insurance claims environment was also good.

Our view reflects the bank’s U.S. exposure and strong domestic P&C business. The advantages of the U.S. exposure relate to: (1) the positive effects of rising rates, (2) stronger economic growth and the resulting benefits on loan growth, and (3) the moderating expense growth expected to play out from the restructuring initiatives in the U.S. In periods when Personal and commercial (rather than capital markets) drives earnings growth, TD has historically outperformed its peers.

Source: Portfolio Advice & Investment Research (PAIR), as at October 3, 2017

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