CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Q3 Highlights Include New Positions in Kraft Heinz and Disney

North American financial markets performed well during the third quarter of 2017 (Q3), despite geopolitical tensions, hurricanes, interest rate hikes, and other concerns. We continue to execute our strategy of owning high-quality companies with good track records that trade at undervalued or reasonably valued levels. During Q3 we made several new investments that fit our strategy. We also sold Canadian Western Bank (TSX:CWB) out of our Total Return Portfolio and our High Yield Portfolio due to its rapid price appreciation, which exceeded our expectations. In this newsletter, we are going to highlight some of the transactions we completed during Q3 in our three model portfolios, including new positions in Kraft Heinz Co. (NASDAQ:KHC) and Walt Disney Co. (NYSE:DIS), and discuss how they fit in to our investment strategy.

Large Gains in Canadian Western Bank Shares

During the second quarter of 2017 (Q2), we purchased Canadian Western Bank (TSX:CWB) shares in the Total Return Portfolio and the High Yield Portfolio at a price of $25.45 per share.[1] On September 29, near the end of Q3, we sold our entire position in both portfolios at a price of $33.83 per share, giving us a gain of around 33%. In addition, we were able to collect two quarterly dividend payments during the holding period. Our short holding period was an anomaly for us, as we typically invest with a 3-5 year time horizon in mind.

Several factors contributed to the rapid gain. During Q2, there were legitimate concerns about the potential failure of Canadian alternative mortgage lender Home Capital Group Inc. (TSX:HCG). Some of these concerns also attached themselves, perhaps unfairly, to Canadian Western, which does some alternative mortgage lending. Home Capital then addressed those concerns by raising new capital.

There was a modest increase in Canadian lending rates during our holding period, which helped Canadian bank stocks as a group. There was also news about signs of recovery in the Alberta economy, which helped Canadian Western due to its large presence in the province. Canadian Western also helped its own cause by posting a good quarterly earnings report in late August. As Canadian Western shares crossed $33 in September, our view on the company being undervalued changed, and we decided to sell. Interestingly, CIBC's analysts cover Canadian Western, and they currently have a 12-18 month target price of $33 on the stock, suggesting that they would expect limited upside from this price.[2] We continue to hold positions in other Canadian financials, so we maintain exposure to the broad industry sector.

Our short holding period in Canadian Western shares reminds us that the value that the stock market places on a company can vary widely in a short period of time, despite no material changes in the actual business of the company. This can create some good investing opportunities for disciplined investors.

A New Position in Kraft Heinz

Kraft Heinz Co. (NASDAQ:KHC) is a global food and beverage producer that was created by the merger of Kraft Foods Group and H.J. Heinz Co. in 2015. The company's products include cheese, meats, coffee, frozen meals, sauces, nuts, dressings and various beverages. We view Kraft Heinz as a high-quality, well-managed company.

We have followed it since the merger, but we did not see an opportune time to purchase shares until recently. After trading above US$90 earlier this year, the company's shares fell below US$80 in September. The lower valuation coincided with a rise in the Canadian dollar, making Kraft Heinz shares even more attractive to us as Canadian investors. On September 22, we purchased a 2.4% position in both the Total Return Portfolio and the High Yield Portfolio at a price of US$78.76 per share.

In addition to the opportunity to acquire the shares at a reduced price, the company has several characteristics that we find attractive. Its shares could potentially generate positive returns even if North American economies underperform growth expectations. Although the food and beverage industry is not growing at a fast pace, it does tend to be less cyclical than many other industries.

Kraft Heinz also pays a dividend of approximately 3.2% annually, providing an incentive to hold the shares. The company is also backed by shareholders with deep pockets - Brazilian private equity firm 3G Capital as well as Berkshire Hathaway Inc. (NYSE:BRK.B). These parties have extensive knowledge regarding acquisitions, and many investors expect Kraft Heinz to attempt another large acquisition within the next few years. Kraft Heinz did make an ambitious US$143 billion bid for Unilever PLC (NYSE:UL) earlier this year, but it withdrew the bid after it was poorly received by Unilever management and shareholders.

3G Capital is known for reducing operating costs at acquired businesses. At Kraft Heinz, cost reduction efforts are ongoing. Kraft Heinz has already closed some North American production plants and consolidated operations at more modernized plants. Analysts are projecting a reasonable level of growth in earnings per share in the coming years. After posting US$3.33 in earnings per share in 2016, Kraft Heinz is expected to post US$3.62 and US$3.92 in earnings per share in 2017 and 2018 respectively, according to Bloomberg estimates. Kraft Heinz could potentially become a multi-year holding in our model portfolios. We are considering adding the company to our Balanced Portfolio as well, potentially in early 2018.

Disney – A Great Company Adapting to Change

Walt Disney Co. (NYSE:DIS) is a high-quality entertainment company with a long track record of success. Its businesses include media networks ABC, Disney Channel and ESPN, Disneyland parks and resorts and movie studios. After trading as high as US$115 earlier this year, Disney shares fell to around US$100 in September. On September 22, we purchased a 2.0% position in the Total Return Portfolio and a 2.0% position in the Balanced Portfolio at a price of US$101.23 per share. Disney shares pay a dividend of around 1.5% annually. After posting US$5.72 in earnings per share in 2016, Disney is expected to post US$5.82 and US$6.44 in earnings per share in 2017 and 2018 respectively, according to Bloomberg estimates.

Disney is facing some challenges, which we think the company will overcome. The "cord-cutting" trend, involving customers dropping expensive cable television packages for cheaper online streaming options like

Netflix Inc. (NASDAQ:NFLX), has hurt the results of Disney's media networks. In response, Disney is planning to remove its content from Netflix and launch its own online streaming services sometime in 2019. Disney recently completed the acquisition of 75% of a company called BAMtech that specializes in streaming video technology.

Movie production is a volatile business, as box office results are uncertain, and a year with blockbuster films can easily be followed by a leaner year. That said, Disney's movie studios are expected to perform well in 2018, with multiple Marvel Studios and Star Wars films scheduled for release.[3]

Parks and resorts are also a significant part of Disney's business. Early indications from the company's new Shanghai Disneyland are positive. Looking at the company's overall potential, we believe that it will successfully work through the challenges it is facing during the next few years. We believe that Disney shares at our purchase price represent far better value than the overall U.S. stock market.

Adding Energy Stock Exposure

It has now been around three years since the rapid oil price crash of 2014, when West Texas Intermediate (WTI) crude dropped from around US$107 in July to US$53 at the end of the year. We devoted most of our fourth quarter of 2014 Newsletter to the topic. Our outlook was as follows:

> "Based on the evidence before us, we need to be prepared for oil prices to average US$65 or lower for the rest of 2015 or possibly longer. We will not venture a prediction on where the price bottoms for this cycle, but sub US$40 is entirely possible. The duration of the down cycle will prove to be more important than the ultimate low price."

The duration of the down cycle has been long. As of October 16, 2017, the date of this Newsletter, WTI crude was trading around US$52, not far off the US$53 quote from the end of 2014. We have weathered the down cycle without too much difficulty. We have done this by avoiding smaller companies in the energy industry that tend to have very volatile results and instead owning the companies with large financial resources like Suncor Energy Inc. (TSX:SU).

As time has passed, global oil demand has risen, despite the numerous headlines about transitioning away from oil. For example, 2014 global oil demand was approximately 92.9 million barrels per day (mbpd). According to the International Energy Agency, 2017 and 2018 global oil demand will be approximately 97.7 and 99.1 mbpd respectively.[4] Oil producers read the same headlines about vehicle electrification and other shifts away from oil as the rest of us. Many large oil projects can require a decade of lead time as well as billions in up front capital in order to produce. At least some oil producers are going to hesitate to spend the capital to continue increasing oil supply, given the mediocre returns suggested by current oil prices and the uncertainty around oil's future.

As investors, we cannot be complacent and assume that energy prices will remain at current levels. Currently we see signs of reasonably strong oil demand and signs that the excess supply globally is beginning to be addressed. Therefore, on October 6, we added a 2.0% weighting in the Total Return Portfolio and the High Yield Portfolio in the iShares S&P/TSX Capped Energy Index ETF (TSX:XEG) at a price of $11.81 in order to slightly increase our allocation to energy companies. This exchange-traded fund is heavily weighted towards large, well-capitalized energy companies. If the TSX energy sector enters into a new bull market in the next couple of years, we will capture some of that upside, and if we are wrong to add slightly more energy exposure, we believe that the downside risk will be manageable.

Conclusion

We have devoted this Q3 edition of the Newsletter to a discussion of certain transactions in our discretionary model portfolios. Our philosophy of buying high-quality businesses trading at undervalued prices has proven to be durable, and we continue to look for opportunities that fit this philosophy. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Q3 Newsletter, and thank you for your business.

David W. Papau *BA, CIM, FCSI*
Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

Andrey Schmidt *BA, LLB, CIM*
Investment Advisor
T: 604 608-5224
andrey.schmidt@cibc.ca

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[2] CIBC Earnings Update on Canadian Western Bank dated August 31, 2017.
[3] http://movieweb.com/movies/2018/disney/
[4] https://www.iea.org/media/omrreports/tables/2017-09-13.pdf