CIBC Wood Gundy

Several Promising New Investments Added in Q1

We maintain a watch list of several hundred high-quality mid and large capitalization companies so we can follow the results of their businesses over time. Our watch list was a great source of new investments in the first quarter of 2013 (Q1).

Wynn Resorts Ltd. and MGM Resorts International

For example, we have monitored various publicly-traded Las Vegas and Macau casino companies for years. In Q1, we got off the fence and chose two from our watch list for our Total Return Portfolio, namely Wynn Resorts Ltd. and MGM Resorts International. The two companies now have a combined weighting of just over 4% in the portfolio. Our purchase price for MGM was US$12.60 per share and we paid US$120.51 for Wynn. A combination of positive industry trends and company-specific factors persuaded us to act.

The Las Vegas gaming industry is still emerging from the 2008-2009 recession. Vegas was hit hard by a decline in visitors and a local housing and unemployment crisis. Exacerbating the problems caused by the generalized economic downturn, a significant number of new hotel rooms came online at the same time as the number of visitors was declining.

As for gaming revenue, according to the Las Vegas Convention and Visitors Authority, for the full year of 2007, casinos on the Vegas Strip took in US$6.8 billion. Gaming revenue declined to US$5.6 billion in 2009 and then partially recovered to US$6.2 billion in 2012.[1] Visual evidence of the downturn remains at the north end of the Strip, where Echelon Place and Fontainebleau Las Vegas, two multi-billion dollar hotel and casino projects, stand unfinished today.

Despite these difficulties, we believe Las Vegas has retained its appeal as an entertainment destination. In 2012, Vegas set an all-time record with over 39.7 million visitors, narrowly surpassing the 39.2 million total from 2007. While revenue per visitor is still down in comparison to the peak years, we think this will gradually improve over the next few years along with the overall U.S. economy.

While Las Vegas appears to be slowly recovering, Macau never really slowed down. Macau, a former Portuguese colony, has been operated as a Special Administrative Region of China since 1999. The government ended monopoly control of the casino industry around a decade ago, resulting in a wave of new investment.

Since 2007, Macau has been the world's most lucrative casino market. Macau received around 28 million visitors in 2012.[2] To put Macau's gaming dominance in perspective, according to the Las Vegas Review-Journal, Macau's US$38 billion in 2012 gaming revenues exceeds the US$36 billion collected by the entire U.S. casino industry. Macau's year-over-year gaming revenue growth for 2011 and 2012 was 42% and 13.5% respectively.

While we do not believe that Macau gaming revenue will continue to grow that rapidly, Macau should still be viewed as a growth market. Improvements to air, land and sea transportation infrastructure planned for the next five years support that view.

Wynn and MGM each have exposure to both Las Vegas and Macau, but our investment thesis on each company is different. We view Wynn as a high quality growth investment that was trading at a reasonable valuation of less than 20x 2013 analyst estimates of earnings per share (EPS) at our time of purchase. Wynn plans to pay $1 per share quarterly in dividends in 2013, a shareholder-friendly move. Wynn has been profitable on an annual basis since 2006, and is in the design phase for a new casino resort to be located on the Cotai Strip in Macau.

In contrast, we view MGM as a turnaround investment, as it took on too much debt in the years prior to the recession. It has lost money on an annual basis since 2009, in contrast to its consistent profitability prior to the recession. On December 20, 2012, MGM announced the completion of a major debt refinancing, anticipated to save it approximately US$230 million of interest expense annually. We viewed this as a material transaction that could help shift investor focus from the company's debt load to its potential recovery. MGM's growth projects include a plan to build a new casino resort in the Cotai area.

We purchased Wynn and MGM with a multi-year time horizon in mind. These companies may be volatile, as they are consumer discretionary businesses that will be negatively affected in an economic downturn.

<u>BP Plc</u>

For almost three years after the catastrophic Gulf of Mexico oil spill, BP Plc sat on our watch list. Some brave investors stepped in to the market and bought in 2010 as the share price collapsed from US$60 to around US$25, but we decided to wait for more clarity regarding the outcome. At the time, there was speculation that the company's U.S. subsidiary could file for bankruptcy, and the leaking well took an agonizing 85 days to cap.

In Q1, we decided it was finally time to buy. On January 2, we bought shares of BP in the High Yield Portfolio at US$42.12. On March 28, we added BP to the Total Return Portfolio at US$42.14. BP shares now make up approximately 2.5% of the High Yield Portfolio and 3.5% of the Total Return Portfolio.

During the three years since the spill, BP has been financially punished (most would say deservedly so). For example, in 2010, BP established a US$20 billion trust to satisfy claims by individuals and businesses in the Gulf Coast region. In 2012, the company agreed to a settlement with the U.S. Justice Department requiring it to pay a US$4 billion criminal fine over five years.[3] The company also spent more than $14 billion on spill response and cleanup.[4]

Currently, a federal trial to determine civil liability is underway in New Orleans. The trial combines hundreds of claims made against BP and its drilling contractors to determine their degree of culpability. In the first phase of this non-jury trial, the court will rule on blame and the level of negligence. A ruling could come as early as July. If the court rules that BP was grossly negligent, environmental fines could reach US$17 billion.[5] The second phase of the trial, scheduled to begin in September, will consider damages. The full outcome of this civil trial may not be known until 2014.

While we cannot predict the outcome of this civil trial, we believe that a majority of BP's spill costs are now in the rear-view mirror. It is tempting to wait for the court's rulings, but investment decisions never allow for perfect clarity. Uncertainty is what creates undervaluation.

Regarding BP's valuation, for 2013, analysts estimate that the company will earn US$4.99 per share. The dividend yield currently exceeds 5% and has room to rise, as payouts are beneath historical levels. Projecting forward, BP cannot be considered a growth company. To survive the spill, it was forced to dispose of some assets. Management's strategy is now focused on projects with high returns instead of delivering growth in oil and gas volumes. Our strategy is to hold the stock for several years, giving investor perception and business results time to improve.

Canfor Pulp Products Inc.

Canfor Pulp Products Inc. is another selection from our watch list. In mid-2011, this company was trading near $20 with a massive dividend yield approaching 10%. We were never seriously tempted back then, due to the company's cyclicality and valuation. On January 25, we decided to buy, acquiring shares for the Total Return Portfolio at $10.05, giving the stock a portfolio weighting of around 2%.

Canfor Pulp owns 49.8% interest in Canfor Pulp Limited Partnership, which operates three northern bleached softwood kraft (NBSK) pulp mills in the Prince George region of British Columbia. NBSK pulp is used to make various paper products.

At our time of purchase, the company was not paying any dividend. Since then, it has reinstated a dividend at $0.05 per quarter. Our intention was to purchase the shares at trough in NBSK pulp prices and the company's valuation. It may take two years to evaluate the purchase.

There is reason to believe that NBSK pulp prices could rise. Raymond James Ltd. is projecting 2013 NBSK pulp prices of US$920 per metric ton (mt) and 2014 prices of US$950 per mt.[6] This compares to early 2012 NBSK pulp prices under US$900 per mt.

Canfor Pulp's results are quite sensitive to NBSK pulp prices and swings in the Canadian dollar. If NBSK pulp prices rise, and the Canadian dollar declines against the US dollar, the shares and the dividend payout could rise substantially.

Raymond James Ltd. estimates that the company's 2013 EPS and EBITDA will be $1.11 and $177 million respectively.[7] At our purchase price of $10.05, the company was trading at an estimated 2013 PE multiple of 9.1x and an estimated 2013 EV/EBITDA multiple of 4.7x.

We do not view cyclical companies like Canfor Pulp as buy and hold forever stocks. Our aim is to sell the shares for a profit within the next three years at a time when NBSK pulp prices are higher.

Manitowoc Co.

On January 16, we bought shares of Manitowoc Co. at US$16.08, giving it a weighting of just over 2% of our Total Return Portfolio. Manitowoc has two business segments, cranes and foodservice. The cranes segment manufactures various mobile cranes and tower construction cranes. It contributed 62% of the company's 2012 revenues. The foodservice segment manufactures ice machines, ovens, refrigerators and other commercial kitchen equipment. Foodservice contributed 38% of 2012 revenues. Manitowoc is a global company, with over 50% of total revenue coming from outside the United States.

When reviewing the company's results going back to 1996, we noticed that earnings and profit margins are highly cyclical, but the company has achieved strong sales growth and has not had an unprofitable year. In the coming years, we expect further growth in the business as well as cyclicality.

Analysts' consensus EPS forecast for 2013 is US$1.26, representing significant growth in comparison to 2012 actual EPS of US$0.78. In 2011, the shares traded up to US$23 at a time when the outlook for the company's business was weaker than today. In 2007, the shares briefly traded above US$50, before declining sharply. Manitowoc is a high-quality business, but we intend to sell its shares for a profit within the next three to five years, not hold them indefinitely.

NCR Corp.

NCR Corp. represents a rare foray into the technology industry for us, but it is not a standard "tech stock". The company has four operating segments: financial services, retail solutions, hospitality and emerging industries. Financial services accounts for over 50% of revenue, as the company is #1 globally in ATMs.

In retail and hospitality, NCR is a force in self-service checkouts and kiosks, a growing business. For example, in November, 2012, the company announced it won a contract to install 10,000 self-service checkout stations in Wal-Mart stores across the U.S.

Looking deeper into the company's business model, in recent years, they have successfully increased gross margins by focusing more on sales of higher margin software and services.

Superficially, NCR does not appear undervalued, as pension expense has suppressed their GAAP earnings. The company has been dealing with an underfunded pension plan and offering lump-sum payments to early retirees. This process should be complete by the end of 2013. The shares are trading around 12x 2012 non-GAAP EPS when you factor out pension expense. For 2013 and 2014 the company has guided for NPOI (non-pension operating income) growth of 15-20%.

In NCR we see a growing company that does not appear statistically cheap, but is in reality undervalued, and will produce better GAAP earnings when the drag of pension expense ends. We bought shares of NCR for the Total Return Portfolio on January 3 at US$26.23. It has a weighting of just over 2% in the portfolio.

Other Notable Transactions

Other notable transactions include our January 2 purchase of Philip Morris International Inc. for the High Yield Portfolio at a price of US$85.39 per share. Also on January 2, we bought shares of Thompson Reuters

Corp. for the High Yield Portfolio at a price of $28.88. These are both solid dividend stocks that fit the objectives of the portfolio.

On February 6 and March 4, we sold shares of Seaspan Corp. for the Total Return Portfolio at US$19.87 and US$19.30. Our cost base was US$15.56, and we also received a large dividend during our nearly two-year hold period. On February 27, we sold a portion of the Total Return Portfolio's position in Richie Bros. Auctioneers Inc. at $23.17. Our cost base was $19.40 and we also received a dividend during our hold period.

Conclusion

Our day-to-day work often involves researching companies that we do not actually end up buying, as we are very selective. We still consider this research time well spent, as we add the high-quality companies that we find to our watch list, where we can follow their progress. This knowledge is cumulative and will benefit long-term clients. We are excited about the new holdings profiled in this edition of our newsletter, now that they have moved from our watch list into client accounts.

As always, we thank you for your business, and invite you to contact us with any questions or comments.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

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[1] http://www.lvcva.com/stats-and-facts/visitor-statistics/ (April 24, 2013).
[2] MacauHub, *Macau received 28 million visitors in 2012*, http://www.macauhub.com.mo/en/2013/01/24/macau-received-28-visitors-in-2012/ (April 24, 2013).
[3] Washington Post, *BP settles criminal charges for $4 billion in spill*, http://articles.washingtonpost.com/2012-11-15/business/35505450_1_bp-rig-supervisors-bp-settlement-deepwater-horizon (April 23, 2013).
[4] Wall Street Journal, *Settlement Offer to BP Takes Shape*, http://online.wsj.com/article/SB10001424127887323549204578320362599078672.html (April 29, 2013).
[5] Financial Post, *U.S. judge approves US$7.8B settlement in BP class action suit*, http://business.financialpost.com/2012/12/24/u-s-judge-approves-us7-8b-settlement-in-bp-class-action-suit/ (April 26, 2013).
[6] Raymond James Ltd., Forest Products, Building Materials and Pulp & Paper Industry Comment dated April 16, 2013.
[7] Raymond James Ltd., Canfor Pulp Products Inc. Company Comment dated February 14, 2013.