CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

July 15, 2019

The Challenge of Finding New High-Quality Holdings

North American equity markets have delivered strong gains in the first half of 2019, easily erasing the losses experienced in the fourth quarter of 2018 (Q4). We remain levelheaded about the gains, as there are reasons to suspect that the next 12-18 months will bring a more challenging environment. Our views in recent months have been consistent. We still do not believe that a Canadian and U.S. recession is imminent, but the odds of one are rising. We still do believe that we are nearing the peak of this economic cycle, which has been among the longest on record. In order to avoid a drawdown in stock prices, we may require good corporate earnings in the next few quarters plus some reacceleration in global economic growth. If we see further weakening of the global economy, central banks lowering interest rates may not be enough to keep equity markets strong.

We have already discussed the big picture in depth in recent Newsletters; therefore, we are going to devote this second quarter (Q2) of 2019 edition to the topic of finding high-quality undervalued companies in the equity markets today. It is far more difficult to find high-quality companies to add to our discretionary model portfolios today than it was during the years 2009-2015. Many high-quality companies are now overpriced in our opinion, and paying top dollar even for exceptional companies often leads to poor returns.

Even though many companies appear to be overpriced, we are always researching potential new investments. Equity prices change constantly, and short-term declines can create opportunity. Also, companies' businesses can change significantly from year to year, often for the better, so it is important to check on promising companies often.

In the sections that follow, we are going to discuss some companies that look appealing to us. In some cases, we already own their shares, and in other cases, we are considering them for purchase. In all economic environments, we look for companies that fit our strategy of investing in high-quality businesses at undervalued prices. We want to find businesses with good future prospects that have also successfully navigated tough economic times in the past. Buying at undervalued prices is a potential way of enhancing returns for clients.

Alphabet Inc. (formerly called Google)

Shares of Alphabet Inc. (NASDAQ:GOOGL) are currently trading just above US$1,100, down from a recent high of US$1,296. While the company has been an exceptional performer over the past decade, looking at the last 18 months, the shares have provided minimal gains to shareholders, despite continued earnings growth.

Nearly all of Alphabet's revenue comes from selling online advertising. Its main businesses are the Google search engine and the online video sharing website YouTube. Alphabet has around one third of the entire global market for online advertising.[1] Unsurprisingly, the company boasts exceptionally high profit margins. It also has a very strong balance sheet with far more cash than debt. Consensus expectations are for the company to continue to grow sales and earnings per share at over 10% per year in the next few years.

With the recent decline and stagnation in the share price, Alphabet shares are looking more attractive to us. That said, we would prefer to buy the shares at a cheaper price. The company is likely going to face some regulatory investigations and challenges in the coming months. Also, due to its past success, the market capitalization (total value of all of its shares) is enormous at around US$800B, and significant positive developments may be necessary to meaningfully increase this valuation. We plan to continue our research on the company, and we may add a position to our discretionary portfolios at any time.

Choice Properties REIT

We believe that Choice Properties REIT[2] (TSX:CHP.un) is a high quality real estate investment trust. At current prices of around $13.80, it appears to be fairly valued rather than undervalued. In May of 2018, Choice acquired Canadian REIT, one of our favorite real estate investments. Canadian REIT was conservatively managed and had a strong record of shareholder returns dating back to the 1980s. Many of our clients owned the units. Lately we have grown more comfortable with Choice, and we may add it to our discretionary portfolios.

The main difference between Choice Properties and Canadian REIT before the 2018 acquisition was the type of property owned. Choice Properties primarily owned shopping centers anchored by Loblaw stores, which include grocery stores such as Canadian Superstore and also Shoppers Drug Mart. Canadian REIT owned a mix of office, retail and industrial properties. The main tenant of Choice is now Loblaw, accounting for 57% of gross rents.[3]

Choice currently provides a cash distribution of around 5.4% annually to unitholders, a slightly higher payout than what Canadian REIT provided. Choice believes that its property portfolio contains various long-term development opportunities, some of which include a residential component. In other words, as Canadian cities grow, a large piece of land containing a grocery store can become a mixed-use property with more square footage that generates more rent. As mentioned above, we do not own any Choice Properties in our discretionary portfolios currently, but it has long-term appeal as a high-quality holding, so we may add it at any time.

CVS Health Corp.

For decades, CVS Health Corp. (NYSE:CVS) has been viewed as a stable, high-quality business that earns most of its profit from its pharmacies in the United States. The company's scale in the U.S. is huge. 70% of the U.S. population lives with 3 miles of a CVS pharmacy. [4] The pharmacy business has some advantages, even if it is competitive and does not have very high profit margins. The main advantage is that people need to purchase medication even in bad economic times, so earnings can remain strong throughout the business cycle. Accordingly, CVS shares have performed pretty well over the last 30 years, providing decent appreciation plus a consistent dividend. Even so, the stock's short-term performance has been quite bad.

CVS shares hit an all-time high around US$110 in 2015 and it has been downhill ever since. After hitting US$80 in 2018, shares are now trading around US$55. The valuation appears cheap on a superficial basis, so we have been motivated to research the company to determine whether it is a buying opportunity.

Several findings stand out from our research. First, CVS is aiming to be much more than a retail pharmacy. It is trying to be a health care provider in a much broader sense. In 2018, CVS purchased health insurer and benefits provider Aetna for US$69 billion to broaden its range of services. CVS is also rolling out a “health hub” clinic concept that will allow customers to walk into a CVS pharmacy and receive a range of basic health treatments. The company aims to have 1,500 health hub clinics across the U.S. by the end of 2021.[5] These moves seem logical and positive to us. Simply dispensing pharmaceuticals may not be a viable business in the coming decades. Overall, the analysis we have read is generally positive on CVS’s ability to increase its earnings in the coming years and the appreciation potential of its shares from current depressed levels.

CVS is also facing some significant risks. The company has taken on a lot of debt in recent years, but it is aiming for rapid debt reduction in the near term. CVS may face competition from Amazon.com Inc. (NASDAQ:AMZN) and other new entrants to the pharmacy industry. Also, CVS sells a lot of regular retail products in its pharmacies, and many customers may now simply choose to purchase those items online or elsewhere. One of our main concerns as Canadian investors, which has nothing to do with the company itself, is the constant debate about U.S. health care. It seems to us like political change is always looming, with uncertain impacts on the current industry leaders. Currently we do not own CVS shares in any of our discretionary portfolios. We may take a small position in the near term, or we may simply watch and wait for clearer signals regarding the company’s future.

Fedex Corp.

Fedex Corp. (NYSE:FDX) is a sophisticated global package delivery and logistics company that we view as a high-quality business. Recently, Fedex shares traded around US$160, down around 30% over the past twelve months. On a superficial basis, it appears to be a cheap stock, so we are devoting more time to the company. We already own a very small 0.75% weighting in Fedex shares in our Total Return Portfolio.

Fedex is very economically sensitive. When the global economy slows down, as it has been doing recently in connection with global trade tensions, Fedex suffers. Accordingly, the company’s management is projecting that earnings for fiscal 2020 will be slightly down compared to fiscal 2019.[6] That said, it is clear that package delivery is not a dying business. The rise of online shopping has vastly increased the demand for Fedex’s services. The problem from an investor’s perspective is that Fedex and other package delivery companies have had to invest large amounts of capital year after year in order to meet the growing demand, so the growth has not been as profitable as expected.

There are also two sources of unorthodox competition. The U.S. Postal Service loses money but continues to provide package delivery services. Part of the outlook for companies like Fedex in the U.S. depends on whether the U.S.P.S. raises prices or exits the market. Second, Amazon.com Inc. (NASDAQ:AMZN) is building its own shipping and delivery network as its online retail business continues to grow.

Despite these concerns, we believe Fedex will be a good investment over the medium to long term. We may look to add to our position in Fedex, especially if the current economic weakness causes the shares to decline further.

Nutrien Ltd.

In early 2018, Agrium Inc. and Potash Corporation of Saskatchewan merged to form Nutrien Ltd. (TSX:NTR). Nutrien is the one of the largest fertilizer producers in the world. Its customers are agriculture businesses such as farmers. In addition to producing potash, nitrogen and phosphate fertilizers, Nutrien owns and operates over 1,700 retail locations, mainly in North America.[7] With shares trading around $65, the stock market values the company at around $39 billion.

We have followed Nutrien and its predecessor companies for many years, and we are currently becoming more interested in investing. We view Nutrien as an improving company with a reasonable valuation. We believe the company will be able to grow its earnings and dividend significantly within the next five years. The challenge we are facing is finding an entry point where we can pay a low price for the shares.

In the coming years, the company intends to expand fertilizer production, expand its retail network, return capital to shareholders through dividends and share buybacks, and continue reducing corporate costs as planned in connection with the Agrium - Potash merger. In the short run, earnings could be negatively affected by the recent poor weather conditions for U.S. farmers. We may add Nutrien shares to our discretionary portfolios if we see the right opportunity.

Vermilion Energy Inc.

We have owned Vermilion Energy Inc.[8] (TSX:VET) at various times in our discretionary portfolios, generally with good results. Our most recent purchase was on June 19, when we added to our Vermilion holdings in our Total Return Portfolio at a price of $27.90 per share. Vermilion now makes up around 1.4% of the Total Return Portfolio and 2.6% of the High Yield Portfolio.

We believe that Vermilion shares offer good value at recent prices. Historically the company has traded at a premium valuation relative to other Canadian oil and gas companies. Investors have been willing to pay this premium due to the company’s geographic diversification, attractive growth projects and sustainable dividend. With current sentiment now fairly negative on Canadian oil and gas companies, Vermilion’s valuation has been dragged lower. This has occurred even though the company’s own positive fundamental characteristics remain intact.

Regarding geographic diversification, Vermilion continues to succeed in Europe, Australia and the U.S. as well as Canada. Lack of Canadian pipeline capacity is not a key issue for Vermilion’s future, as the company has no exposure to significantly discounted Western Canadian heavy crude oil prices. The company’s production and reserves per share have risen significantly over the past five years. Its dividend yield is now above 9% at today’s market prices. Since 2003, Vermilion has consistently paid its monthly dividend. The dividend has not been cut during downturns in oil and gas pricing.

The company has now paid shareholders cumulative dividends of over $3.3 billion, which is significant, considering that its entire stock market capitalization today is only around $4.4 billion.[9] It will be interesting to watch Vermilion's corporate performance over the next couple of years.

Wells Fargo & Co.

We have held significant positions in U.S. banks for many years following the global financial crisis of 2008-2009. They have generally performed well for clients. Three of our largest holdings have been Bank of America Corp. (NYSE:BAC), JP Morgan Chase & Co. (NYSE:JPM) and Wells Fargo & Co. (NYSE:WFC). In recent years, the performance of Wells Fargo has significantly lagged the others. Wells Fargo is a high-quality bank with a long corporate history that maintained its profitability during the financial crisis. Part of the problem has been the 2016 scandal involving Wells Fargo employees opening numerous new customer accounts that were neither requested nor needed. This hurt the bank's reputation, and likely contributed to its weak revenue growth in recent years.

At one time, Wells Fargo was viewed as the leading bank in the U.S., but now many would argue that JP Morgan Chase leads the industry. In any case, we believe that Wells Fargo shares are starting to look more attractive, especially with a multi-year hold period in mind. The dividend is now around 4%. Wells Fargo is also returning significant amounts of capital to shareholders through share buybacks, which are reducing the number of outstanding shares. We have recently added slightly to our existing position in Wells Fargo in our High Yield Portfolio. It now has a 3.2% weighting in that portfolio and also has a 2.4% weighting in our Total Return Portfolio. Patience may be required, but we believe it will turn out to be a solid investment for clients.

Conclusion

Since clients already understand our somewhat cautious big-picture economic outlook, we decided to focus this Newsletter on a review of certain interesting companies that are attracting our attention. As always, we are looking for high-quality businesses selling at undervalued prices. Unsurprisingly, with some markets at all-time highs, these types of companies can be hard to find. We must still continue our research, as circumstances are constantly changing, and being up to date will help us react swiftly when opportunities arise.

Thank you for reading our Q2 Newsletter. 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 your business.

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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] JP Morgan Alphabet Inc. Research Report dated April 30, 2019
[2] 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.
[3] CIBC Research Report on Choice Properties REIT dated April 26, 2019
[4] CVS 2019 Investor Day Presentation
[5] CVS 2019 Investor Day Presentation
[6] Credit Suisse. Fedex Corp. Research Report dated June 26, 2019
[7] Value Line Report on Nutrien Ltd. Dated July 5, 2019
[8] 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.
[9] Vermilion Energy June 2019 Company Presentation

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