Portfolio Update – Empire Life's Dividend Growth Fund

By Doug Cooper, Sr. Portfolio Manager, Canadian Equities
May 28, 2020

In recent commentaries, I have highlighted a number of high quality global names that we have opportunistically added to the Dividend Growth Fund, primarily in the latter half of 2019. For this commentary, I would like to highlight a high quality Canadian company, Restaurant Brands International (QSR), which we added to the portfolio during the COVID-19 related equity market sell-off in February and March.

Often, I have spoken about a global approach being an important point of differentiation with the fund, including leveraging the fund's 30% foreign content limit. An equally important component of this global approach is investing in high quality global companies domiciled in Canada which provides significantly more diversification outside of Canada than implied by the 30% foreign content limit – QSR is a great example. Further, in Canada we are seeing a lot of value in the share prices of the Canadian banks; taking a longer term view, we believe they are well positioned to outperform the broader equity markets.

QSR is the owner of three very strong quick service restaurant brands – Tim Hortons, Burger King and Popeye's. Some of the attributes we like about this business include its strong brands which create a wide economic moat around its business; its franchise model which results in both strong free cash flow generation and low operating leverage; and the company's strong financial position supported by ample liquidity. Additionally, while growth in the short term will be under pressure from the COVID-19 related lockdown, longer term in a more normal environment, we anticipate that the business can grow revenue organically in the high single digit range.

During February and March, the share price of QSR came under significant pressure which pushed valuation on a trailing twelve-month basis from ~25x earnings to ~11x earnings. On average, we bought the shares for ~16x trailing earnings or a ~25% discount to our fair value estimate, which for all the attributes mentioned above, we viewed as very compelling. Finally, the company pays a dividend which yielded between 4 and 5 percent when we built up our position. While we would expect the dividend to remain unchanged in the short term, we expect to see it increasing steadily over time.

While Tim Hortons clearly gives the company exposure to Canada, QSR is a global business with over half of its revenue generated outside of Canada, and more importantly, the vast majority of its growth will also come from outside of Canada – specifically, from Burger King's international expansion and Popeye's expansion in the U.S., and longer term, in international markets such as China. So while QSR is domiciled in Canada, it provides material global exposure and these are the type of Canadian companies we aspire to own in the Dividend Growth Fund.

Today, non-Canadian stocks comprise ~25% of the fund, but ~60% of the fund's revenue is generated outside of Canada. This implies that a significant portion of the fund's Canadian domiciled companies generate a substantial portion of their revenue outside of Canada giving the fund diversification away from Canada's more cyclical economy and exposure to markets in the U.S., Europe and Asia. Other examples of Canadian domiciled companies in the fund that generate the majority of their revenue (ranging from ~70% to ~95%) outside of Canada include Saputo, Stella Jones, Granite Real Estate Investment Trust, Open Text, and Alimentation Couch-Tard. We would expect the 60% figure cited above to increase over time as non-Canadian stocks increase closer to the ~30% limit and the fund's more global focused Canadian holdings continue to expand outside of Canada.

Moreover, we are seeing a lot of value in Canadian banks, hence the fund's 19% weight mostly comprised of Royal Bank, Bank of Nova Scotia and TD. At current valuations, coupled with 5-7% dividend yields, we expect the Canadian banks to outperform the S&P/TSX Composite Index over the medium-term. In the short term, the banks face considerable headwinds primarily from an increase in provisions for credit losses and loan impairments; however, with the Canadian banks trading, on average, at just over 1x price/book on a trailing twelve-month basis we see a lot of these headwinds as being priced-in. Also, dividends cuts are unlikely considering the relatively low dividend payout ratios of the banks and Canadian retiree's reliance on Canadian bank dividends. It is also important to note that capital levels are at near record highs which, coupled with the banks strong organic capital generation, will help to act as a meaningful shock absorber from higher provisions for credit losses and eventual loan impairments.

We are mostly through the Canadian bank's second quarter earnings which began this past Tuesday on May 26th with the Bank of Nova Scotia. This quarter was not about reported earnings versus expectations but more about dividend sustainability and the market gaining comfort around capital levels and provisioning for credit losses. So far, none of the banks have cut their dividends and capital levels remain very strong and well above the regulatory minimum. Provisions for credit losses varied substantially versus expectations but most of the banks appear to be using conservative economic assumptions for provisioning which suggests that in a scenario where economic activity gradually improves, provisioning for credit losses could decrease in the next two quarters.

Since Bank of Nova Scotia reported earnings on May 26th, the Canadian banks have rallied substantially – there remains a significant amount of uncertainty in the short term related to COVID-19, and impaired loans will be a headwind for the banks in the coming quarters. However, with valuation levels still at decade lows, a lot of this uncertainty appears to be priced-in. The market seems to agree, considering how the share prices of the banks have responded so far post second quarter earnings.

In summary, the Dividend Growth Fund's exposure to markets outside of Canada is much higher than what is implied by the percentage of non-Canadian stocks in the fund. The percentage of non-Canadian revenue generated by the portfolio or global exposure – roughly 60% today - has steadily increased over the past year as a result of opportunistically adding high quality global stocks, and more recently, global focused Canadian companies like QSR. We anticipate the global exposure of the fund to increase further which should help maximize returns and minimize cyclicality. We also like the funds exposure to Canadian banks where we see considerable value taking a longer term view.

As a final concluding comment – the Dividend Growth Fund has a healthy level of cash today. Over the past month, we have selectively trimmed names that have outperformed the impressive rally in equity markets since the end of March 2020. We view this as prudent considering the extent to which equity valuations have increased coupled with risks related to COVID-19 as economies gradually reopen – specifically, productivity challenges from social distancing and the possibility of a resurgence of COVID-19 cases.

As always, thank you for your ongoing support.