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Brad's Musings

A Whopper of a Trade

In this musing I will discuss one of the most important investment topics today: what to do about low interest rates and the implications for equity investors. For a long time now, commentators, including myself, have been pointing out how illogical it is for government bonds to be priced at their current valuations. The bull market for bonds started 35 years ago and it has pretty much been a one way moon shot ever since[1]. Two weeks ago, the US 10 year Treasury yield hit an all-time low of 1.32%[2]. At that yield, and using the highest marginal tax rate in Ontario of 53.53%[3], the implied price-to-earnings multiple ("P/E") on that bond is 163x. This compares to the S&P500's current P/E multiple of 18.4x[4].

I have been wrong (or perhaps just too early) but I maintain my strongly held view that government bonds are dangerously overvalued and are likely to be lousy investments. Such low yielding bonds fail to compensate investors for the very real loss in purchasing power stemming from inflation. One of the counter arguments is that the low bond yields have some great predictive power and that they portend a major catastrophe coming for equities. And so the logical conclusion of that thinking is to buy businesses that are incredibly stable, benefit from lower interest rates, exhibit low stock price volatility, see their stock prices outperform when markets fall and who endured through the 2008 crisis with flying colours. After all, if a bond offering zero growth and zero inflation protection is worth 163x net earnings, then solid but slow growth businesses like apartment buildings, utilities, grocery stores, and canned soup makers are absolute bargains at 20-35x net earnings. This thinking has become widespread and today staple-like businesses are in a raging bull market.

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[1] Source: Bloomberg; High for USGG10YR Index (US Generic 10 year Yield) was 1981
[2] Source: Bloomberg; Low for USGG10YR Index (US Generic 10 year Yield) was 7/6/2016
[3] Source: EY Personal Tax Calculator 2016, http://www.ey.com/CA/en/Services/Tax/Tax-Calculators-2016-Personal-Tax
[4] Source: Bloomberg; SPX Index Bloomberg Estimated PE Ratio (1 Year Forward PE Ratio)

It's anyone's guess how high valuations can go but there's no reason why the safest and the most stable of businesses can't be worth nearly as much as bonds. Given the choice of owning a government bond yielding 1.32% or the 407 Highway at the same yield, I'd unquestionably own the highway given its ability to raise prices and defend its value against inflation. If the 407 is worth a 1.32% capitalization rate, then surely Toronto apartment buildings would be worth close to that too. And so the logic continues and one day we may wake up and find Loblaw Companies Ltd. trading at something like 60x P/E and we'll ask ourselves – how the heck did we get here?

There are three ways to position for this as an investor: get on board the train, try to fight it or try to take advantage of the relative mis-pricing opportunities that result from the massive changes in valuation. I believe there is a great set-up currently for making strong risk-adjusted returns from the third option. One source of opportunity is to identify staple-like businesses that deserve to be in the exclusive club of stocks loved by bond refugees, but for some reason or another, aren't valued as such yet. The most obvious bond-like equities already have high valuations and are the ones everybody owns: utilities, Real Estate Investment Trusts (REITs), consumer products companies, food companies, etc. They all exhibit low stock price volatility, high relative valuations and appear to be very crowded. Crowding is a hot topic these days and it occurs when the shareholders of a company look the same, act the same, utilize the same assumptions and have significant overlap in their portfolios. These crowded and highly valued stocks are where we frequently hunt for our short positions to offset our long holdings. One theme that we have found to be rewarding on the long side is to look for "second-derivative" consumer staple companies with similar, stable business fundamentals when compared to traditional consumer staple companies, but at more compelling valuations given their growth rates. For example, rather than owning one of North America's largest bacon producers, Hormel Foods Corp., we own North America's largest bacon packaging producer, Winpak Ltd. Rather than owning consumer products companies like The Procter & Gamble Company and The Clorox Company, we own CCL Industries Inc., who supplies the food, beverage and pharmaceutical industries with labels and containers.

Then there are the stocks that should be realizing higher valuations but aren't for the nonsensical reason that they also have substantial earnings growth. Because they are growing companies, these stocks attract a different type of investor and typically exhibit more volatility around quarterly reporting and during market sell-offs. This in turn disqualifies them for membership in "Low Volatility" Exchange Traded Funds and the billions of institutional dollars investing in "Smart Beta" strategies. Ironically, earnings growth has become something a lot of people simply don't want in their portfolios because they are so focused on minimizing volatility. It's ironic because anyone who has ever built a discounted cash flow model will tell you that it is the faster growing businesses that benefit the most from using a lower discount rate. As a result of this distortion, some interesting opportunities develop. Take Constellation Brands Inc. for example. It's an alcoholic beverage company, similar to Brown-Forman Corp. and Anheuser-Busch InBev SA, but it happens to have a relatively higher growth rate due to secular market share gains and margin expansion. One would think that Constellation Brands Inc. should receive a healthy valuation premium for its superior growth, but this is not the case and I think it's due to the concentration of growth investors and hedge fund owners in the stock.

One of our favourite investment ideas today is Restaurant Brands International ("RBI"). RBI, formerly known as Burger King Worldwide Inc., acquired Tim Hortons Inc. in a reverse takeover in late 2014. 3G Capital, the Brazilian private equity firm, owns 43% of RBI and has a stellar reputation for creating shareholder value. We like RBI because it generates roughly 75% of its operating income by collecting royalties from franchisees who operate the actual restaurants. Not only are these revenue royalties stable and predictable, but RBI doesn't have to be concerned with food, coffee or labour inflation eating into its operating margins. In fact, RBI actually benefits when food inflation occurs because the restaurant operators have no choice but to raise prices, leading to increases in same store sales and royalties to RBI.

Another excellent benefit of a royalty structure is that the restaurant-related capital expenditures are the responsibility of the restaurant owner. RBI is essentially the Franco-Nevada Corporation of the restaurant world.

If you want to find a steady consumer staple business worthy of owning instead of a government bond, RBI is a top contender; however, despite having a low volatility free cash flow stream, RBI is not yet one of the highly valued go-to substitutes for bond investors. We think this is driven by: (i) RBI's relatively low dividend yield of 1.4%, as management chooses instead to use its cash flow to pay down debt and pursue additional accretive acquisitions, (ii) high hedge fund concentration in the stock driven by the 3G cost-cutting angle, and (iii) because it is one of Pershing Square's largest holdings. Pershing Square had a big position in Valeant Pharmaceuticals International and their flagship fund declined 20.5% last year[5] and a further 25.6% in Q1 2016[6]. When a big fund with concentrated bets has a decline of that magnitude, many of its portfolio holdings are aggressively sold by other 'copycat' hedge funds that had invested in the same names. Compounding this selling pressure were other hedge funds who shorted Pershing Square's top holdings in anticipation of client redemptions and subsequent selling pressure. This led to a significant increase in price volatility and what I would describe as a stock that acted horribly most of the time during the market turmoil in early 2016. Yet another problem confronting RBI is that it reports in US dollars yet roughly 65% of its revenues are generated in Canada. As the price of oil fell precipitously in late 2015 through early 2016, so did the Canadian dollar. For a long time RBI became nothing more than an oil stock. The net result of all this was a very disappointing share price performance (down 4.3% in 2015 and a drawdown of 19% during Q1/2016). For bond refugees and quants who screen for stocks that rise when interest rates decline, RBI never had a chance to make their lists of stocks to buy. But therein lies the opportunity: RBI is actually a bond-like business with significant

[5] http://assets.pershingsquareholdings.com/2014/09/Pershing-Square-2015-Annual-Letter-PSH-January-26-2016.pdf
[6] http://assets.pershingsquareholdings.com/2014/09/Pershing-Square-1Q2016-Investor-Letter_May-11-2016_PSH.pdf

growth. The Canadian dollar has bounced back and it will start to become a tailwind for RBI in Q4 of 2016.

One of our analysts, David Greenwald, recently prepared an excellent presentation outlining the opportunity we see in RBI and I've attached his presentation to this email. I urge you to look at the stability of RBI's margins and the high free cash flow conversion stemming from very low capital spending. To put the opportunity in simple terms, RBI trades at approximately 17x our estimated Fiscal Year ("FY") 2018 cash earnings per share ("EPS")[7], despite having a model that can deliver high-teens EPS growth in the foreseeable future along with additional upside from future acquisitions. Contrast this with one of the bellwether consumer staple stocks, The Clorox Company, which trades at 25x FY2018 EPS[8] and is only expected to grow earnings in the mid-to-high single digit range.

In summary, yes, I think bond-like equities are forming a bubble, but I also recognize that bubbles can last for a long time, and so I am playing this one with a hedged approach, looking to capture value from a tilt towards growth and a contraction in the valuation gap between the unjustified and the deserving.

Brad Dunkley

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[7] Source: Waratah estimate for fiscal year ending December 31, 2018. Cash EPS = Reported EPS + D&A/share – capex/share.
[8] Source: Consensus estimates on Bloomberg for the fiscal year ending June 30, 2018.

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