



# Canadian & U.S. Morning Comments

July 11, 2017

## Scotiabank GBM DailyEdge Summary by Warren Hastings and Sunny Singh

### **Alimentation Couche-Tard Inc. (ATD.B, \$59.31, SO, \$76.00) – Another Nice Deal! Bonus: Commissary & Car Wash**

- < ATD.B signed an agreement to purchase privately owned Holiday Station stores with 522 stores in the Midwest U.S. This an interesting acquisition providing ATD.B with significant synergies that go well beyond incremental cash flow related to acquired EBITDA of \$180M-\$190M. Holiday operates a food commissary that produces fresh and frozen food for the entire network, and operates 221 car washes. Holiday extends ATD.B presence in 10 states and sees a move to 6 new markets. Store base is highly productive with enviable locations, difficult to replicate. Car washes and food commissary provide strategic advantage. Thus we see as a solid strategic move for ATD.B. Beyond the usual targeted synergies of purchasing and admin, we see long-term (L/T) significant revenue synergies as ATD.B exploits the commissary / food service and car wash expertise. Striking this deal hot on the heels of the CST closing speaks to the beauty of the decentralized model which will permit integration by different teams. Balance sheet (B/S) discipline will come to play as this deal closes in Q4/F18 when ATD.b will be well on the path of deleveraging from CST deal, making timing key.
- < **Top quartile network of c-stores / fuel stations great strategic fit for ATD.b.** Acquisition of privately held, Minnesota-based Holiday Station stores adds 522 stores (374 owned, 148 franchised) across 10 states, as well as a food commissary and fuel terminal. ~40% of the network is located in the Greater Twin Cities, home to 3.5M people. Deal adds six new states (ID, MN, WY, ND, SD, AK) to ATD.b's network, giving the company cross-country coverage (48/50 states). The network also includes a strong car wash business consisting of 221 locations. Holiday sites drive ~ twice the volumes of the average U.S. station. Food service penetration at just under 20% another positive.
- < **We anticipate initial synergies to be within ATD.B stated synergy goals for transactions (30-40% target EBITDA); there is significant potential here for reverse/revenue synergies over the longer term.** The car wash and commissary operations at Holiday hold exceptional promise here, in our view. ATD.B noted it could scale the commissary operation, adding a shift and possibly even expanding the facility, to serve other markets.
- < **ATD.b will finance the deal with cash on hand and existing facilities.** Pro forma leverage to reach 3.5x EBITDAR (incl. CST) with plan for rapid deleverage. Price not disclosed but we assume 10x EBITDA multiple (pre-synergies),

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which pegs deal at ~\$1.85B. We will update model following Q4 results July 12, though initial calculation yields ~\$0.12 accretion to EPS pre-synergies, or ~3.8% on F2019E EPS.

### Real Estate & REITs - The REIT Stuff - Take a Hike, Eh! Or Two or Three...

- < The title of this edition of The REIT Stuff (*Take a Hike, Eh! Or Two or Three*) surfaces nostalgic memories of the great Canadian classic movie "Strange Brew" where rising beer prices were perhaps more consequential than rising interest rates! Much has changed since Bank of Canada (BoC) senior leadership remarks on June 12/13, with an imminent BoC rate hike now on the table as policy normalization takes hold (CAD REITs are -3.5% since June 12, lagging the TSX by 1.7%; as shown in Exhibit 1 in the analyst's full comment available on Scotiaview.com). In this edition, we revisit CAD REIT performance during tightening cycles, both in absolute terms and relative to income alternatives. We conclude that potential further near-term CAD REIT unit price downside exists, but a meaningful decline (5%+) serves as a better entry point into a sector that is capable of medium-term outperformance.
- < **We like organic growth (NAVPU & distribution), low leverage, and well-located portfolios to combat a steeper yield curve, but pay attention to the NAV premium paid.** Our unchanged top picks include AAR, AP, BAM, BPY, CRT, REF, RUF, and SRU. We continue to think REITs delivering superior per unit growth will be rewarded, particularly as private market cap rates trough (i.e., cap rate compression can no longer be relied on). **The average NTM NAVPU growth of our top REIT picks is 5.5% versus ~4.5% average for our universe.** However, we would also avoid paying excess premiums to NAV (see our prior REIT Stuff). Of our SO-rated names, we note BPY and RUF trade at the biggest discounts to our Forward NAV (22% and 8%, respectively).
- < **Rate hikes driven by better economic times should put Canada on the map...** Exhibit 1 shows relative CAD REIT performance vs. TSX, noting flat/lagging performance leading into and out of the initial rate hike. However, as shown in the "T +12" column, CAD REITs have beat the TSX by an average ~6% in the 12 months post the initial BoC hike on total return (albeit at an uninspiring 50% frequency), with outperformance taking place after "T+6". CAD REITs have delivered a positive total return in the "T+12" period in each tightening cycle, compared to 60% during BoC easing cycles (CAD yield curve has flattened an average of 147 bp during the four periods; Exhibit 4). **Bottom line, we believe that an improving domestic economy is positive for Canadian REITs** on improving occupancy and rent, particularly in shorter lease-duration assets (i.e., hotel, free-market apartment, industrial, etc.). Anecdotally, we believe international (and U.S.) REIT investors are generally underweight Canada relative to global benchmarks on housing, consumer, and energy concerns, thereby surfacing a potential marginal buyer as downside earnings (FFOPU) revision and currency risks moderate (again, economy is important).
- < **... but locals may take REITs lower in the near term, creating a better entry point.** We believe a reasonable absolute valuation (2% discount to our NAV, 14.2x 2018E AFFO, and 6.3% implied cap rate) and slightly unfavourable relative valuation (versus banks and lifecos; Exhibit 2) may limit domestic investor flows, possibly driving a deeper discount to NAV (5%+). As in the past, we recommend buying the sector at a double-digit discount to NAV, which we think would be a very attractive entry point given Exhibit 3 shows CAD REITs recovering versus other yield as the tightening cycle progresses.

### Summary of target price / rating changes:

- < **Cogeco Communications (CCA, \$82.09, SO, \$95.00)** – Target price increased from \$83.00
- < **MTY Food Group Inc. (MTY, \$45.75, SP, \$49.00)** – Target price increased from \$48.00

**In terms of companies reporting results:**

- < **Jean Coutu Group PJC Inc/The (PJC.A)** – PJC.A reported adjusted EPS of \$0.25 vs consensus of \$0.23. Total same store sales (SSS) +6.8% vs consensus of 5.9%. Pharmacy SSS +10.1% vs consensus of 3.5% and Front-end SSS +1.4% vs consensus of 1.9%.

**Outside of earnings related news, we would highlight the following items:**

- < **Gildan Activewear Inc. (GIL)** – Cut to Sector Perform from Outperform at RBC Capital Markets
- < **Dream Industrial REIT (DIR.UN)** – Raised to Buy from Hold at Canaccord Genuity
- < **Imperial Oil Ltd. (IMO)** – Raised to Overweight from Equalweight at Barclays
- < **Husky Energy Inc. (HSE)** – Cut to Equalweight from Overweight at Barclays
- < **Cogeco Communications Inc. (CCA)** – Cut to Hold from Buy at Desjardins Securities
- < **Athabasca Oil Corp. (ATH)** – Cut to Speculative Buy from Buy at Canaccord Genuity
- < **Pengrowth Energy Corp. (PGF)** – Cut to Hold from Speculative Buy at Canaccord Genuity
- < **Tamarack Valley Energy Ltd. (TVE)** – Cut to Hold from Buy at Canaccord Genuity

## U.S. Market Commentary by Paul Bhangu and Rakesh Gupta

### Credit Suisse Research:

#### Applied Materials Inc. (AMAT, OUTPERFORM, Target Price: US\$ 54)

##### Well Positioned for Long Term Growth

- < Bottom Line: We attended the Technology briefing for sell-side investors at AMAT's headquarters yesterday. The Company now expects \$45bn as new norm for wafer fabrication equipment (WFE), driven by new end markets such as hyper-scale/Artificial Intelligence/Smart Cars, which have long-term growth associated with them. AMAT also highlighted its ability to innovate faster and win at key inflections due to differentiated capabilities on Device R&D and materials research, and a much broader product portfolio. We walked away with greater confidence on the near-term industry outlook, and in AMAT's ability to outgrow their market segments over the long term. We expect that upcoming analyst day will be a positive catalyst for the stock, and see EPS for midpoint of target model at ~\$4.50+ (vs. expectation of \$4), driven by WFE growth and market share gains. We continue to believe that market is pricing AMAT's secular growth as cyclical, and see potential for multiple and earnings upside. Our CY18 EPS of \$3.59 is 10% above street. Maintain target price of \$54 (15x CY18 EPS).
- < Memory Driven by Data Growth - AMAT gaining share: AMAT estimates that NAND WFE can sustain at \$11-13bn range at 40% bit growth but could grow to \$19bn by 2020 if growth accelerates to 60%. AMAT made a strong argument that data growth is underappreciated, and even with 1% adoption of smart cars/ smart factories, there is potential for 5x/25x growth in DRAM/NAND bit demand by 2020 - however more leading edge logic may be used to drive more efficient use of memory. AMAT's comments as also positive view for Micron (MU), and Lam Research (LRCX). AMAT highlighted their key technologies which are enabling 3D NAND scaling, and have driven market share gains.
- < Patterning - Growth With or Without Extreme ultraviolet lithography (EUV). AMAT expects the patterning market/company revenues to grow from \$3.2bn/\$600mn in 2017 to \$4bn-\$4.4bn (depending on EUV)/>\$1.4bn by 2020. The Company highlighted Dep-Etch co-optimization, and Multicolor solution for addressing the Edge placement error issue - and these could be key growth drivers going forward.

##### Rating Changes: Source CNBC

**Coach (COH) , Michael Kors (KORS)** – MKM began coverage on both companies, issuing a "buy" rating on Coach and a "sell" rating on Michael Kors. It said Coach is a growth story gaining momentum, while pointing to deteriorating sales metrics and bloated inventory at Kors.

**Exxon Mobil (XOM)** – Barclays upgraded the energy giant to "overweight" from "equal weight," noting the company's diversified portfolio and recent underperformance by the stock.

**Snap (SNAP)** — The Snapchat parent's stock was downgraded to "equal-weight" from "overweight" by Morgan Stanley, citing competition from Instagram and slower-than-expected development of Snap's ad product. The stock fell below its \$17 initial public offering price for the first time Monday.

##### Earnings and Corporate Reporting: Source CNBC

**PepsiCo (PEP)** – The snack and beverage giant reported Q2/17 adjusted profit of \$1.50 per share, 10 cents per share above estimates. Revenue also topped forecasts, and PepsiCo raised its full-year forecast.

**Barracuda Networks (CUDA)** – Barracuda reported adjusted quarterly profit of 18 cents per share, matching estimates, with the cybersecurity company's revenue coming in above forecasts. Barracuda gave weaker-than-expected current-quarter earnings guidance, however.

**News:** *Source CNBC*

**Amazon.com (AMZN)** – Amazon is in the midst of its annual Prime Day, which began last night and will run through the overnight hours tomorrow morning.

**J.C. Penney (JCP)** — Chief Financial Officer Edward Record is stepping down from that role effective today, although he'll remain in an advisory role for the retailer through August 7. Chief accounting officer Andrew Drexler will handle the CFO duties on an interim basis.

**Rent-A-Center (RCII)** – Rent-A-Center received a takeover offer from Vintage Capital for about \$800 million. The private-equity firm's proposal to the rent-to-own company is worth \$15 per share, compared to Monday's closing price of \$11.10. Vintage wouldn't comment on the report, but Rent-A-Center said in a Securities and Exchange Commission filing that the proposal significantly undervalues the company.

**Western Digital (WDC)** – Western Digital said it has matched outstanding bids for Toshiba's semiconductor unit, which currently peak at \$18 billion. That comes ahead of a court hearing on Friday in which the disk drive maker seeks to halt the auction process.

**Sanofi (SNY)** – The drugmaker announced a deal to buy privately held Protein Sciences, a Connecticut-based company specializing in vaccines. Sanofi will pay \$650 million upfront and up to \$100 million depending on the achievement of certain milestones.

**Microsoft (MSFT)** – Microsoft is proposing a \$10 billion program to bring broadband internet to rural areas in the U.S., according to the *Seattle Times*. The details will be announced at an event in Washington, D.C., scheduled for today.

**Arena Pharmaceuticals (ARNA)** – Arena said an experimental drug designed to treat a rare but deadly lung disease met its primary goal in a mid-stage study.

**Amicus Therapeutics (FOLD)** – The drugmaker will submit a new drug application for its treatment of Fabry disease during the fourth quarter of this year. The Food and Drug Administration told Amicus it could submit the application following a series of discussions about the treatment.

## Fixed Income

### Morning Comment

#### Quiet Start to the Week

- < **Yields ended little changed.** Absent any market-significant data yesterday morning, and despite strong trade data from Germany, global bond yields tracked lower for most of yesterday's session. In Canada yields shifted back to unchanged in the afternoon while the U.S. remained bid. This could likely be a result of market participants taking advantage of last week's losses. At the close, U.S. yields were lower by no more than 2bps while Canada was mostly unchanged.
- < **Canadian housing and Fed commentary could provide highlights today.** Canadian June housing starts are due at 8:15am ET and are expected to increase over the prior month. The data will no doubt be useful in gauging the supply response in the Canadian housing market, with focus on the greater Vancouver and Toronto regions. Additionally, it could have an impact on the discussion of tomorrow's Bank of Canada rate announcement. Then at 12:30pm ET, U.S. Federal Reserve Governor Lael Brainard (voting, dove) will share her views on "Normalizing Central Banks' Balance Sheets."

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Research Associate Vincent Perri visited several of Gildan's textile and sewing facilities, located in Honduras, on December 2 to 4, 2013. Partial payment was received from the issuer for the travel-related expenses incurred by the Research Associate to visit this site. **Gildan Activewear Inc.**

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