cardinal UPDATE

FEBRUARY 2018

DIVIDEND INCREASES

Canadian Utilities Ltd.	10.0%
Canadian National Railway Co.	10.3%
Enbridge Inc.	10.0%
Comcast Inc.	20.6%
Simon Property Group Inc.	5.4%
Intel Corp.	10.1%
Novartis AG	1.8%

(During the period January 1 to January 31, 2018)

NAFTA

Concerns surrounding NAFTA have been top of mind as a sixth round of negotiations wrapped up in late January. There is a real risk of a U.S. announcement to pull out from NAFTA. This may well be a negotiating tactic; however, the Canadian market would react negatively. Over the longer term, the markets will adjust to whatever new trade rules take the place of NAFTA. But until then, the uncertainty could impact various companies including Magna and Gildan.

As a global auto parts manufacturer, Magna's products can cross borders multiple times before final assembly and delivery to the customer. The Canadian auto parts industry is one of the largest exporters to the U.S., shipping $90b annually. That said, Magna's business is best positioned among its peers to adjust to potential pro-America changes with close to half of its North American revenues (and employees) located in the U.S. We also feel that changes to trade rules will be less severe than headlines suggest, as the U.S. has just as much to lose from trade changes in the auto parts sector. Almost all of the major U.S. auto parts suppliers have manufacturing in Canada or Mexico with supply chains tightly integrated. Further, while Mexico seems to be a specific target of the Trump administration, Mexican auto production increasingly serves a global market. Its automotive exports have shifted away from the U.S., with now only half of their overall automotive output being shipped to the U.S. For these reasons, we see the potential long-term impact to be more muted than feared.

Clothing manufacturers are also subject to trade agreements. However, with nearly all clothing manufactured outside of the U.S., any additional duties would be passed onto the consumer. Higher prices may decrease demand and dampen clothing sales, but those with cost advantages or strong brands are less likely to feel the full brunt.

Gildan is well positioned given its low cost leadership. At a per unit cost of less than a couple dollars, a modest duty won't have a major impact. Additionally, about half of costs are incurred in the U.S. due to Gildan's U.S. yarn spinning operations. U.S. made yarn is shipped to its manufacturing facilities, predominately located in the Caribbean, to be made into finished products. Gildan's Caribbean manufacturing facilities are covered under the Central America Free Trade Agreement (CAFTA), which means that goods flow duty free between the U.S. and Central America. To date, concerns have not been raised about CAFTA and with the U.S. being a net exporter, notable changes are unlikely. Gildan also has manufacturing in Mexico; however, most production could be sold in international markets or manufacturing could be shifted to other plants.

NAFTA negotiations resume in Mexico City at the end of February and will be watched to see if some of the more hopeful tones struck at the January negotiations lead to progress on a revised agreement. The continued uncertainty about the future is arguably the greatest negative and increased certainty about the outcome, whether good or bad, would allow companies to begin planning for the future and adapt as they have throughout the decades.

COMPANY FOCUS:

WALGREENS

Walgreens Boots Alliance (WBA) is the largest retail pharmacy by store count in the United States and also has a significant international presence. The majority of WBA's revenues and earnings are generated in the U.S. and WBA recently further expanded its U.S. footprint with the acquisition of 1,932 Rite-Aid stores. The pharmacy market remains fragmented in the U.S. as CVS Health and WBA make up ~45% of prescription revenues, leaving ample room for further market share gains.

Outside of the U.S., WBA has an underappreciated growth opportunity as European countries such as Italy deregulate, which has allowed chain pharmacies to establish a presence in these countries. Latin America also presents an avenue for growth as WBA is the #3 player in Mexico with 1,100 stores and is looking to further consolidate the industry.

Fears of Amazon disrupting the healthcare industry have caused a sell-off across the entire healthcare supply chain. This has allowed us to purchase a quality company that trades at an attractive valuation. Strong cash flow generation should allow WBA to extend its streak of 42 consecutive years of dividend increases.

400 - 1780 Wellington Avenue
Winnipeg, Manitoba R3H 1B3

Phone: (204) 783-0716
Fax: (204) 783-0725
Toll Free: (800) 310-4664

www.cardinal.ca

CARDINAL CAPITAL MANAGEMENT, INC.