cardinal UPDATE

DECEMBER 2018

DIVIDEND INCREASES

Company	Increase
Canadian Tire Corp., Class A	15.3%
Siemens AG	2.7%
Sun Life Financial Inc.	5.3%
TELUS Corp.	3.8%

(During the period November 1 to November 30, 2018)

CANADIAN OIL: WHAT'S THE DIFFERENTIAL?

Beginning in August of 2018 the differential between Western Canadian Select (WCS) and West Texas Intermediate (WTI) widened from <US$20/bbl to $50/bbl. In this note we will address why differentials have increased, our rationale for an average $25-$30/bbl differential in 2019, the low $20's/bbl in 2020, and a longer-term view. In sum, we do not believe that panic is warranted.

The writing has been on the wall that a sub-$20/bbl differential was not sustainable. Utilizing Canadian production forecasts from CAPP and adding up available pipeline capacity, a clear gap between the two was emerging for late 2018/2019. With no pipeline capacity expected to start until late 2019, this production would have to be transported by rail. In order to "incentivize" barrels to move via rail, the differential has to rise above the cost of railing crude from Alberta to the Gulf Coast, which is estimated at ~$17-$20/bbl; however, instead of settling modestly above this, the differential blew by it to $50/bbl. We believe this was primarily due to extensive refinery maintenance in October and November. Refinery maintenance in the U.S. Midwest was equivalent to over 12% of all Canadian crude exports.

As we write this, the differential has already narrowed to $30/bbl. We believe this is due to these key refineries coming back to the market. It is also due to continued ramp up in crude by rail as well as shut-in production by producers.

For 2019, we are expecting an average differential of $25-$30/bbl. Why is this above the cost of rail? First, we want to be on the conservative side when we value our companies. Secondly, it is because the ramp up in rail capacity will take some time. Cenovus was a first mover in rail and their expected 100mbbl/d of capacity is expected by mid-2019. There is upside to our 2019 forecast from more free-market driven production shut-ins and the potential for the province of Alberta to force producers to shut-in more production.

Things should continue to improve in 2020 primarily due to the completion of Enbridge's Line 3 Replacement project, which will increase low-cost pipeline capacity by 375mbbl/d. This project has cleared the lion's share of its regulatory hurdles and has a high probability of meeting its construction targets. Further, more rail deals will materialize. The government of Alberta recently announced its intention to purchase rail cars and sign a 3 year deal to transport 120mbbl/d of crude. Given the continued need for rail, we expect the heavy oil differential to be around $20/bbl.

Beyond this, in order to return to the historical mid-teens differential, we would need to replace the rail capacity with either Keystone XL or the TransMountain Expansion. Much ink has been spilled on prognostications of these steel corridors and we have no special insight. We remain comfortable with our investments in the Canadian energy sector in the event neither project proceeds, but are hopeful one of them can get built.

COMPANY FOCUS:

TRANSCANADA

We attended TransCanada's Investor Day last month and it supported why we continue to like the stock. TransCanada currently trades at a similar valuation as the 2008-2009 recession, while the company fundamentals have never been stronger. Year to date earnings are at an all-time high and have increased by 25% from last year, while the share price has declined by 12%. The company's project backlog is $36B and growing and does not include the $8B Keystone XL project. This backlog should support the company's ability to grow its already robust dividend by 8-10% per year.

What's driving growth is obvious but constantly overlooked due to KXL: 70% of the company consists of the Canadian, US, and Mexican natural gas pipeline business which transports 25% of North American demand. Of the $36.2B backlog, $32.1B of it is natural gas related, not oil. A majority of these projects are low risk as they are of manageable size ($1-2B) and have low regulatory risk. This last point is particularly underappreciated as most of TRP's growth is expanding its pipelines in place, rather than riskier brand new pipelines.

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