October 31st, 2016

QUIC RESEARCH REPORT

Consumers & Healthcare

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Canadian Consumers Sector Update

Consumer Discretionary / Staples Primer and CTC Sell Pitch

Introduction

This report outlines the Canadian Discretionary and Staples markets. We used the research from this report to help us evaluate our current holdings in Canadian retail space. As such, we decided that it was time to sell one of our older holdings, Canadian Tire. This report includes our sell pitch on Canadian Tire, and the implications on our portfolio.

Highlights

- On the discretionary side, e-commerce has been limiting the potential of department stores to increase revenues. Restaurant sales have also been declining as grocery prices are becoming more attractive

- On the staples side, food wholesalers have been experiencing lower revenues and food prices continue to fall

- Canadian Tire has been one of our strongest holdings since its purchase in 2014. That being said, the new threat of e-commerce and retail giant's entering Canada brings us to believe that Canadian Tire will underperform going forward

- We currently believe Canadian Tire is significantly overvalued, and our DCF showed a (6.1%) return over the next year

QUIC Research Reports focus on emerging investment themes that affect current portfolio companies and companies under coverage.

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Consumer Discretionary Industry Overview

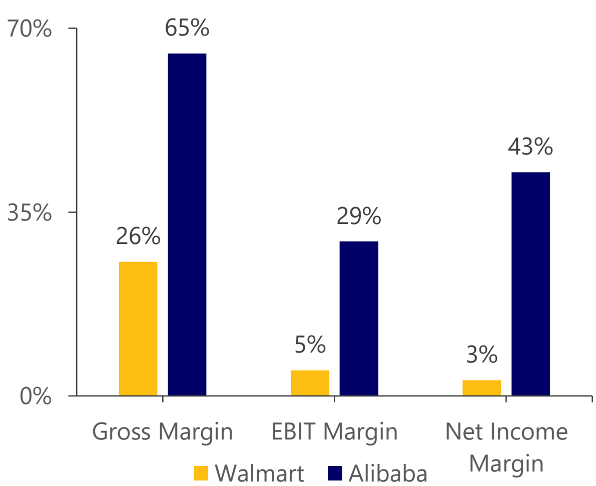
Macroeconomic growth drives this industry as it is very closely tied to the financial health of the consumer. Canadian consumer spending has been on a healthy rise in most provinces, growing by 5.53% in the second quarter of 2016. Only Alberta reported a decline due to the downturn in the energy industry.

Department Stores

Increasing competition from the e-commerce industry has been limiting the potential of department stores in Canada. E-commerce operators, such as Alibaba and Amazon, are able to offer much more competitive prices due to the lower overhead costs. Department stores often compete on their real estate locations, and thus incur a premium cost. E-commerce stores benefit from their online presence and are able to reduce their overhead costs associated with physical property to just regional distribution centres. Moreover, e-commerce stores see cost savings in terms of wages as well due to a lesser need for sales staff. In response, department stores have been forced to slash prices to retain their customer base, as well as open up their own e-commerce platforms which have failed to impress.

EXHIBIT 2

Retailer Cost Structure Differences



Source: Capital IQ

However, there are signs that it is not yet game over for traditional department stores. The pace of online sales growth has decelerated, from 39.3% in 2012 to 18.6% in 2015. Moreover, online sales volumes are still not high enough to justify the closing of department stores. It is also important to note that certain department stores are affected differently. General merchandise stores sell products which are easily distributed by online retailers, whereas clothing-based department stores like Hudson's Bay are less likely to be negatively affected. Similarly, furniture stores such as Leon's are more protected against the rise of e-commerce due to sheer size and weight of their offerings, which adds an increased shipping cost for the online players.

Department stores are also facing competition from supercentres, who's business encompasses that of department stores but also offers groceries. This makes supercentres a "one stop shop" for consumers, and as a result leading department stores have begun the conversion process to supercentres. A notable industry player who has undergone this process is Walmart. Other general purpose department stores such as Canadian Tire are unlikely to make the conversion process and thus will continue to face this competition.

Auto-Parts & Retailers

As mentioned in the Auto Industry Primer, the QUIC team's view of the auto-industry is dim. Input costs and regulation are rising, and demand is propped up by extended-term loans.

Restaurants

Canadian restaurants are subject to falling revenues as grocery store prices are becoming more attractive. This trend has been felt by the fast food players with poor earnings performance recently. Moreover, the costs of dining-out actually rose in Canada by 2.6% in September 2016. Consumers are opting to make their own meals rather than eat at restaurants due to the financial benefit.

Consumer Staples Industry Overview

The Consumer Staples industry is non-cyclical and thus generally does not reflect the same macroeconomic drivers as the Consumers Discretionary industry. However, agricultural commodity prices can have an impact.

Over the past year, major agriculture commodities have seen their price deflating. As agricultural producers are becoming more efficient, their yields are rising and this is keeping prices at bay. Corn, wheat, soybean, cattle, and hog have all been on the decline. The only outlier here is poultry, which has been on the rise. This is likely to change the way consumers balance their choice of meat products.

Food Wholesalers

While this has resulted in lower input costs for the Canadian producers, it has also resulted in lower revenues as retailers are asking for lower prices as well. Some of the larger players like Saputo and George Weston are able to mitigate these requests, but smaller players are having a more difficult time.

Food Retailers

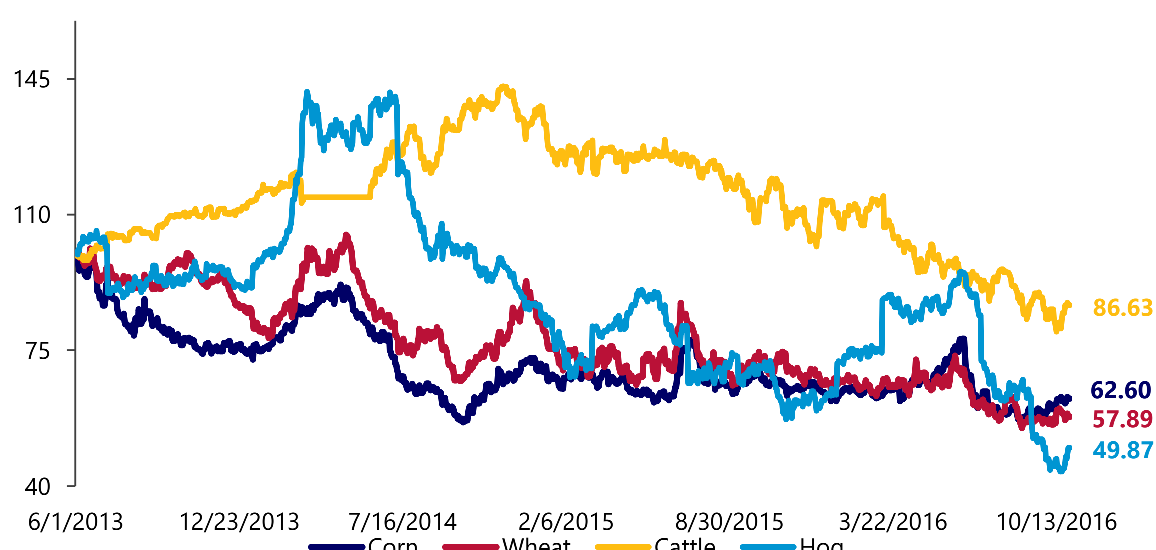
Food prices in stores fell by 2.8% in September 2016, the first signs of deflation in the past 8 years. Supermarket stores are benefiting from lower prices due to the extra market share captured from restaurants.

In the U.S, this issue is having an adverse affect on supermarket stores. Due to the intense competition, companies are having a hard time maintaining their margins. The Canadian players face far less competition and are not interested in having a price war. However, it is important to note that Canadian food price deflation has been limited due to the weakening Canadian Dollar, which cannot be relied on as a source of price stability into the future.

Supermarket stores such as Loblaw's and Metro protect themselves from business cycles by owning discount grocery stores as well. When disposable income falls, consumers tend to trade down to more affordable brands, and the above mentioned companies can benefit from this through their No Frills and Food Basics subsidiaries.

EXHIBIT 2

Agricultural Commodity Prices



Source: Capital IQ

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Canadian Tire Corp. (TSX:CTC.A) "Sell" Pitch

A Department Store Facing Stiff Competition

Introduction

Although Canadian Tire was able to survive the attack put on by Walmart, today it faces an opponent who plays a different game. E-commerce giants such as Amazon are taking market share away from retail department stores at a rapid pace. While some brick-and-mortar stores have been sheltered so far, general merchandise providers such as Canadian Tire have not been so lucky. Amazon's reach into the Canadian market is far from complete, but we believe that it will pose as a serious threat to Canadian Tire in the coming years.

Highlights

- Canadian Tire's retail segment is the largest of its kind in Canada with 30.7% of the total market share
- Canadian Tire has a diversified portfolio with operations in the retail industry, petroleum, REIT's, and financial services
- The growth of e-commerce and mobile payments are posing a significant threat to Canadian Tire's legacy retail business. Although it is attempting to even the odds online, it is falling behind
- We believe Canadian Tires shares are overvalued at today's levels of $143.61. Our price target on the shares is $120.49 representing an overvaluation of 6.1%

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Company Overview

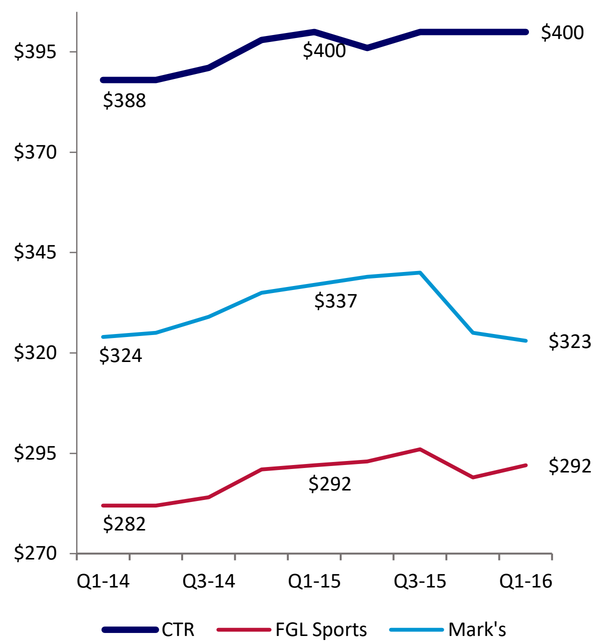
Canadian Tire operates general merchandise retail stores, automotive parts specialty stores, and a network of gas stations. The company operates 293 stores and kiosks, 83 car washes, 5 vehicle lubrication facilities, and 81 propane stations under the Canadian Tire brand. Canadian Tire's retail stores hold 30.7% of the market share in Canada. The company also operates sporting goods retail stores under the FGL Sports brand, and specialty apparel stores under the Mark's brand.

Outside of merchandise, Canadian Tire operates a Real Estate Investment Trust which is composed of 282 retail properties, 2 distribution centres, a mixed-use commercial property, and 2 development properties.

Canadian Tire also operates a Financial Services segment which markets a range of Canadian Tire-branded credit cards, insurance and identity theft products to customers, interest savings accounts and guaranteed investment certificates.

EXHIBIT 2

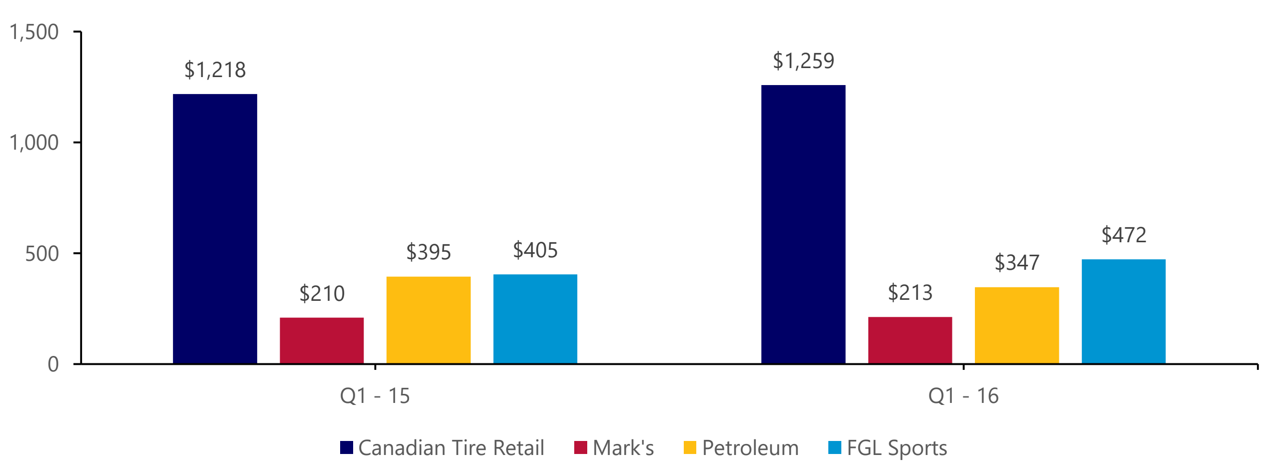
Sales Per Square Foot



Source: Scotiabank

EXHIBIT 1

Quarterly Segmented Revenue Growth (in millions)



Source: Company Reports

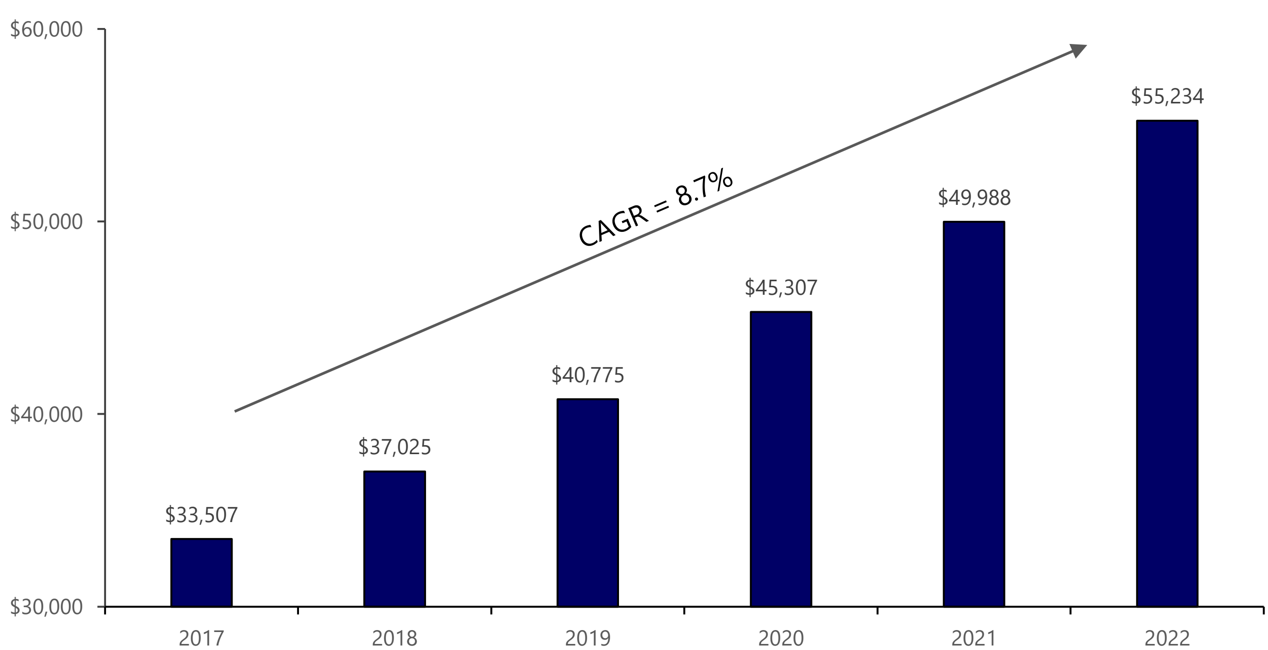
Sell Thesis I: Vulnerability to E-commerce

For the General Merchandise Stores industry, competition from e-commerce sites like Amazon is expected to continue rising. Tech advancements such as mobile wallets are expected to become increasingly more popular in Canada due to the recent introduction of Apple Pay and its partnership with the major banks. Trends such as these are making online shopping more feasible and are threating the retail stores which offer general merchandise, such as Canadian Tire.

When Walmart first entered the Canadian market. It was predicted that the demise of Canadian Tire was soon to come. However. Canadian Tires' strong footprint on Canadian soil gave it a significant competitive advantage over Walmart. However, with Amazon's Prime delivery system, shoppers are seeing fewer reasons to leave their home in order to purchase general merchandise items. Other businesses, such as Loblaw's, are finding protection since Amazon and other e-commerce platforms have not yet mastered online grocery delivery. However, Canadian Tire is left exposed as its retail product offerings are easily available online.

Although Canadian Tire is attempting to enter the e-commerce market, it is trailing behind Amazon and other competitors, as launching such a platform requires significant capital for acquisitions and will lead to in-store cannibalization. Furthermore, the product array available at stores like Amazon far surpasses Canadian Tire, meaning that customers are more drawn to the idea of only having to place one order. Canadian Tire does not have the proper plan in place to develop its platform before other retail giants take over.

Estimated E-commerce Growth in Canada (in millions)



Sell Thesis II: (Over)-Valuation

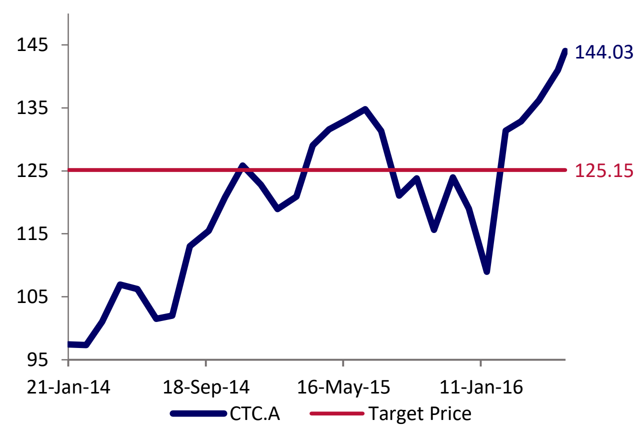
CTC.A was first added to QUIC's Canadian portfolio on January 21, 2014 at an average cost of $107.13. Today, CTC.A trades at $143.61, representing a total return of 34.1%.

Catalysts including options for the company to create value for shareholders through growth, acquisitions, or shareholder returns appear to be priced in to the stock. We believe that value from the real estate spin-off has been priced in, and there is no more room for growth. CTC.A is also limited in its ability to repurchase stock as it has a large Net Debt / EBITDA multiple of 3.6x.

Low interest rates and the lack of high quality investable assets in Canada have made CTC.A a popular and thus expensive stock. With disposable income expected to fall, there is a high probability that CTC.A revenues will fall.

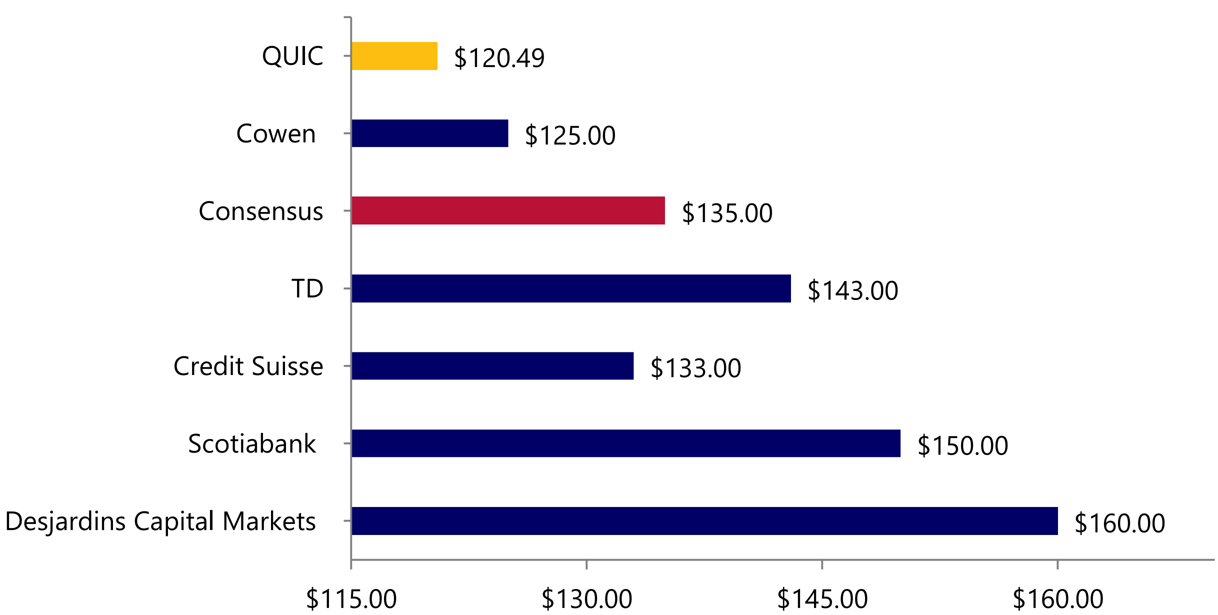
EXHIBIT 4

Canadian Tire Stock Performance vs. Target Price



Source: Capital IQ

Price Targets



Appendix: DCF Analysis

	Historical Period					Projection Period				
	2011	2012	2013	2014	2015	2016E	2017E	2018E	2019E	2020E
Total Revenues	10,387	11,427	11,785	12,462	12,279	12,582	12,830	13,019	13,145	13,207
Year over Year Growth %		*10.0%*	*3.1%*	*5.7%*	*(1.5%)*	*2.5%*	*2.0%*	*1.5%*	*1.0%*	*0.5%*
Cost of Goods Sold	7,326	7,929	8,063	7,981	7,692	8,431	8,468	8,463	8,413	8,321
% of Revenue	*70.5%*	*69.4%*	*68.4%*	*64.0%*	*62.6%*	*67.0%*	*66.0%*	*65.0%*	*64.0%*	*63.0%*
Gross Profit	3,061	3,498	3,722	4,481	4,587	4,152	4,362	4,556	4,732	4,886
Margin %	*29.5%*	*30.6%*	*31.6%*	*36.0%*	*37.4%*	*33.0%*	*34.0%*	*35.0%*	*36.0%*	*37.0%*
Operating Expenses	2,303	2,696	2,550	2,752	2,812	2,768	2,823	2,864	2,892	2,905
% of Revenue	*22.2%*	*23.6%*	*21.6%*	*22.1%*	*22.9%*	*22.0%*	*22.0%*	*22.0%*	*22.0%*	*22.0%*
EBITDA	758	802	1,172	1,729	1,775	1,383	1,539	1,692	1,840	1,980
% of Revenue	*7.3%*	*7.0%*	*9.9%*	*13.9%*	*14.5%*	*14.5%*	*14.5%*	*14.5%*	*14.5%*	*14.5%*
Year over Year Growth %		*5.8%*	*46.1%*	*47.5%*	*2.7%*	*(22.1%)*	*11.2%*	*9.9%*	*8.7%*	*7.6%*
Less: Depreciation and Amortization	289	367	385	288	347	362	369	375	379	380
% of Revenue	*2.8%*	*3.2%*	*3.3%*	*2.3%*	*2.8%*	*2.9%*	*2.9%*	*2.9%*	*2.9%*	*2.9%*
EBIT	469	435	787	1,441	1,428	1,021	1,170	1,317	1,461	1,600
Year over Year Growth %		*(7.2%)*	*80.9%*	*83.1%*	*(0.9%)*	*(28.5%)*	*(18.8%)*	*12.6%*	*11.0%*	*9.5%*
Less: Income Taxes	162	177	220	238	265	306	351	395	438	480
Effective Tax Rate	*34.5%*	*40.7%*	*28.0%*	*16.5%*	*18.6%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*	*30.0%*
Net Operating Profit After Taxes	307	258	567	1,203	1,163	715	819	922	1,023	1,120
Year over Year Growth %		*(16.0%)*	*119.8%*	*112.2%*	*(3.3%)*	*26.1%*	*(31.9%)*	*12.6%*	*11.0%*	*9.5%*
Plus: Depreciation and Amortization	289	367	385	288	347	362	369	375	379	380
Less Capital Expenditures	(230)	(222)	(404)	(538)	(515)	(501)	(575)	(648)	(720)	(790)
% of Revenue	*2.2%*	*1.9%*	*3.4%*	*4.3%*	*4.2%*	*4.0%*	*4.5%*	*5.0%*	*5.5%*	*6.0%*
Less: Change in Net Working Capital	(375)	16	(136)	705	491	503	513	520	53	53
Unlevered Free Cash Flow	(9)	419	412	1,658	1,486	1,079	1,126	1,169	734	764
Discount Period						0.5	1.5	2.5	3.5	4.5
Discount Factor						96.5%	89.8%	83.5%	77.7%	72.3%
Present Value of Unlevered Cash Flows						**1,041**	**1,011**	**976**	**570**	**552**

Appendix: DCF Analysis Output

WACC Calculation	
Risk-Free Rate	1.85%
Market Risk Premium	6.00%
Levered Beta	1.15
Cost of Equity	**8.75%**
Cost of Debt	2.50%
Tax Rate	27.70%
After Tax Cost of Debt	**1.81%**
Capital Structure	
Debt	19%
Equity	81%
Total:	**100%**
WACC	**7.47%**

Share Price Calculation	
PV of UFCF	4,151
Terminal Year Growth Rate	2.00%
Discount Rate	7.47%
PV of Terminal Value	7,455
Enterprise Value	**11,605**
Enterprise Value	11,605
Less: Total Debt	4,166
Plus: Cash and Cash Equivalents	754
Implied Equity Value	**8,193**
Shares Outstanding	68
Implied Share Price	**$120.49**
Current Price	$130.79
Target Price	$120.49
Dividend Yield	1.8%
Total Return	**(6.1%)**

Appendix: Comparables Company Analysis and Summary

	Market	Enterprise	EV / EBITDA			Price / Earnings		Net Debt / EBITDA		EBITDA	FCF	Dividend
Company Name	Cap ($MM)	Value ($MM)	LTM	2016E	2017E	2016E	2017E	2016E	2017E	Margin	Yield	Yield
Dollarama Inc.	$11,806	$12,889	20.2x	19.3x	17.4x	28.3x	24.6x	1.6x	1.5x	23.8%	3.4%	0.4%
Hudson's Bay Company	$3,043	$7,003	11.1x	8.4x	6.8x	(52.3x)	92.1x	4.8x	3.9x	6.1%	1.5%	1.2%
Richelieu Hardware Ltd.	$1,449	$1,432	15.7x	15.3x	14.0x	23.4x	21.1x	(0.2x)	(0.2x)	11.3%	2.1%	0.9%
Leon's Furniture Ltd.	$1,190	$1,567	10.7x	9.2x	8.3x	15.9x	13.6x	2.2x	2.0x	8.2%	4.6%	2.4%
Mean			14.4x	13.0x	11.6x	3.8x	37.9x	2.1x	1.8x	12.4%	2.9%	1.2%
Median			13.4x	12.2x	11.2x	19.7x	22.8x	1.9x	1.7x	9.8%	2.8%	1.0%
Canadian Tire Corp. Ltd.	**$9,588**	**$15,245**	**11.0x**	**9.8x**	**9.3x**	**14.4x**	**13.2x**	**3.6x**	**3.4x**	**12.6%**	**7.3%**	**1.8%**

We valued Canadian Tire using a comparable companies analysis and a DCF model.

The companies used for comparison were selected based on their industry of operations, which included departments stores. From the analysis, it can be concluded that Canadian Tire is overvalued on an EV/EBITDA with a major area of concern lying in the company's Net Debt / EBITDA ratio, which is far greater than the peer group average at 3.6x. This large debt load makes it more difficult for Canadian Tire to maintain its high valuation due to its limited ability to repurchase shares. Canadian Tire also lacks in its ability to generate cash in comparison to its peers, with a free cash flow yield of 1.8%.

To derive a share price target, we used a DCF model valuation. Assuming historical trends for revenue growth and EBITDA margin maintained, in combination with a perpetual forecast model at the rate of Canadian GDP, Canadian Tire's shares are intrinsically worth $120.49 implying a loss of 6.1%.

References

1. Capital IQ
2. Thomson One
3. Credit Suisse
4. Toronto-Dominion
5. Scotiabank
6. IBIS World
7. Barclays
8. Morgan Stanley