GAVIN

GAVIN EQUITY POOL: TALE OF THE TAPE

Edition 1, Volume 2, September 2020

SHORT-TERM RESULTS	1-Month	3-Month
GAVIN EQUITIES	(4.35%)	0.67%
S&P/TSX COMPOSITE	(2.06%)	4.73%
BENCHMARK INDEX*	(1.57%)	5.74%

*50% SP/TSX Composite and 50% S&P 500 (CAD)

The third quarter was a tale of two halves as reopening the economy spurred a lift in economic data early on. Meanwhile, the return to more normal daily routines, and especially school, produced a large increase in COVID case counts. The NASDAQ, S&P 500 and the Canadian S&P/TSX Composite fell 5.67%, 3.80% and 2.06%, respectively in September. The timing of the case surge coincided with a run-off in government stimulus which was keeping many individuals afloat. In the first half of 2020, fiscal stimulus in the U.S. reached $3 trillion. Employment conditions have improved as temporary jobs losses were regained, but permanent layoffs are on the rise and unemployment remains high overall.

The composition of returns over the last six months for major indices has been concentrated in top line growers, narrative based themes and high short interest names. As a collective, these types of investments can be classified as speculative. We loathe this connotation as it blankets the efficiency of the market and suggests we are “passing the buck”. Our belief is that while the market has effectively sifted through corporations that will be positively and negatively impacted by the economic impacts of COVID, there are plenty of instances where the “baby has been thrown out with the bathwater”. On the flip side, there is also glaring evidence that many business models have had growth accelerated and multiples have since re-rated. In certain instances, this is justified when high growth rates are combined with profitability (Zoom or Snowflake) but reviewing the price action of Nicola or Hertz reveals a general healthy appetite for risk.

The enthusiasm for growth and story stocks has left many parts of the U.S. equity markets with late cycle valuations that are typically seen after several years of strong economic growth. While the speed at which the economy has shifted plays a roll, all-time lows in government bond yields and loose monetary policy appear to be having an impact as well. With fiscal stimulus now at the forefront of political posturing the makings of significant shifts in markets and the economy are under way. The U.S. dollar has come under pressure as a result of fiscal and monetary spending, with the DXY Index falling 5.2% during the quarter. The dollar has major implications for other asset classes, most directly commodity prices which advanced 14.5% for the quarter.

The strong quarter for commodity prices has not been transferred over to energy equities. To put this in perspective, U.S. growth stocks, driven by technology and consumer discretionary, have risen 24.3% year-to-date as compared to a loss of 11.6% for stocks categorized as value. Within this cohort, the primary detractor has been energy. For both the quarter and year-to-date energy has lost 19.7% and 48%, respectively in the U.S. Most other commodities have faired much better. Lumber and copper for example, buoyed by strong housing and electric vehicle demand, as well as supply restrictions, were up 40% for the quarter. This asset class appears to finally be waking up after approaching all-time lows in relative value over the last 12-18 months.

Looking out over the next few months, market experts are predicting a rise in volatility. This has been the norm ahead of the U.S. presidential election. This is also being priced into futures markets with elevated volatility measures showing up. Our decision-making process is more aligned with the business cycle than election outcomes. Furthermore, these are never single point decisions. Factors such as valuation, fundamentals and technical indicators are also incorporated into investment decisions.

3Q 2020 Contributors

Canfor Corporation (+27.4%) - While the likes of Tesla and Apple have stolen headlines, the parabolic rise in lumber prices moved in lockstep with high flying technology names. Lumber prices began the quarter just above its median 5-year level of $400 per 1000 board feet but ended the quarter at over $600 after reaching highs of $980. Prices were pushed higher as a result of a lower US dollar, lean inventories across the supply chain and transportation restrictions which contributed to limiting available supply. Supply limitations extend beyond COVID-19 impacts as the mountain pine beetle in Western Canada has wiped out available supply, forcing several mills to close. During the second quarter Canfor completed the 100% ownership takeover of the Elliott Sawmilling Company in the US while Vida entered into an agreement to purchase three sawmills in Sweden from Bergs Timber. Going forward, the regional production mix for the company is now 43% British Columbia, 31% the US south, 22% in Europe and 4% in Alberta versus 88% Canadian in 2013. Trading at less than 1.2x book and 9.36x earnings, shares of Canfor are relatively inexpensive despite its ascent. We believe the stock is worth $19.50 per share, implying nearly 30% upside to its intrinsic value. We have traded around the position well, taking profits at cycle peaks and repurchasing at temporary bottoms.

IAA Inc (+32.4%) – After falling over 50% through the March selloff, shares of IAA re-established all-time highs in September. As the economy reopened and miles driven returned to pre-COVID levels, IAA revenue stabilized through the second quarter. Management noted that revenue per unit had started to exceed previous levels which helped offset part of the 19% decline in the topline. With the company speeding up its online push however margins were impacted. Going forward this trend will reverse as the associated cost benefits from shifting to a fully online model flow through the financials. This includes auctioneer expenses as well as auction day labour and other costs. Management also completed two strategic land acquisitions during the quarter. The move from 100% leased sights was not unexpected but now adds a real estate component to the asset base. Despite the decline in revenue, free cash flow is set to easily beat last years levels with the first six-months already matching all of 2019. After shares touched as low as $25, we selectively added to our position in the company in both April and May at $33 and $36 as previous resistance levels were broken. The stock price ended the month of September at $52.07, up 23.7% year-to-date while the Russell 2000 Index of small-capitalization stocks remains down over 2%.

Agnico Eagle Mines (+19.9%) – We have held Agnico Eagle shares since mid-2015. The opportunity to purchase a solid gold producer which has mines in favorable geopolitical jurisdictions came from a four-year slump in gold prices, production issues at a mine caused by wildlife, and record highs in a key cost component, oil. Since this time, gold prices have returned to near record levels while oil prices have been cut in half. Meanwhile, AEM shares have tripled with the company now priced as a premium operator. With the gold market setup for a good run, given low real interest rates and loose monetary policy, we do not expect to lower our exposure to miners. However, we will continue to seek out an opportunity to rotate in a better value name while maintaining the key attributes of AEM. During the second quarter cash from operations grew 20% year-over-year. Furthermore, the ramp-up of operations from COVID shutdowns is now complete. July production is expected to exceed 160,000 ounces of gold according to management. As a result, the company is well positioned to have a strong second half with gold production to average 480,000 to 500,000 ounces per quarter with declining unit costs. Management also expects to generate significant free cash flow in the second half of 2020. Gold production in 2020 is now expected to be 1.68 to 1.73 million ounces (versus previous guidance of 1.63 to 1.73 million ounces), while total cash costs per ounce and AISC per ounce continue to be in the range of $740 to $790 and $1,025 to $1,075, respectively. Capital expenditures will be approximately $690 million in 2020. Previous gold production guidance for 2021 and 2022 remains unchanged with a mid-point of 2.05 million and 2.10 million ounces, respectively.

3Q 2020 Detractors

Suncor Energy Inc (-28.2%) – Following a severe curtailment in demand earlier in the year, consumption of oil improved from the lows but remains approximately 5-7 mmbbl/d below last year. The sharp decline in demand saw WTI futures trade across an $80 per barrel range from negative to positive $40 a barrel. These actions have thrown many corporate cash flows in the energy space into a negative balance. Suncor remains a disciplined player within the space and is expected to nearly breakeven on free cash flow in 2020. This should be achieved despite the fire at its Base Plant which caused unplanned production cuts and management's commitment to projects that will help funds from operations grow ~$1Bn by 2023. Shares are enormously depressed, trading at less than 3.2x normalized cash flows and 0.6x book value. While governments appear to be committed to climate change and new electric vehicles are being released every month, electricity still needs a power source. Suncor should be a winner from a forced consolidation within the industry given its balance sheet. Meanwhile, the incredible lack of investment across the industry suggests supply loss is likely to vastly outstrip demand (excluding COVID impacts demand is still growing). This sets up for a skewed outcome.

Recro Pharma Inc (-56.4%) – Recro reported a continuation of challenges caused by the Coronvirus during its second quarter earnings. In particular, cardiovascular medication refill rates have declined 15% with doctor visits in decline, while pediatric medications related to ADHD have fallen 41%. This led to a 50% decline in revenues on product sales and royalties from three of the company's commercial customers. When combined with shifting development priorities causing delayed business opportunities, second quarter results disappointed investors. Fixed costs ate heavily into the lower topline as margins compressed substantially. However, management did make progress on securing an exclusive development agreement with a top 20 pharmaceutical product manufacturer to produce a high potency oral product and also launched their new clinical trial material offering (CTM). The CTM capabilities include on-demand services for innovative trial design and direct-to-patient supply logistics. Despite the progress however management admitted that the path to a full recovery may be a ways out as they expect the second half to be impacted by COVID-19, discontinuation of product lines, slower than expected new project starts and delayed customer programs. As a result, we parted ways with the position for now at the beginning of September.

Fairfax India (-17.1%) – Despite a falling US dollar and the India Sensex Index gaining 9.03%, Fairfax India fell in the third quarter. The underperformance year-to-date is likely related to the company's crown jewel holding, the Bangalore Airport, which has been directly impacted by COVID-19. This disruption has not altered the investment thesis which is centered around being aligned with one of the best investors in the world as well as gaining exposure to one of the few countries with a demographic profile that will act as a tailwind. Additionally, economic opportunities will evolve as the country attempts to exit third-world status. The position also works well within our portfolio as a hedge against a declining US dollar which will typically benefit emerging economies. For the second quarter, the company's investments bounced back, gaining 5% and remain down just 10% on the year. The majority of the volatility was caused by public holdings with the Sensex still down 20% year-to-date, however the company's investment in Bangalore airport also faced additional expenses. The Bangalore airport handled approximately 7.63 million passengers in the first six months of 2020 representing a decline in overall traffic of 54.8% compared to the first six months of 2019. The lockdown and resulting slowdown of construction activities is expected to delay the completion of the first phase of the Terminal 2 expansion by approximately six to twelve months. The total cost of the Terminal 2 expansion is expected to increase primarily due to incremental interest and pre-operational expenses.

3Q 2020 Additions / Subtractions

With elevated volatility, the third quarter was an unusually active quarter for our names. No new positions were initiated but we had a few exists as well as timely purchases and sales.

We added to our position of Aginco Eagle (AEM-TSX) at the beginning of the quarter, picking up shares around $93 on what we believed to be profit taking. This paid off following talks of stimulus which lifted gold prices and confirmation from the company's quarterly earning that production was returning to normal. Shares ended the quarter at $105.80.

Cimpress (CMPR-NASDAQ) has been a name that we have traded around well, taking profits on surges and buying near lows. For example, after trimming our position at $91.35 in June, we brought its weight back up in September around $76. CMPR is an internet-based company that handles large volumes of small, individually customized orders for a broad spectrum of products. Its flagship brand is Vistaprint.

Booking Holdings (BKNG-NASDAQ) is another long-term holding of ours. We have held shares of the online travel company since 2014, where shares grew from $1,100 to over $2,000 prior to the COVID crisis. As shares increased towards our price target we reduced its weight in the portfolio. While the pandemic has disrupted travel around the world, we believe that the structural changes impacting the industry will continue to benefit BKNG when travel returns to normal. As a result, we added to the stock as we believe it has located new support.

Shares of French domiciled Societe BIC (BICEY-OTC) have remained under pressure following our initial purchase in December of 2018. After what appeared to be a bottom formation we averaged down on the owner-controlled manufacturer. BICEY is a highly profitable and low leverage leading manufacturer of lighters, stationary and razors.

We rounded out positions in our two new holdings, Keysight Technologies (KEYS-NYSE) and Grocery Outlet (GO-NASDAQ), during the weakness in September. KEYS is an equipment testing company with exposure to the 5G build-out while GO is a deep discount grocery outlet store.

Biotechnology giant, Amgen Inc (AMGN-NASDAQ), has been a strong performer in the portfolio for over five years. As it approaches our valuation threshold, two standard deviations above its historical trends, we began taking profits. We believe this is particularly prudent ahead of a potential democratic sweep in November.

News of a TikTok deal lifted Oracle (ORCL-NASDAQ) shares in September enough for us to exit our position. In our opinion, directing capital to purchase cloud-based customers does not improve the company's position in the Enterprise Resource Planning software business, its core competency. This also coincided with shares becoming over-valued and stretched from a technical perspective. As a result, we elected to book our gains.

Another exit from the portfolio was Scorpio Tankers (STNG-NYSE), this time at a loss. We attempted to catch a deep value, falling knife in STNG. Despite improving fundamentals and earning nearly half its market capitalization in free cash flow over the trailing twelve months, shares have refused to turnaround. We have therefore been forced to adhere to our process and humbly accept that the market is aware of something we are not.

Canfor Corporation (CFP-TSX) was reintroduced to the portfolio in April at $6.74. CFP is an integrated forest products company based in Vancouver. The company has production facilities in BC, Alberta, North and South Carolina, Alabama, Georgia, Mississippi, and Arkansas. We have been forced to take profits along the companies quick path to over $18, as the tripling in shares in just four months has increased the size of the position in the portfolio.