

Pendulum

Between 2009 and the middle of 2015, the Capital Ideas Fund, like the broader equity markets, performed well. However, markets need to reset and these resets come in the form of corrections. The Toronto Stock Exchange has been in the midst of a correction since the third quarter of 2014 and that correction continues into early 2016.

Pessimists and doomsayers, who always sound most compelling at market bottoms, are usually wrong. The correction we are now experiencing is long in the tooth and I suspect will ultimately be nowhere near as serious as the one that took place in 2008/2009. While I do not profess to be a market timer, I think the preconditions for a significant rally in Canadian stocks are now in place because both our currency and our stock market are undervalued.

In 2015, the Capital Ideas Fund was up 4.06%¹, compared to the S&P/TSX Total Return Index, which fell 8.32%² last year. While the start of 2016 has been challenging, like 2009, I expect the market to perform better as the year unfolds.

902 – 123 FRONT STREET W
TORONTO, ON M5J 2M2
416 364 8505
DONVILLEKENT.COM

The next bull market

The 2009-2015 bull market is over. Since the Canadian stock market peaked in September of 2014, Canadian equity indices are down roughly 24%³. This clearly represents a significant reset, but neither I nor anyone else knows if this correction is over.

Here is what I do know. I know that oil is trading at a price level that is unsustainably low. I know that the Canadian Dollar is in the lower third of its historical trading range and from a purchasing power of parity (PPP) perspective is quite undervalued. Fair value for the Canadian Dollar is probably somewhere between USD 0.80 and 0.84. I also know that both Canadian and international equity investors are significantly underweight the Canadian market. I read every day about foreign investors who are snapping up

Canadian real estate, from ski chalets to office towers. And I also know that Canadian growth stocks are very, very attractively priced.

So how attractively priced is the Canadian stock market right now? I regularly track the forty fastest growing companies in Canada (hereafter referred to as the Fast 40) and the valuation of these companies by quartile is presented in Figure 1 below. The cheapest quartile of growth stocks trades at 4.7x 2016 cash earnings and even the second quartile trades on just 8.2x 2016 cash earnings. Twenty of the forty fastest growth stocks in Canada now trade on less than 10x 2016 earnings.

Figure 1 - Valuation of Canada's Fast 40 Growth Stocks by Quartile

Quartile	2016 P/Cash Earnings (x)
1	4.7
2	8.2
3	13.4
4	24.3

Source: Donville Kent

The last time I saw valuations this low was back in 2009 when we were emerging from a far more serious stock market correction. The correction of 2008/2009 was in my view an actual crisis whereas today's correction stems primarily from concerns related to the slowdown in the global economy. The collapse of various commodity prices, trouble in China and the slowdown in emerging markets are all growth problems. October 2008 was about a financial system that was broken. In 2015/2016, we are dealing with a growth slowdown that is ultimately linked to global demographics.

The demographic challenges we are facing are extremely well articulated in Harry S. Dent's book *The Demographic Cliff* – I encourage everyone to read it. Notwithstanding Dent's somewhat alarming title, the book carefully points out how the demographic growth profile of so many countries has peaked in the last two to three years. If you are familiar with what has happened in Japan over the past twenty years, now assume that the same phenomenon is hitting most western countries plus China. A big slowdown in global growth was inevitable.

Is there really no growth left in the world? Not necessarily, but growth is going to be a bit harder to find for at least another decade. Economic growth historically comes from demographics and innovation. Dent's analysis suggests to me that companies that require population growth to grow will struggle because growth in industries that require population growth will become a zero-sum game.

Of course, not all demographic segments are peaking. The demographic segments that represent people over the age of 55 (in relation to the rest of the population) are growing rapidly. Thus, even in the context of demographically based growth, there are growth niches. Demographic growth amongst our oldest population segments will support companies selling products to seniors for the next twenty years. However, most other segments of the economy that are dependent on population growth for profit growth will struggle.

Besides population growth the other source of growth in our economy comes from innovation. Companies that invent, discover and make new things have always been an important part of our economy, but there are two reasons why in the next ten years they will be even more important. First, the market share of companies that grow because of innovation compared to those that grow primarily because of population growth will almost certainly increase given the demographic slowdown. But the second reason is the speed at which innovation itself is occurring. We live in a world where technology and innovation allow for the adoption of new gadgets, medicines, services and technology at an increasingly fast pace. Thus, one can easily argue in 2016 that at the same time that demographic growth is slowing rapidly, innovation based growth is accelerating.

The phenomenon I describe above is reflected in stock markets all over the world, and certainly one can see it on the TSX. In Figure 2 below I once again make reference to the Fast 40 vs the weighting of the TSX 60 index. Here we see that more than half of the Fast 40 companies are either in technology or healthcare industries, while only 6% of the TSX 60 consists of companies operating in those sectors. At the other end of the scale, we see the TSX 60 with a 27% weighting in natural resources while similar stocks represent just a 2.5% weighting in the Fast 40. If you are building a Canadian Growth portfolio, it will bear little resemblance to the TSX 60.

Figure 2 - Fast 40 Weightings vs TSX 60 Weightings

Sector	Fast 40 Weighting	TSX 60 Weighting
Technology	32.50%	2.50%
Health care	22.50%	3.60%
Consumer	22.50%	12.30%
Financials	10.00%	39.10%
Industrials	10.00%	15.60%
Resources	2.50%	26.90%
Total	100.00%	100.00%

Source: Donville Kent

Given my outlook for growth in 2016, it is time to turn our attention to specific companies. Before I do I should point out that I often describe technology and

health care companies as being in knowledge based industries. Most growth companies have some kind of technological or knowledge based competitive advantage that is reflected in both their revenue growth rates and margins, and this in turn drives consistently high returns on equity. However, many consumer and financial services companies, which at first glance do not appear to be a knowledge based business, are in fact highly innovative and extremely adept at using knowledge to deliver high returns on equity (ROE) for years to come. I guess what I am saying is that while we want growth, we must be prepared to find it in less than obvious places.

Finding compounders in 2016

The Capital Ideas Fund invests in companies that are run by ethical and competent management teams. Typically, we invest in companies that consistently earn a high ROE without excessive use of leverage. As we look into 2016, here are the 25 high ROE stocks in Canada with market caps greater than \$500MM that are on our focus list. Note that the Fast 40 companies I refer to above have market capitalizations of greater than \$75MM whereas the companies I discuss have market capitalizations in excess of \$500MM. Thus, the constituents of the Fast 40 and those represented in the following tables are not identical but overlap significantly.

Figure 3 - High ROE stocks in Canada - Based on 2016 DKAM estimates					
Rank	Company	Ticker	Industry	Mkt Cap (\$MM)	ROAE*
1	Valeant Pharma	VRX	Pharma	30956	63.1%
2	Spin Master	TOY	Toys	1958	57.6%
3	Colliers	CIG	Real estate mgmt	2222	55.7%
4	Constellation Software Inc.	CSU	Technology/Software	7731	50.9%
5	Cara Operations	CAO	Restaurants	1330	34.0%
6	Dollarama	DOL	Retailing	9220	32.2%
7	Clearwater Seafoods	CLR	Seafood	592	27.2%
8	Kinaxis	KXS	Technology/Software	1100	27.1%
9	Concordia Health	CXR	Pharma	1497	23.9%
10	Alimentation Couche-Tard	ATD.B	Convenience Stores	24365	23.9%
11	Boyd Group	BYD.UN	Autobody	996	23.3%
12	Enghouse	ESL	Software	1599	21.3%
13	Canadian Pacific Railway	CP	Railways	26149	21.3%
14	Exco Technologies	XTC	Technology/Software	613	21.1%
15	CGI Group	GIB.A	IT services	16820	20.9%
16	Amaya Gaming	AYA	Gaming	3156	20.9%
17	Open Text	OTC	Software	5581	20.7%
18	MTY Foods	MTY	Food franchising	574	20.6%
19	Linamar	LNR	Auto parts	3808	20.5%
20	Mitel Networks	MNW	Network	718	20.1%
21	MacDonald Dettwiler	MDA	IT/Space/Technology	3104	19.9%
22	CCL Industries	CCL.B	Packaging	7088	19.5%
23	Home Capital Group	HCG	Specialty Lender	1826	19.2%
24	Intertape Polymer	ITP	Tape	986	18.9%
25	Intertain Group	IT	Gaming	625	18.5%

* Return on average equity, based on cash earnings and adjusted for dividends

Figure 3 gives us a fairly good look at the 25 high ROE stocks that populate our database and we would argue that this list of 25 companies on average represents a very high quality sample of companies listed on the TSX. However, what Figure 3 does not address is valuation. Our goal is to own high quality companies that are attractively priced.

Figure 4 - High ROE stocks in Canada - Ranked by 2016 DKAM estimated P/E					
Rank	Company	Ticker	Industry	Mkt Cap (\$MM)	P/E
1	Concordia Health	CXR	Pharma	1497	3.6
2	Intertain Group	IT	Gaming	625	4.5
3	Home Capital Group	HCG	Specialty Lender	1826	5.2
4	Amaya Gaming	AYA	Gaming	3156	5.2
5	Mitel Networks	MNWX	Network	718	5.3
6	Valeant Pharma	VRX	Pharma	30956	6.5
7	Linamar	LNR	Auto parts	3808	8.2
8	Exco Technologies	XTC	Technology/Software	613	10.1
9	CGI Group	GIB.A	IT services	16820	12.1
10	Open Text	OTC	Software	5581	12.3
11	MacDonald Dettwiler	MDA	IT/Space/Technology	3104	12.4
12	Clearwater Seafoods	CLR	Seafood	592	13.0
13	MTY Foods	MTY	Food franchising	574	13.3
14	Canadian Pacific Railway	CP	Railways	26149	14.3
15	Intertape Polymer	ITP	Tape	986	14.7
16	Cara Operations	CAO	Restaurants	1330	16.2
17	Spin Master	TOY	Toys	1958	16.6
18	Constellation Software Inc.	CSU	Technology/Software	7731	17.9
19	Boyd Group	BYD.UN	Autobody	996	19.2
20	CCL Industries	CCL.B	Packaging	7088	20.8
21	Alimentation Couche-Tard	ATD.B	Convenience Stores	24365	21.4
22	Dollarama	DOL	Retailing	9220	23.3
23	Enghouse	ESL	Software	1599	24.5
24	Colliers	CIG	Real estate mgmt	2222	24.7
25	Kinaxis	KXS	Technology/Software	1100	59.9

In Figure 4, we show the exact same list as we had in Figure 3, but this time we rank the list from cheapest to most expensive. For those of you who care to go back to our past newsletters, it is interesting to note how many companies have been here before. However, in every case, the stocks that were on last year's list and this year's list are now significantly cheaper than they were a year ago.

In Figure 5 we rank the stocks by a ratio of ROE to P/E. Effectively what this shows is how many units of growth one buys for a unit of P/E. Thus, Valeant offers 9.8 units of growth per unit of P/E while Kinaxis offers a half a unit of growth per unit of P/E. While there are clearly companies in this database that have questions surrounding future earnings, there are still a number of very solid companies that offer excellent investment potential.

Figure 5 - High ROE stocks in Canada - Ranked by 2016 DKAM Estimated ROAE/PE Ratio

Rank	Company	Ticker	Industry	Mkt Cap (\$MM)	ROAE/PE
1	Valeant Pharma	VRX	Pharma	30956	9.8
2	Concordia Health	CXR	Pharma	1497	6.7
3	Intertain Group	IT	Gaming	625	4.2
4	Amaya Gaming	AYA	Gaming	3156	4.0
5	Mitel Networks	MNW	Network	718	3.8
6	Home Capital Group	HCG	Specialty Lender	1826	3.7
7	Spin Master	TOY	Toys	1958	3.5
8	Constellation Software Inc.	CSU	Technology/Software	7731	2.8
9	Linamar	LNR	Auto parts	3808	2.5
10	Colliers	CIG	Real estate mgmt	2222	2.3
11	Cara Operations	CAO	Restaurants	1330	2.1
12	Clearwater Seafoods	CLR	Seafood	592	2.1
13	Exco Technologies	XTC	Technology/Software	613	2.1
14	CGI Group	GIB.A	IT services	16820	1.7
15	Open Text	OTC	Software	5581	1.7
16	MacDonald Dettwiler	MDA	IT/Space/Technology	3104	1.6
17	MTY Foods	MTY	Food franchising	574	1.5
18	Canadian Pacific Railway	CP	Railways	26149	1.5
19	Dollarama	DOL	Retailing	9220	1.4
20	Intertape Polymer	ITP	Tape	986	1.3
21	Boyd Group	BYD.UN	Autobody	996	1.2
22	Alimentation Couche-Tard	ATD.B	Convenience Stores	24365	1.1
23	CCL Industries	CCL.B	Packaging	7088	0.9
24	Enghouse	ESL	Software	1599	0.9
25	Kinaxis	KXS	Technology/Software	1100	0.5

Five great stocks for 2016

Concordia Health Care (CXR) – Oakville, Ontario based Concordia Healthcare is a diverse, international pharmaceutical company focused on legacy products and orphan drugs. Concordia trades on 3.6x 2016 earnings and below book value per share. Concordia's share price has been negatively impacted by the turmoil facing the global pharma industry over the past year. Concordia is carrying more debt than we would like, but that debt is being paid down rapidly and in all other respects Concordia is executing very well on its strategy. We expect this stock to re-rate significantly in 2016.

Concordia Healthcare (TSX:CXR)

FYE Dec	2013	2014	2015E	2016E	2017E
Revenue (\$MM)	40	122	350	1030	1133
Cash Earnings (\$MM)	3	23	120	371	420
Cash EPS (\$)	0.14	0.78	2.34	7.21	8.16
Net Margin (%)	6%	19%	34%	36%	37%
ROAE	6%	14%	12%	21%	21%

Source: Donville Kent

Home Capital (HCG) – Toronto based Home Capital Group is the largest independent Mortgage and Trust Company in Canada. The Company has an excellent track record of managing through real estate slowdowns in part because it is a low ratio lender. Home Capital trades at 5.2x 2016 earnings and close to BVPS. Over the past twenty years, Home’s actual loan losses on its mortgage portfolio have been lower than any of Canada’s large banks, which are high-ratio lenders.

Home Capital Group (TSX:HCG)

FYE Dec	2010	2011	2012	2013	2014	2015E	2016E
Revenue (\$MM)	309	361	423	481	580	598	640
Cash Earnings (\$MM)	181	191	229	264	324	312	325
Cash EPS (\$)	2.61	2.75	3.30	3.81	4.62	4.45	4.64
Net Margin (%)	59%	53%	54%	55%	56%	52%	51%
ROAE	27%	25%	26%	25%	25%	20%	18%

Source: Donville Kent

Constellation Software (CSU) – Toronto based Constellation Software is a leading provider of software and services to a select group of public and private sector markets. We also view the management team as one of the most astute in corporate Canada. While the stock is not as cheap as it was in 2009, its multiple is reasonable given the Company’s growth rate and the potential for acquisitions in 2016.

Constellation Software (TSX:CSU)

FYE Dec	2010	2011	2012	2013	2014	2015E	2016E
Revenue (\$MM)	634	773	891	1211	1669	1854	2132
Cash Earnings (\$MM)	98	159	178	212	276	347	382
Cash EPS (\$)	4.62	7.49	8.39	10.02	13.04	16.39	18.01
Net Margin (%)	15%	21%	20%	18%	17%	19%	18%
ROAE	76%	80%	69%	81%	105%	116%	99%

Source: Donville Kent

CGI Group (GIB.A) – Montreal based CGI Group is an IT services company that operates throughout the world. CGI is both reasonably priced and generates a consistently high ROE. The Company historically makes a major acquisition every 2-3 years, which it typically borrows to pay for. CGI has now fully integrated its last acquisition and now has both the balance sheet and managerial capacity for another acquisition. CGI’s reputation as both an acquirer and operator is superb.

CGI Group Inc. (TSX:GIB.A)

FYE Sep	2010	2011	2012	2013	2014	2015E	2016E
Revenue (\$MM)	3732	4224	4772	10085	10500	10287	10674
Cash Earnings (\$MM)	486	571	587	650	1038	1184	1313
Cash EPS (\$)	1.79	2.19	1.91	2.09	3.32	3.85	4.27
Net Margin (%)	13%	14%	12%	6%	10%	12%	12%
ROAE	22%	25%	20%	17%	23%	21%	20%

Source: Donville Kent

CRH Medical (CRH) – While we don't usually recommend small cap stocks as part of our January newsletter, we are going to make an exception this year with CRH Medical. Vancouver based CRH Medical operates throughout North America, providing physicians with innovative products and services for the treatment of gastrointestinal diseases. The company has a strong management team and its operating model is straight forward and easy to understand. Trading on 8.8x 2016 earnings and with a projected and sustainable ROE of over 35%, we think the company represents an excellent long-term investment.

CRH Medical Corp. (TSX:CRH)

FYE Dec	2011	2012	2013	2014	2015E	2016E
Revenue (\$MM)	5.5	6.8	7.7	12.0	45.3	54.3
Cash Earnings (\$MM)	1.2	1.4	2.5	4.1	11.8	20.4
Cash EPS (\$)	0.02	0.03	0.05	0.08	0.17	0.29
Net Margin (%)	22%	21%	33%	34%	26%	38%
ROAE	39%	30%	37%	30%	35%	36%

Source: Donville Kent

Final thoughts

Last year was a tough year. Even though we beat the index by more than 12%⁴, it didn't feel like a win. Looking into 2016, I sense that we will have better numbers to report by year end. The pendulum that has taken the Canadian market and currencies lower feels like it is about to swing back the other way.

I also once again want to thank and compliment my team. Dominika, Chris, Jesse, Jordan and Ali are hardworking and ethical. They embody the qualities that I also look for in the management teams of the companies we invest in. I am a lucky man to be able to work with such fine people and by extension the investors in Donville Kent are lucky to have such fine people watching out for us.

Write me if you want to chat – *J.P. Donville*

Jason@donvillekent.com

¹ Time weighted rates of return for Class A Series 1, net of all fees and expenses as of December 31, 2015

² S&P TSX Composite Total Return Index is the Net Total Return version of the S&P/TSX Composite Index

³ S&P/TSX Composite Index

⁴ Time weighted rates of return for Class A Series 1, net of all fees and expenses as of December 31, 2015 compared to S&P TSX Composite Total Return Index is the Net Total Return version of the S&P/TSX Composite Index

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