Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | APRIL 2, 2017

WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL

Where Do We Go From Here?

The bulls have made an impressive run. Since the November election, markets are up 9% riding the coattails of President Donald Trump's victory. The bears insist that there are ominous signs pointing to a downturn and the S&P 500 is certainly not cheap trading at over 18 times forward earnings.

AP PHOTO/PABLO MARTINEZ MONSIVAIS

Certainly, Trump's economic policies offer up some intriguing ideas to stimulate a US economy that has not done much over the last eight years. Reducing corporate taxes seems like a good idea – (whether it gets passed is another story). Eliminating Dodd Frank – rules that were put in place to prevent banks from making irresponsible risky decisions like they did in 2008 – not so smart.

Let's be clear, today's failing economy was put on life support under the Obama administration and it was left there to wither. Companies learned how to thrive by focusing on raising stock prices instead of increasing production. Low interest rates helped funnel money to the rich, the investor class, and Corporate America, but did little in terms of real job growth for middle class Americans. Trump's economic policies actually give companies an incentive to hire and to get more Americans working – not just to hoard cash.

So far the early evidence points to some very positive indicators that the economy is on a roll. Consumer confidence has taken off on the prospect of lower taxes and more infrastructure spending. The Consumer Confidence Index hit 125.6 in March, its highest level since December 2000.

Likewise, the jobs market has finally awakened from its slumber. In February, US employers hired workers at a robust pace with job gains averaging over 209,000. Construction payrolls in particular surged by 58,000, and the mining sector added 7,700 jobs. These are good jobs – the seeds of real productivity in industries that drive productivity for other sectors. Things are lining up, and in the proper order, for a real recovery and a possible boom.

Finally, Trump's plan to reduce corporate income taxes from 35% to 15% is a major adrenaline rush for the economy. We need only look to Canada for proof of concept. Over the last fifteen years, the Canadian government has reduced the corporate income tax rate from 28% to 15% and business has boomed over this period.

Here in Canada, it has led to stronger employment growth, higher levels of employment, higher levels of business investment in new facilities, greater spending on research and development, and faster growth rates for GDP and personal incomes of Canadians.

Ironically corporate tax cuts deliver a net fiscal benefit to the government sector even though the rate goes down. That's because the revenue stream increases that much more to offset the lower tax rate.

Nobody is saying that you should recklessly toss your life's savings onto the stock market roulette table. But for the wise investor, we believe smart dollars even in this market can be directed towards stocks that have a rational and predictable upside with enough intrinsic value to keep the bottom from falling out.

WHY HOME DEPOT IS BUILT TO WITHSTAND THE 'AMAZON EFFECT'

PHOTO: HOME DEPOT

You may have heard that the retail industry is in tatters. Department stores are shedding profits as fewer customers visit. Apparel companies are struggling as they face increased competition from e-commerce operators like Amazon. And bankruptcies have hit a range of sectors from sporting goods to apparel to electronics.

HOME DEPOT (TICKER HD; PRICE $146.83 AS OF MAR 31, 2017)

One store that seems to be immune to the so-called "Amazon Effect" is Home Depot. Last month, the company reported record revenues and profits. While other retail behemoths like Macy's, Sears, JC Penny, and Target are all struggling with store closures, Home Depot continues to expand both its physical and online presence.

Home Depot is one of a very few number of retailers that has successfully integrated business-to-customer and business-to-business sales. The company attracts professional clients including contractors, builders, traders, interior designers, and renovators – plus plumbers, electricians, and delivery providers.

They will sell you a water heater and hook you up with a company to install it. They'll sell you designer terrazzo tile and a list of installers, or they'll rent you a wet saw so you can do a professional job yourself. You can't get that in the mail via Amazon. And having an army of trained employees on hand to help customers make appropriate choices is just one way the company has differentiated itself.

Home Depot has also invested considerable sums in providing a superior customer experience. It was one of the first companies to regularly

PHOTO: GREG MOONEY / HOME DEPOT

organize workshops and clinics targeted at the do-it-yourself customer and their kids. Not only do the workshops provide a learning experience, but the company creates an emotional and generational connection with customers as well.

On the supply chain front, Home Depot's distribution process has undergone significant changes resulting in higher inventory turnover and better in-stock rates. And unlike traditional bricks and mortar retailers that are slowed down by capital expenses, Home Depot actually benefits in many ways from its diverse physical infrastructure and network of warehouse-style retail outlets.

Nearly 40% of online orders are actually picked up in-store. Customers like having the ability to shop online with the timeliness of being able to directly access the goods within a few hours of ordering.

"Two-Day free shipping" is simply not good enough when the weekend do-it-yourselfer, the local gardener or your project-laden contractor needs the instant gratification that come with a pound of mortar, a bag of lawn fertilizer, or ten sheets of drywall.

In addition, the often bulky nature of goods to be shipped can present logistical challenges. Paying freight for cheap patio blocks or building a drone to carry them is not in the cards any time soon. In the rare case of Home Depot, having a physical presence actually helps to drive online sales.

The company is anticipating that annual revenues will grow by a modest 4.6% – not bad for a company that regularly surpasses its own earnings estimates. But the real reason for optimism is twofold. Consumers are clearly benefiting from a US economy that is on more stable footing. And Trump's proposed cut to corporate income taxes would be a major earnings driver - Home Depot has the highest effective tax rate at 36.4%. Imagine the earnings boost of a 15% or even 20% nominal tax rate.

The market valuation of Home Depot is 18 times its forward earnings, putting it right in line with the S&P500's ***18 times forward multiple***. With a market cap over $170 billion, by no means is the stock cheap. At the same time, it's hard to imagine losing money on this trade. Management is extremely disciplined and respectful of excess cash flow. Debt is manageable at $23.5 billion and operating margins are a healthy 14%.

The same can be said about the day-to-day operations. The company has demonstrated a knack for delivering cost savings to the business and increasing operational margins. Few companies can report this kind of operational success. The stock also pays a 2.4% dividend, and the company bought back over $2.6 billion of its own shares in 2016.

The US housing market continues to grow and house prices have bounced back setting new all-time records and surpassing the highs from before the financial crisis. Americans are becoming increasingly willing to spend on home-improvement projects, and the latest payroll numbers show construction leading the way. So it is that the company that *sells the brick and mortar* seems to be resilient against the online forces that are causing businesses with physical stores to crumble.

UNDER THE RADAR: ADOBE IS UP TO SOMETHING

Adobe, a leader in publishing and marketing software, is rapidly moving from the physical confines of a cardboard box and CD ROM into the ether of the digital cloud.

The move to the cloud has allowed Adobe to grow its business at an annual rate of 30% by wisely deciding to provide a subscription service instead of a product. It's working for the music and entertainment industries, and it's turning Adobe into a major success story in the software industry.

For the longest time and like many other software manufacturers, Adobe operated under a very simple model of selling its technology to users in a 'box' with a disc inside. All their applications could be had for an up-front one-time fee. Great that the company collects a nice payout on the frontend but it leaves little recurring revenue stream on the backend.

More recently, Adobe has moved to a cloud-based revenue model with subscription-based pricing along similar lines to that of Netflix – another company that ditched the disc years ago. People no longer want "stuff;" they just want the magical powers that are programmed into the stuff.

Shifting to a subscription business model has enabled the company to improve the stickiness of its products with higher retention rates while enabling them to successfully cross-sell and bundle other products. "Adobe Sign" is a product that we have adopted religiously here at Frontwater.

With Adobe Sign, you can prepare and send documents to be e-signed in a few quick clicks. The document can be signed and returned on any device in minutes. Each step can be tracked from beginning to end. And the document is automatically stored in the cloud for future reference.

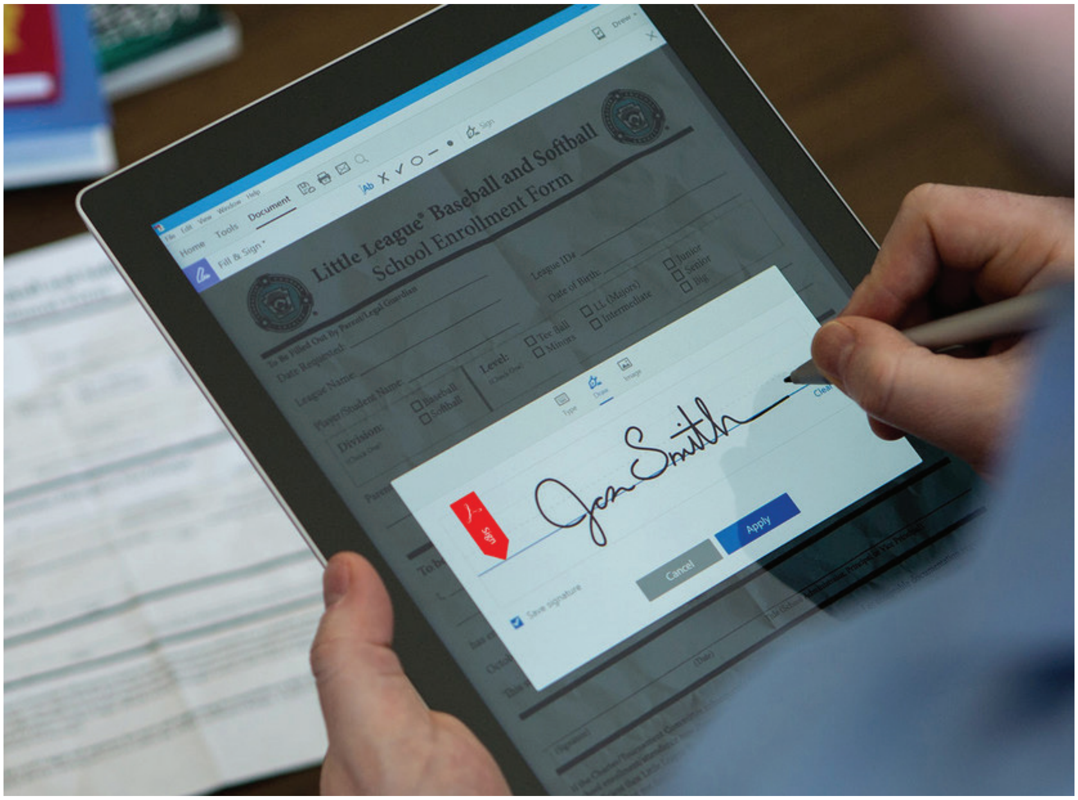
Make no mistake – this is a major piece of disruptive software. You no longer need paper to print the document. You no longer need pens to sign the document. You don't even need a scanner to scan your signed copy. All those interim steps are now obsolete. Adobe Sign has a chance of saving more trees than Greenpeace ever will.

And the efficiency gains are another story altogether. Just being able to track the progress of a document's tedious process of collecting information and signatures is simplified from end to end and completed without leaving the platform. The product is tremendously beneficial in sales acceleration as the time to get contracts reviewed and signed decreases tremendously.

Adobe Sign can be had for a rather measly price of $10 a month. For a few buck more (ie $5), customers can upgrade to the full suite of products, Adobe Pro DC. At those price points, it's like Netflix and a no-brainer for individuals and corporations to sign on.

Combined with the dominant competitive position and strong cash-flow generation of the media business, Adobe is leading the digital transformation age. The company does not trade cheaply at 26 times forward earnings. But with earnings growing at over 20%, profit margins above 20%, and very little debt on the books, a high valuation is warranted.

Pie in the sky has never been a good investment – but we think that pie in the cloud might be the future of sound investing.



PHOTOS: ADOBE

TICKER ADBE, PRICE: $129.40 AS OF MARCH 31, 2017

Adobe Sign

FRONTWATER SERVICES

We have the expertise to protect our investors from currency fluctuations on US dollar denominated assets. Our investors can invest in markets outside Canada without having to worry about volatile foreign exchange rates.

SERVICES

- Managing Investments
- Assessing your Risk and Investment Profile
- Designing your Asset Allocation
- Customizing a Financial Strategy
- Retirement and Tax Planning Considerations
- Structuring of Family Wealth
- Estate Planning
- Business Continuation Planning
- Protecting US$ Investments against Currency Risks
- Hedging against Extreme Events

PRODUCTS

- Equities
- Bonds
- Income Trusts
- Initial Public Offerings (IPOs), new issues
- Derivatives (Calls, Puts, Futures)
- Commodities
- FX Trading
- Insurance (Offered thru WDBA and Associates)
- Alternative Assets

ACCOUNT TYPES

- Cdn$ and US$ cash and margin accounts
- RRSPs, RESPs, RRIFs
- Tax Free Savings Accounts (TFSAs)
- Individual Pension Plans (IPPs)
- Locked-In Retirement Plans (LIRAs)
- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

IS RETAILING DEAD?

RETHINKING THE MODEL

The destiny of the retailing industry has been an interesting topic of conversation and speculation among investors since the dot com era. The emergence of companies such as Amazon and Netflix devastated businesses such as Block Buster, Indigo and Circuit City while stress-testing traditional business models such as Wal-Mart, and Target. How far will disruption go and change the way shopping is done?

We should never generalize and punish an industry in its entirety based on certain trends. Costco (COST), Lowes (LOW) and Home Depot (HD) have been tremendously successful during the change of retail and have been able to report solid financials year after year. It's possible to say the same thing about Oreilly Auto Parts (ORLY). One thing the latter companies have in common is that they are specialty retailers. Consumers prefer to pick-up these specialty products in a retail location rather than having it shipped to their front door.

Overall, the retailing industry will be a battle ground where "winner takes all" mentality is going to rule for the foreseeable future. There are certainly products that consumers feel 100% comfortable ordering online. Movies, electronics, computers, laptops, patio sets, pizza are but a few examples. On the other hand, there are definitely retail segments that are resistant to changes in technology. Overall, there is tremendous amount of potential for certain players to keep their dominance while others will fail miserably.

Guaranteed Investment Certificates (GICs)

WHY INVEST IN GICS?

GICs are secure investments that guarantee your initial principal investment, while earning a fixed rate of interest over their lifetime. GICs offer predictable income and are the foundation of many balanced portfolios.

HIGHER RATES, SAME RISK

As a deposit broker representing over 30 financial institutions across Canada, we are able to offer our clients personalized service at a lower cost.[1] This means that the savings get passed along to you through higher interest rates with the same principal guarantee that all GICs provide.

BENEFITS OF OUR GICS:

In addition to offering CDIC protected GICs which provide protection up to $100,000, we also offer GICs with:

- UNLIMITED deposit insurance protection by:
  - ✔ CUDIC of British Columbia
  - ✔ Deposit Guarantee Corp. of Manitoba
  - ✔ CUDGC of Alberta
- 1%-1.5% higher than average rates (see table*) from over 30 Canadian institutions [2]

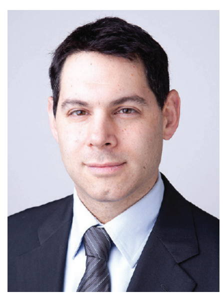
	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.10%	1.50%	1.50%	1.50%
2yr GIC	2.12%	1.65%	1.65%	1.65%
3yr GIC	2.15%	1.80%	1.90%	1.80%
4yr GIC	2.17%	1.90%	1.95%	1.90%
5yr GIC	2.25%	2.05%	2.05%	2.05%

* Rates subject to change

[1] Frontwater does not issue GICs. GICs are issued through independent, third-party financial institutions.

[2] Based on comparable posted rates as of March 31, 2017 at Canada's five largest financial institutions.

JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). He has more than 15 years capital markets experience.



Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Commodity Trading Adviser, and Exempt Market Dealer.

FRONTWATER CAPITAL

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