House Stock
Current price C$33
United Kingdom

Fund in the spotlight: CGI
CGI

Source: Bloomberg

Code	CGI
NAV	C$52
Discount	37%
Mkt Cap	C$682m
Estimated Div Yield	2.8%

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Canadian General Investments +

Leveraged recovery play

Canadian General Investments (CGI) is a dual-listed fund focused on medium to long-term investments in well-established, Canadian corporations. Through successful bottom-up stock selection and the timely recognition of capital gains/losses, the trust has an impressive long-term track record, helped by the structural gearing in place. 2022 was a difficult year having been underweight Energy and overweight Technology, however recent performance has been positive. We believe investors should consider increasing their exposure to Canada, a market that has outperformed other major Western economies and appears to be relatively well placed, by investing in CGI which currently trades at a 37% discount, well below its historic average (25%). HOUSE STOCK.

Investment Objective: Founded in 1928, CGI is a closed-end equity fund focussed on medium to long-term investments in primarily Canadian listed corporations, with allocation to US listed equities capped at 25%. It strives, through prudent security selection, timely recognition of capital gains/losses and appropriate income-generating instruments, to provide better than average returns to investors, exceeding the S&P/TSX Composite Index.

Excellent long-term track record: CGI has delivered a 20Y NAV TR of 1,081% (S&P/TSX: 684%), which implies an annualized TR of 13% in sterling terms. Whilst 2022 was not without its challenges, recent performance has been encouraging and we feel reassured by the trust's historic returns. The manager, Greg Eckel, remains cautious but believes there are several ways in which the portfolio could rebound. For now, he is sticking to his proven strategy, maintaining a fully invested portfolio with leverage in place, ready to deliver when markets recover.

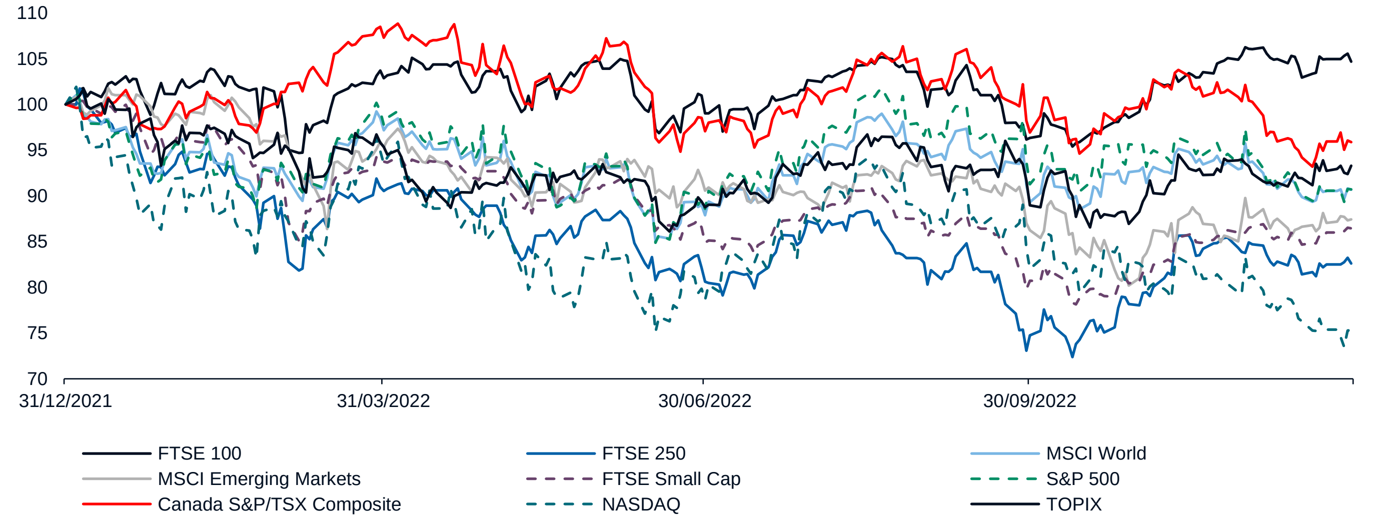
Canadian equities trading at a material discount to the US: The S&P/TSX now trades at a 27% discount to the S&P 500 on a PER basis; at the lower end of its historic range. This is despite the Canada being one of the best performing developed markets in 2022. The outlook for Canada also appears to be more robust, with the IMF forecasting growth of 1.5% in 2023 and 2024 (UK: -0.6% & 0.9%), supported by the ongoing resilience of the US economy. There are also signs interest rates are beginning to peak, with the Bank of Canada having signalled a pause to further rate hikes following signs inflation is softening, albeit the labour market remains tight.

Persistently high discount: Other than a few brief periods of trading at a premium, CGI has consistently traded at a discount. This can be explained by the concentrated shareholder register (Jonathan A. Morgan and Vanessa L. Morgan own or control 52.1% of the outstanding common shares), and the fact that CGI is unable to buy-back shares due to its Investment Corp status. Still, we do not believe these factors justify a 37% discount (20Y average: 25%), given the trust's record of strong NAV returns and that it is well placed to grow the dividend over time.

Canada outperformed in 2022

The S&P/TSX Composite Index (S&P/TSX) fared better than most other major indices, as the world reopened following an extended period of Covid-related lockdowns, leading to a surge in global demand as consumers started spending again.

Figure 1: 2022 re-based TR (£)

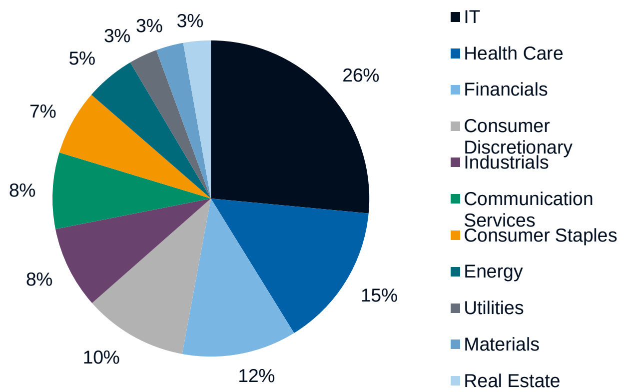


Source: Factset

Canada was able to outperform the US and other developed markets in 2022

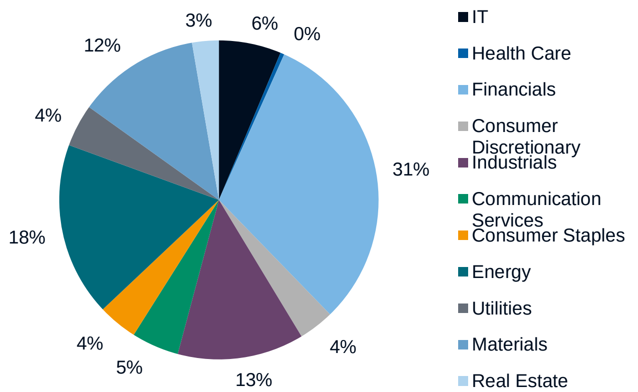
The subsequent widespread supply chain disruption and labour shortages helped drive the highest levels of inflation we have seen in decades. Events in Ukraine exacerbated these inflationary pressures, forcing central banks to take aggressive action in attempt to bring inflation down to central banks' target rates. In this context, Canada was able to outperform the US and other developed markets in 2022, helped by the strong performance delivered by its Energy sector and also its overweight exposure to Financials in a rising rate environment.

Figure 2: S&P 500 Sector breakdown as at 31 January 2023



Source: SP Global

Figure 3: S&P/TSX Sector breakdown as at 31 January 2023



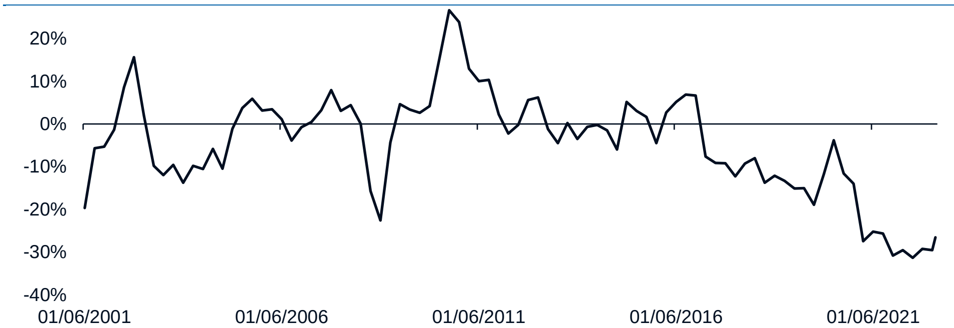
Source: SP Global

S&P/TSX trading at a material discount to the S&P 500

S&P/TSX currently trades at a 27% discount to the S&P 500

Even though Canada performed well relative to other developed markets including the S&P 500 in 2022, the S&P/TSX currently trades on an FY+1 PE of 13x, 27% below the S&P 500, which is the widest the discount has been in over 20 years. This is partly a function of the growing dominance of the US tech giants over the past decade and the S&P 500's superior earnings growth. Bloomberg forecasts suggest that the S&P/TSX is expected to deliver average FY+1 EPS growth of 6.5%, falling to 3.0% in FY+2, which compares to the S&P 500 expected EPS growth of 8.8% and 9.8% respectively. However, by historic standards the manager still considers the valuation gap to be wide and that the valuation differential should continue to narrow in a non-zero interest rate environment.

Figure 4: S&P/TSX trades at a material discount to the S&P 500 (FY+1 PE basis)



Source: Bloomberg

Canada may avoid a recession in 2023

Signs of inflationary pressures easing

Global inflation remains high; however, we are starting to see signs of inflationary pressures easing, helped by a rapid decline in energy prices and easing of global supply chains. We believe that inflation is likely to moderate substantially in 2023 but will remain well above the 2% target set by central banks and note that the outlook for Canada is more positive than some other advanced economies. The IMF is projecting Canada will deliver real GDP growth of 1.5% in 2023 and 2024, which is also ahead of the US.

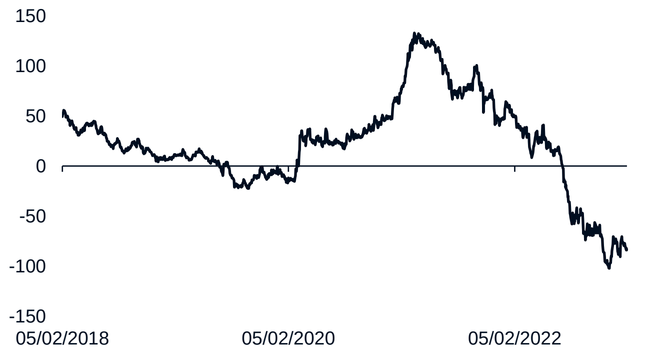
Figure 5: IMF World Economic Outlook - Real GDP Growth

		Estimate	Projections	
	2021	2022	2023	2024
Canada	5.0	3.5	1.5	1.5
France	6.8	2.6	0.7	1.6
Germany	2.6	1.9	0.1	1.4
Italy	6.7	3.9	0.6	0.9
Japan	2.1	1.4	1.8	0.9
Spain	5.5	5.2	1.1	2.4
UK	7.6	4.1	-0.6	0.9
USA	5.9	2	1.4	1.0

Source: IMF

The Bank of Canada has been quicker to raise rates than some of its peers and has become the first major central bank to signal a pause to the interest rate cycle at 4.5%, although it did emphasise it would resume rate rises should inflation fail to return to target levels. The bond markets continue to price in a recession in Canada, however, the latest data from Statistics Canada confirmed that although growth continues to slow, Canada does not appear to be in a recession at this point in time.

Figure 6: CAYC2Y10 – 2/10 Y spread



Source: Bloomberg

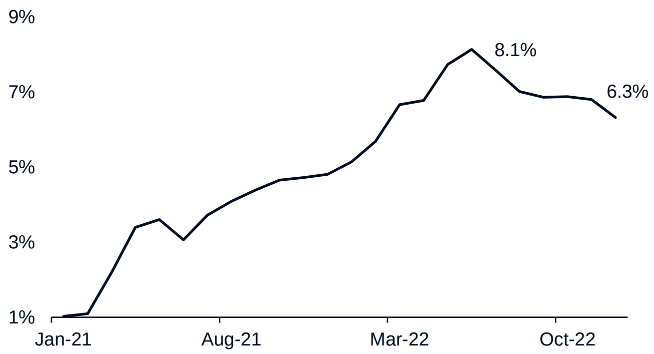
Figure 7: STCA – Labour Force unemployment rate (%)

Source: Bloomberg

Recent jobs data was very strong

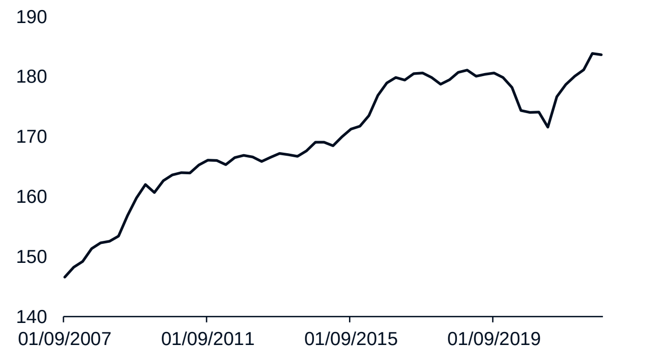
As higher interest rates work their way through the Canadian economy, a slowdown in consumer spending and business investment is expected. Some economists predict Canada could experience a mild recession in 2023. The outlook for inflation is unclear, however commodity prices have retreated from the highs reached post Russia's invasion of Ukraine and supply chains are gradually being restored, which could help sustain CPI's recent downward trajectory. Adding to the challenges around inflation, the labour market remains tight, with the unemployment rate close to historic lows. Recent jobs data was very strong, beating expectations, with 150k new jobs added in January, which was ten times more jobs than expected. Whilst this should help support the consumer in Canada, it is also likely to put pressure on the Bank of Canada to revisit its "conditional pause" to raising rates.

Figure 8: Canada CPI YoY change, not SA (%)



Source: Statcan

Figure 9: CA Household & NPISH debt to disposable income (%)



Source: Bloomberg

The housing market is more challenged, with high levels of household debt. Although very regionalised, transaction volumes have fallen and Canadian house prices are falling having declined by 13% on average in 2022 according to the Canadian Real Estate Association. The manager argues that whilst we may see some further weakness in the housing market, a combination of mortgage rates softening (typically fixed for 5 years in Canada), high levels of employment and immigration alongside a structural shortage of housing, should limit further downside.

Unlike the US, Canada also benefits from full recourse mortgages, facilitating more responsible borrowing and significantly lower foreclosure than in the in the US. Other factors working in Canada's favour include the fact that mortgage insurance is relatively common and that mortgages are not tax deductible as they are in the US.

CGI – time to increase exposure to Canada

CGI's portfolio is well differentiated relative to the benchmark

CGI was established in 1930 and has been managed by Morgan Meighen & Associates Limited since 1956, who has over $2bn in assets under management for private clients, institutional clients, and closed-end fund investors. CGI is dual listed on the Toronto Stock Exchange and the London Stock Exchange. Whilst remaining alert to the macro-economic environment, the manager adopts a bottom-up strategy, to identify companies with attractive investment potential with consideration for the respective industries in which they operate in and external trends affecting the companies. As a result, CGI's portfolio is well differentiated relative to the benchmark.

Investment Manager: Morgan Meighen & Associates

D. Greg Eckel Senior Vice-President

The portfolio manager for Canadian General Investments, Limited, Greg Eckel (CPA, CGA, CFA) joined the firm in 1989, progressing through various financial and analytical roles until his appointment as a full-time member of the investment team in the mid-1990s. He concentrates on North American markets with Canada as his main focus.

Jonathan A. Morgan - Executive Vice-President & COO

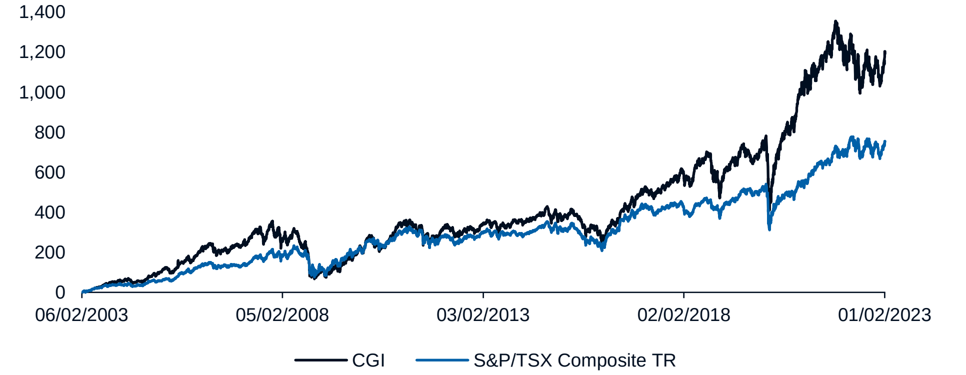
A principal of the firm and President and CEO of Canadian General Investments, Limited, Jonathan has over 10 years' experience in the industry. In addition to being the lead investor relations representative, his responsibilities include portfolio management, strategic planning, business Investment development and security analysis. Jonathan is a Certified Investment Manager (CIM).

Long-term history of outperforming the S&P/TSX

Low turnover and long-term outperformance

CGI has a history of low portfolio turnover and long-term outperformance, helped by the structural gearing in place. We highlight the trust's exceptional track record of outperforming the S&P/TSX, having delivered a 20Y NAV TR of 1,081%, which compares to the 684% return achieved by the index over the same period (in sterling terms). This implies an impressive, annualized TR for CGI of 13% (S&P/TSX: 11% annual TR).

Figure 10: 20Y NAV TR £ (%)



Source: Morningstar

US equities capped at 25%

Diverse portfolio of Canadian equities

CGI benefits from a diverse and actively managed portfolio of well-established, predominantly Canadian equities, with exposure to US equities capped at 25% of the portfolio. The portfolio typically consists of just under 60 equity holdings. Portfolio turnover is low.

As of 31 January 2023, there were 56 holdings in the portfolio, with the top ten holdings accounting for 39% of the total portfolio. The portfolio has high exposure to the Industrials, IT and Materials sectors, which combined account for 57% of the portfolio.

Figure 11: Top ten holdings as of 31 January 2023

Company	% Portfolio	Sector
Canadian Pacific Railway Limited	4.80	Industrials
West Fraser Timber Co. Ltd.	4.70	Materials
Franco-Nevada Corporation	4.50	Materials
First Quantum Minerals Ltd.	4.40	Materials
TFI International Inc.	4.10	Industrials
NVIDIA Corporation	3.50	Technology
Apple Inc.	3.20	Technology
WSP Global Inc.	3.20	Industrials
The Descartes Systems Group Inc.	3.10	Technology
Mastercard Incorporated	3.10	Financial Services

Source: Company Data; Shore Capital Markets

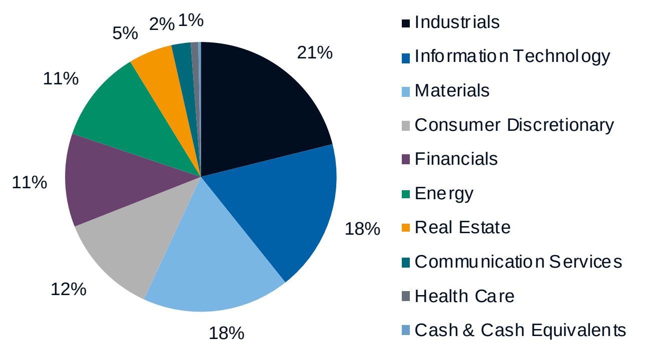
CGI's exposure to the energy sector is now c.11%

Overweight Industrials, IT, Materials, Consumer Discretionary & Real Estate

The manager had anticipated a cyclical led recovery in 2022, however the outcome for the year proved to be very different. CGI's underweight position in energy stocks and overweight exposure to technology companies, contributed to the trust's underperformance. Despite the trust's longstanding underweight position in the sector, the manager did invest in the dip in the energy sector adding Baytex Energy Corp., with the view that the opportunity still looked attractive over the long-term. CGI's exposure to the energy sector is now c.11%.

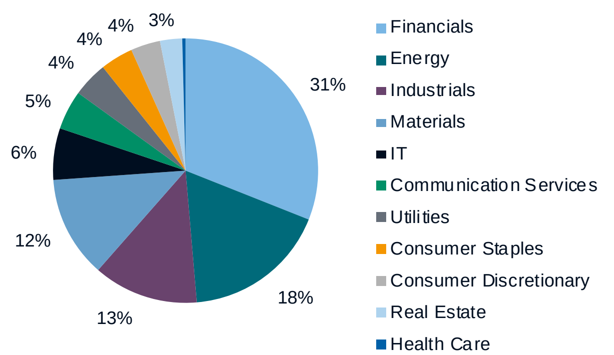
Although the manager is open to adding to the sector, due to Eckel's long-term investment horizon and prudent investment approach, it will only add in a measured way when an attractive entry point presents itself.

Figure 12: CGI Sector breakdown as at 31 January 2023



Source: Company Data; Shore Capital Markets

Figure 13: S&P/TSX Sector breakdown as at 31 January 2023



Source: Company Data; Shore Capital Markets

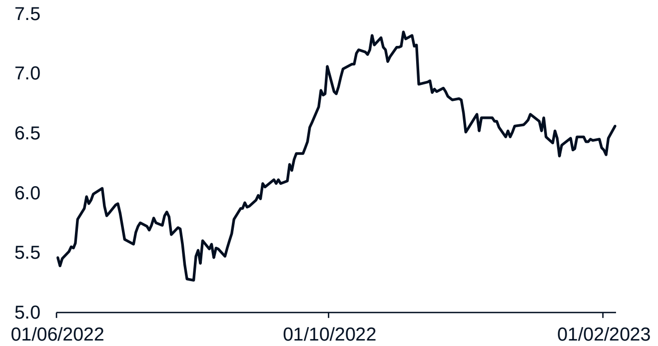
Successful track record of realising profits

The trust has historically maintained a large weighting to IT stocks and the manager has a successful track record of realising profits, having taken sizeable gains in late 2021 going into 2022. This included profit taking in Amazon.com Inc., Block Inc., NVIDIA Corporation and Shopify Inc., CGI's IT exposure has fallen from a high of 30% in June 2020 to the current 18% weighting (S&P/TSX: 6%). Some of these holdings have de-rated considerably and the manager therefore sees potential for some of these holdings to come back in favour, as and when market conditions improve.

Materials had a difficult year

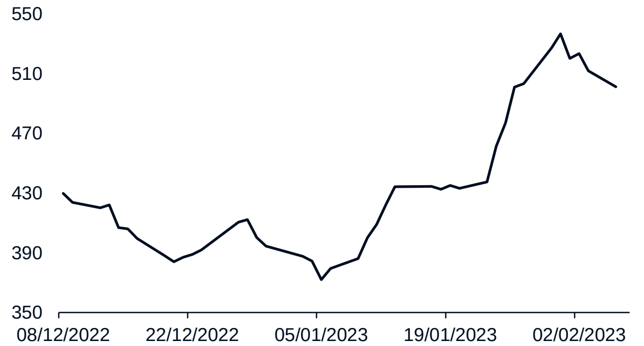
Materials had a difficult year, as rising interest rates impact housing in the US, which had a knock-on effect on the performance of CGI's lumber stocks where it is overweight relative to the benchmark. These companies have had a good start to the year, helped by more encouraging housing market data from the US and the decline in US mortgage rates, which have fallen back towards 6%. This has been reflected in the sharp rally in lumber futures seen since the start of the year.

Figure 14: US average 30Y mortgage rate



Source: Bloomberg

Figure 15: Lumber Futures May 23 ($)

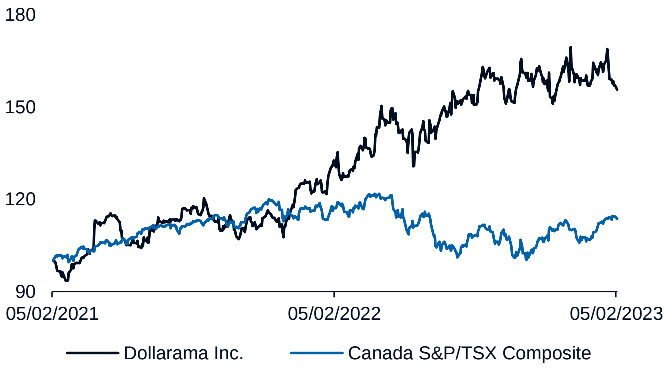


Source: Bloomberg

Dollarama had a good year thanks to its defensive offering

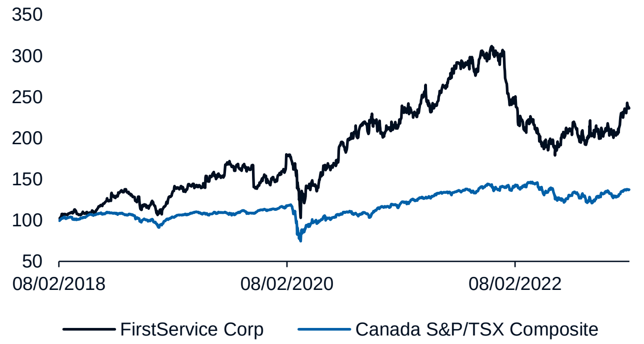
Some of the trust's real estate plays including First Service Corporation, a leader in outsourced property services in North America, are starting to see some signs of stability as more reassuring signals emerge from the US housing market. Amongst the consumer holdings, Canadian dollar store retail chain Dollarama had a good year thanks to its defensive offering in a rising interest rate and inflationary environment.

Figure 16: Dollarama 2Y re-based share price outperformance



Source: Bloomberg

Figure 17: First Service Corp re-based share price



Source: Bloomberg

YTD NAV performance has been encouraging

Leveraged recovery potential

Whilst remaining cautious about the outlook for the year, the manager is sticking to its strategy with the view that a rebound in the portfolio could materialise in several ways. This could be driven by a recovery in some of the tech holdings that have materially de-rated (such as Shopify) or from a flight to quality holdings. The NAV performance in the year to date has been encouraging, having delivered a 6.8% NAV TR in the YTD, ahead of the 4.3% return reported by the index.

Nvidia

We highlight one of the top 25 holdings, US-listed Nvidia, as a quality company in the hard-hit semi-conductor sector. The manager considers it to be one of the most attractive ways to gain exposure to the semi-conductor sector and argues that China's reopening should help drive chip inventories down significantly over the next few months. Nvidia is also considered to be a leader amongst its peers on the technology front, specialising in graphics processing units (GPUs) and artificial intelligence (AI).

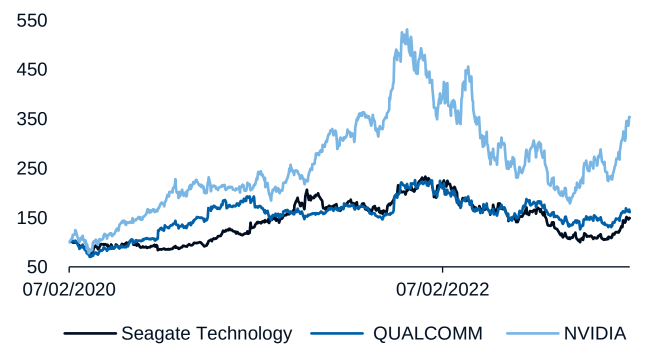
In Q4'22, the company announced a multi-year collaboration with Microsoft to build a cloud-based AI supercomputer and a new multi-year partnership with Oracle. It also confirmed that it had begun shipping samples of its new H100 Tensor Core GPU.

Growing interest in AI applications following the successful launch of chat GTP has sparked a rally in the semi-conductor sector, as investors seek exposure to the semi-conductors powering AI applications, with Nvidia amongst some of the biggest winners. The Philadelphia semi-conductor index is up 18% in the YTD, meanwhile Nvidia has rallied 45%.

Figure 18: Philadelphia Semi-conductor index

Source: Bloomberg

Figure 19: Re-based 3Y re-based performance



Source: Bloomberg

The manager has harvested significant profits

Shopify

Shopify, the international e-commerce company has been one of CGI's most successful investments to date and the manger argues it has the potential to be the Amazon of Canada. It was previously the largest holing in the trust, having been added to the portfolio in 2016 when Eckel felt that it had emerged as a leading e-commerce platform for online merchants. The manager has harvested significant profits (over $100m), by following a disciplined approach since its first investment, with the position now accounting for c.2% of the portfolio.

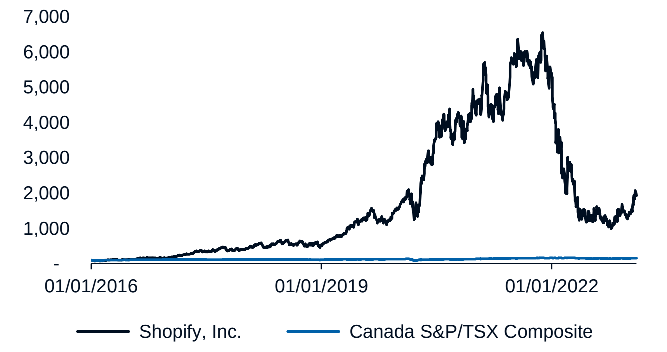
Shopify has announced average price increases of 33%

Having benefited from the boom in the e-commerce market during the pandemic, Shopify later fell victim to a slowdown as the pandemic induced ecommerce tailwinds subsided. Happening alongside a sell-off in the tech sector as central banks acted to control inflation, at one point the shares were down c.85% from their peak of $169 at $25. The shares have since recovered, currently trading around the $42 mark.

The record Black Friday – Cyber Monday sales reported, combined with some of the recent initiatives management has adopted have been promising. Action has been taken to scale back Shopify's expansion plans and right-size the business. More recently, the company announced average price increases of 33% across a range of its products, the first in over a decade. These increases are due to come into effect as of 23 April 2023.

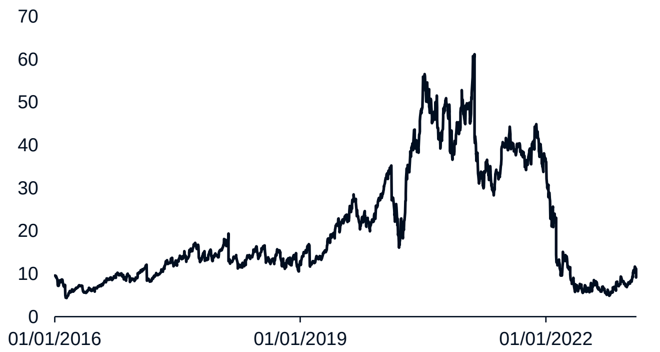
Although the position lost a lot of unrealised value along with some of the trust's other technology holdings in 2022, Eckel believes Shopify has the potential to bounce back and generate significant value for investors as a well-managed business that has fallen victim to the sell-off in highly rated stocks and also consumer weakness. Bloomberg forecasts suggest the company will almost break-even on an adj.EPS level in FY22F, before resuming double-digit profit growth going into FY24F and FY25F.

Figure 20: Shopify TR vs S&P/TSX



Source: Bloomberg

Figure 21: Shopify FY+1 EV/Sales

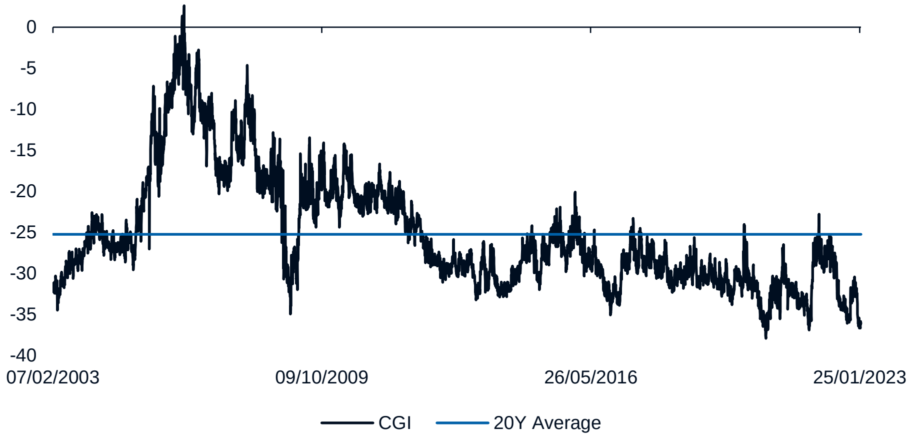


Source: Bloomberg

Discount approaching a 20 year low

Aside from a few brief periods of trading at a premium to NAV, CGI has persistently traded at a discount. This can partially be explained by the concentrated shareholder register and the fact that CGI is unable to buy-back shares. As at 30 June 2022, Jonathan A.Morgan and Vanessa L.Morgan beneficially owned directly or indirectly exercised control over 52.5% of the outstanding common shares of the company. This implies that a buy-back of even a single share by the company or related parties would trigger the loss of CGI's Investment Corp Status, which eliminates a layer of taxation, with capital gains only being taxed at the shareholder level. In addition, it allows the payment of capital gains dividends to shareholders and reduces the rate of tax on investment income. Thus, the interests of long-term shareholders of CGI would be negatively impacted by buy-backs.

Figure 22: 20Y premium/discount & 20Y average



Source: Morningstar

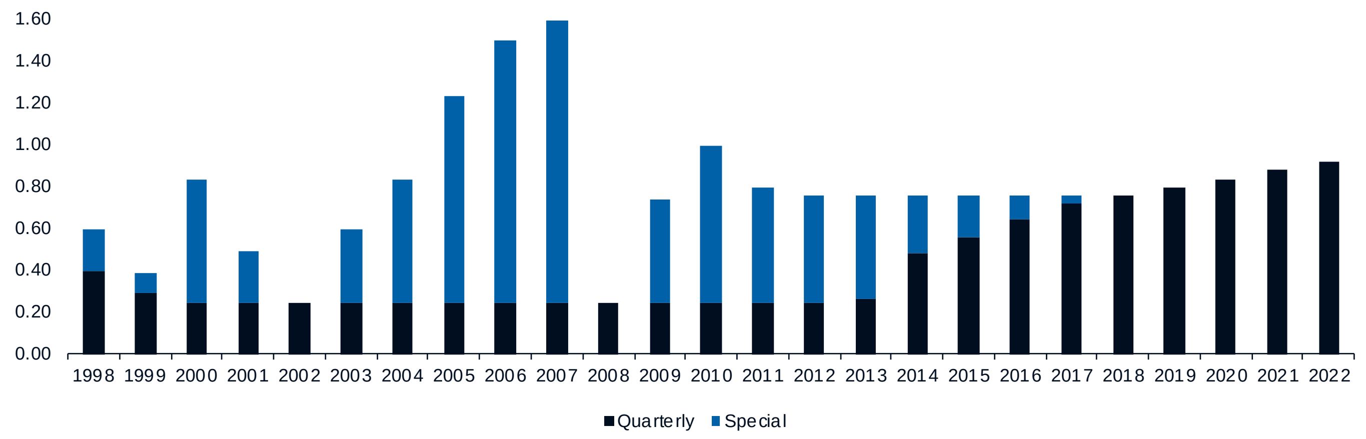
Despite this constraint, the discount has widened below its historic average (20Y average: 25%) and at 37%, is approaching a 20-year low. Given the manager's exceptional long-term track record of outperformance, and chances of a leveraged recovery from a diversified portfolio of quality companies, we believe that investors should consider increasing their exposure to North America by investing in CGI which looks set to benefit from a recovery in NAV performance and a rising dividend over time.

Dividend

Steady to rising quarterly dividend

Since 1998, cumulative pay-outs have totalled over $408m and the trust has not missed the payment of a dividend since the 1930s. Since 2013, the Board has targeted a steady to rising quarterly dividend for shareholders. The payment of capital gains dividends continued, but the year-end special dividend was de-emphasized with more of the annual distributions paid to common shareholders in the form of the four quarterly dividends, in hope this would provide common shareholders with greater reliability as to their expected dividend income.

Figure 23: Historic quarterly & special dividends ($)



Source: Company Data; Shore Capital Markets

CGI pays both regular, taxable income dividends and capital gains dividends to shareholders. All taxable dividends are considered "eligible dividends" for purposes of the Income Tax Act (Canada). Qualifying as an investment corporation for tax purposes, payment of capital gains dividends allows CGI to recover taxes paid, or payable, on realized capital gains. The type of dividend paid is specified at the time of the announcement. The trust currently yields 2.8%, based on the $0.92 dividend paid in 2022.

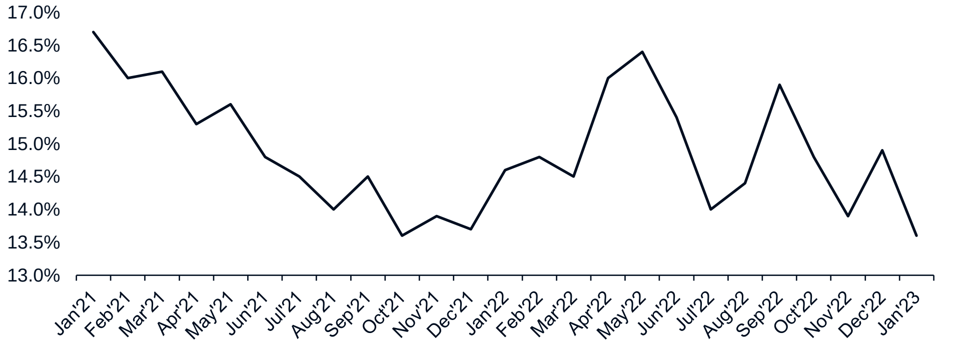
Capital Structure

Leveraged through its borrowing facility and preference shares

CGI is leveraged through its borrowing facility and preference shares in an effort to enhance returns to shareholders. The combined cost of the margin facility and preference shares is 4.6%. We note that the combined leverage is at the lower end of where it has been historically. As at January 31, 2023, the combined leverage represented 13.6% of CGI's net assets, down from 14.9% at the end of 2022 and 14.6% at January 31, 2022.

Combined cost is 4.61%

Figure 24: CGI leverage as % net assets



Source: Company Data; Shore Capital Markets

In May 12, 2021, CGI entered into a prime brokerage services agreement with a Canadian chartered bank to secure margin borrowing of $100m. All amounts borrowed under this facility bear interest at the one-month Canadian Dollar Offered Rate (CDOR) plus 0.60% per annum. The agreement requires the company to pledge securities as collateral for margin borrowings and may be terminated immediately by the prime broker upon the occurrence and continuation of an event of default, as defined in the agreement, or by either party with 30 days' notice. As of June 30, 2022, the $70m outstanding under the borrowing facility represented 7.4% of CGI's net assets. The current interest rate on the margin facility is 5.47%.

In addition to the $75 million borrowed under the facility at 31 January 2023, CGI also has outstanding $75 million 3.75% cumulative, redeemable Class A preference shares, Series 4, which become redeemable, at par, to the Series 4 shareholders on or after June 15. The cost of this debt to the company is 3.75%.

When these preference shares come to the end of their 10-year life in June this year, the manager will have to decide how best to structure CGI's leverage strategy. Whilst the preferred share market is not attractive at this point, the manager could consider extending its margin facility to replace the $75million preference shares outstanding. Another option would be to reduce the overall leverage of the trust. The manager is conscious of the rising cost of gearing in the current environment but will ultimately take a long-term view when deciding what will be in the best interest of investors.

Conclusion

The Bank of Canada expects headline inflation to continue to fall over the next two years as the economy absorbs the impact of a higher interest rate environment. Whilst there have been some signs that inflation is starting to soften, we are mindful of the potential effects of China's reopening and also Canada's tight labour market. Even if this leads to further interest rate hikes, we believe Canada must be approaching the end of the cycle and that its long-term outlook is more positive relative to some other developed markets, helped by the resilience of its largest trading partner.

Eckel has repeatedly delivered in terms of NAV performance and has an excellent record of identifying winners. We believe investors can therefore be confident CGI's historic outperformance will resume, helped by its portfolio of high-quality investments which should deliver as markets recover, amplified by the leverage. The manager has stuck to his investment strategy and experience navigating down-market cycles, which has proven to be successful for investors over the long-term. Whilst the outlook for the global economy remains uncertain, as we have said, we believe Canada is better placed than many of its developed peers. Investors should therefore consider increasing exposure to Canada by investing in CGI at a 37% discount.

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Company	Disclosures	Date	Recommendation
Canadian General Investments +	1,3,4,9,13	15 April 2019	House Stock

Disclosures

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