

Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JULY 2, 2016

Post Brexit Blues: What's Next?

Referendums bring uncertainty, and uncertainty brings frustrated investors, which translates into volatility in the markets. As we say time and time again, uncertainty brings 'buy opportunities'. This recent market sell-off is no different.

WRITTEN AND PRODUCED BY



The unexpected happened on June 23. The British people commanded the divorce between the EU and the UK. Shortly thereafter, Standard and Poor's stripped the UK of its AAA rating, the British Pound lost 10% of its value, and stocks dropped five to ten percent. But why did the UK consider a referendum in the first place and what are the long term implications of Brexit on the global capital markets?

The motivation underlying Brexit can be traced back to the severity of the 2008 financial crisis. Whereas the US had experienced a moderate recovery by 2011 - in large part to the Fed's easy monetary policies, the UK and its European allies followed a different path. The ECB instituted an opposite course of action of tighter monetary policy and higher interest rates; thus contributing to a prolonged recession in the Union.

As European nations combatted the remnants of the financial crisis, the increased unemployment and lackluster consumption frustrated the British. Meanwhile, Britain experienced an influx of qualified and unqualified Europeans seeking refuge of employment and prosperity.

By 2012, British politicians started to talk about a possible referendum to leave



the EU putting pressure on David Cameron to address the issue formally. The European Union Referendum Act was introduced to the British parliament on 28 May 2015, and was approved by the House of Lords.

As we all know the 'Yes' side won. Though the referendum was created merely to "guide" parliament, members of parliament are expected to follow through on it; democracy at times come with a cost.

Moving forward, parliament needs to approve the referendum and the UK needs to notify the EU to start negotiations. Britain has 2 years in order to finalize the exit negotiations. The

sustenance of a close relationship between the UK and the EU would certainly benefit both parties economically.

Realistically, we at Frontwater Capital believe Brexit will have a marginal effect on the world's economy. We imagine it will take a very long time to come into effect, if ever. Divorces are never easy. Imagine all the intertwined agreements and treaties that need to be renegotiated when two countries separate. The sheer complexity of any kind of Brexit separation will leave politicians' heads spinning. Eventually Britons will come to their senses and realize that the status quo makes

most sense. Remember the margin of victory was slim at best and many British voted 'no' as a protest vote. A little voice of reason from top politicians at a later date and a change in heart by the people is certainly not insurmountable.

Regardless, as negotiations proceed we will see what portion of the status quo remains and what advantages the UK forfeits by leaving the Union. Still, it will take several months if not years to really know the 'look' and 'feel' behind a Brexit. Stock valuations may be high but Brexit on its own is no reason for investors to run away.

Priceline is the blue whale of online travel. With a market capitalization of \$63 billion, they are more than five times larger than the next biggest player, Expedia. Priceline has changed the way consumers approach travel by making it easy, convenient and cheap.

By putting a cafeteria menu of airline, hotel, and rental car options at our fingertips, and all at a bargain rate, everybody is a winner! The planes, resorts, and hotels are full, and people are willing to travel more often with less hassle and lower costs. If another company becomes a threat, Priceline just buys them.

A one-stop shop for every aspect of travel, Priceline.com helps consumers to save by offering more deals than any other travel site. It offers bookings for hotels, rental cars, and flights and is widely known for its unique products: Express Deals, Tonight-Only Deals, and Name Your Own Price service. Additionally, consumers can book rental car reservations worldwide through its Rentalcars.com brand.

With its war chest of online brands and capacity to borrow, Priceline has made a number of shrewd strategic acquisitions over the last three years to further solidify its online presence:

■ In 2013, the company purchased KAYAK for \$1.8 billion USD. The web site gives consumers the ability to “price compare” across dozens of different travel websites through one meta-search.

■ In 2014, the company purchased OpenTable for \$2.6 billion USD. OpenTable is the global leader in providing online restaurant reservations. On average, OpenTable seats more than

15 million diners every month across 32,000 restaurants.

As a company that connects consumers with providers of travel services through its plethora of online global web-sites, it has no need for costly inventory or much of a tangible infrastructure. It makes money on expensive airplanes, fancy hotels, and automobiles without ever having to build, buy, staff, or maintain any of them. Consequently, one of the most attractive features for investors is its cash-generation potential.

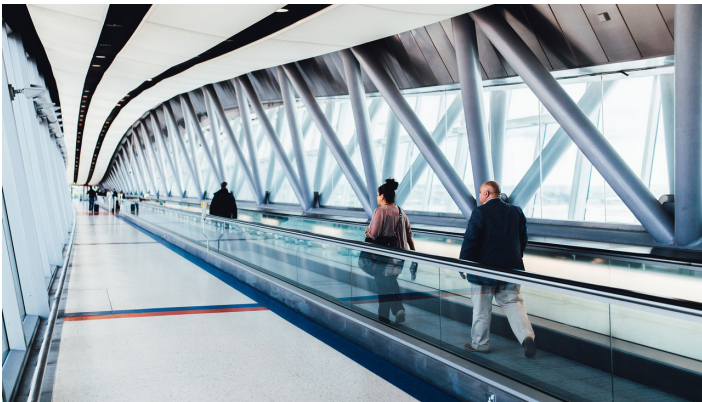
Financially speaking, Priceline is performing very well. Priceline has grown its



PRICELINE (PCLN) \$1,248.31 USD
AS OF JUN 30, 2016

top and bottom lines rapidly over the past five years of business. It has by far the strongest profit margins in the industry at 27% and manages its capital efficiently with a Return of Equity near 30%.

On the heels of the Brexit vote, Priceline’s stock dropped 10% creating a rare buy opportunity for the long-term investor. While some analysts, post-Brexit, feel that the company is exposed to potential declining growth in Eurozone companies and adverse government measures that could impact travel demand, we believe this view is shortsighted



and altogether wrong.

We don’t often take a contrarian outlook, but in this case we think it means money in the bank. Combined with increased discretionary spending, lower airfare (based not just on cheap oil, but also on an improving global economy), and the shift of travel booking from offline to online, Priceline is well positioned to capture even more market share within the trillion-dollar travel industry.

Booking.com is the world leader in online booking accommodations. It helps business and leisure travelers with varying spending thresholds find and book travel reservations all around the world. The site is available in 42 languages, offers over 600,000 accommodations in 200 countries, and displays customer reviews of properties. Likewise, **Agoda.com** provides hotel reservation services, primarily within Asia.

Ctrip is China’s version of Priceline with a market share that exceeds 35%. A host of global and domestic factors in the Chinese market are contributing to the company’s rapid growth, including rising disposable income levels, an expanding middle class, higher inbound and outbound visits to China, and aggressive growth in the hotel and airline industries.

Add to the fact that online travel still occupies a very small portion of China’s overall travel market, and you can begin to see the long term potential of this company.

Ctrip blankets the travel market with a range of services from hotel reservations, to air ticketing, to packaged tours, and travel management services for business and corporate travelers, enhancing its reach into the biggest foreign markets.

The company is on the fast track to enhancing shareholder value with a global strategy of leveraging its brand with travel suppliers in China and around the world. This approach has helped the company lower prices for consumers while becoming the most profitable travel agency in China - a very attractive combination. They’ve also managed to shave costs and negotiate favourable rates with suppliers, creating a compelling win-win scenario.

But Ctrip’s strategic positioning and attraction for investors doesn’t end there. The company continues to consolidate its strength both within China and worldwide. In May 2015, Expedia (second only to Priceline in the US) sold off its entire stake in eLong (one of Ctrip’s competitors) to Ctrip and another party. Part of the sell-off deal

included Ctrip and Expedia entering into a collaboration agreement to share packaged tour and air ticket inventories within geographic districts.

And there’s more. Shortly after the eLong transaction, Priceline in December 2015 increased its \$1.5 billion investment in Ctrip to \$2 billion, or nearly 15% of the company. That cash injection allowed Ctrip to invest \$180 million in India’s largest online travel company, MakeMyTrip. That deal gave Ctrip the option to increase its stake in MakeMyTrip to over 26%. This means that the ambitious Chinese giant now



CTRIP (CTRP) \$41.20 USD
AS OF JUNE 30, 2016

has deep operational connections with the top online agencies in the world’s three most populous nations – who together represent over 43% of the global economy.

It may seem a tad confusing and somewhat incestuous. Admittedly, some of this confusion shows up on the financial statements. Income from the purchase and sale of stock combined with operating earnings creates some weird results on the statements.

Still, Ctrip had one of its best years in 2015. After doing our analysis and dissecting the numbers on the statements,

a couple of positive trends appear. On a normalized basis, we see an opportunity for Ctrip to triple its both income and EBITDA through growth over the next five years. Not too many industries or companies can offer these kinds of results.

It’s true that competition from disrupters such as AirBnb pose a threat to the travel industry as a whole. But we actually view AirBnb as a positive headwind as it encourages an even greater consumer shift towards online travel.

Ctrip is no doubt focusing on the right things. It is aggressively positioning itself to dominate the Asian market as their online marketplace rapidly becomes digital. It is forging strategic alliances with global leaders in online travel in established and growth areas of the world. It is developing an open platform that leads to more pricing transparency. And it’s sitting right in the middle of a growing Chinese market destined to become the largest wealth machine on the planet. We are pretty sure it deserves our continued scrutiny – and yours too.

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

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- Income Trusts
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- Derivatives (Calls, Puts, Futures)
- Commodities
- FX Trading
- Insurance (Offered thru WDBA and Associates)
- Alternative Assets

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- Individual Pension Plans (IPPs)
- Locked-In Retirement Plans (LIRAs)
- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

ETF STRATEGIES: Canadians Snowbirds: Head South For Your Dividend Aristocrats

Two things that wealthy Canadian investors love: warm winters down south and consistent, dividend paying securities, also referred to as dividend aristocrats. It should be no surprise that there are a plethora of Exchange Traded Funds that Canadians can choose from – some listed in Canada and some in the US.

Indeed, a basket of dividend paying companies are almost always beneficial for one's portfolio no matter one's risk appetite, financial condition and age. Unfortunately, the disadvantage with investing in any of the Canadian Dividend oriented ETFs is that a Canadian investor winds up with one more fund heavily weighted towards the Canadian banks and financial institutions.

In isolation of other portfolio holdings, this might not prove troublesome. But within a basket of Canadian oriented ETFs, an investor can easily wind up with over exposure to the energy and financial services sectors.

For example, the iShares S&P/TSX Canadian Dividend Aristocrats Index ETF (Canada) is 36% invested in Canada's top 6 banks and another 15% in the energy sector alone. Another dividend aristocrat ETF, Vanguard Canadian High Dividend fund is 64% invested in the financial

sector alone. If the goal is to own a reliable, stable and diverse basket of dividend paying champions, it's very unlikely that any of the Canadian Dividend ETFs will fulfill that purpose.

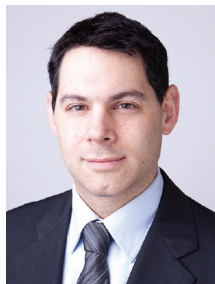
The US however is a different story. Both iShares and Vanguard in the US have nicely diversified dividend focused ETFs. Each of these ETFs are constructed of predominantly large cap consumer staples, healthcare and industrials companies. For example, in XHD's Top 10 holdings, you are going to find large multinational players such as Coca Cola, Procter and Gamble, Johnson and Johnson, Phillip and Morris, Merck, Pfizer. These large cap multinational companies simply do not exist on the Canadian stock exchanges.

Moreover, these US based companies have great track records of not only continuously paying out a dividend but also increasing it year in year out.

Canadians need to understand that just owning a bunch of various Canadian ETFs does not automatically ensure diversification. In fact, it may do the opposite as a lot of Canadian ETFs will have a high concentration towards the financial services and energy sectors.

Thus, it is important that each ETF in your basket serves a vital and unique purpose and is taken in context with the other ETFs you hold in your portfolio; otherwise you will end up with a lot more risk than you thought. The more unique each basket, the more diversification you have.

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.



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