Top 10 Canadian Stock Picks for 2015

ScotiaMcLeod Portfolio Advisory Group

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- **The Canadian equity market will likely lag the U.S. in 2015, but a potentially strong second half recovery in the energy sector could tilt the scales in Canada's favour**.
  - This year's top 10 picks are (in alphabetical order): Brookfield Property Partners LP (BPY.un), Brookfield Renewable Energy Partners (BEP.un), Canadian Natural Resources (CNQ), Cenovus Energy (CVE), Empire Company (EMP.a), Linamar (LNR), Lundin Mining (LUN), Pembina Pipeline (PPL), Power Corp of Canada (POW), and Royal Bank of Canada (RY).

- **The 2014 list of top picks significantly outperformed the S&P/TSX Composite Index**.
  - Average gain of 24.05% for 2014's top 10 picks, 1662 bps of outperformance over the S&P/TSX Composite's 7.42% gain last year.

Top 10 Canadian Stock Picks for 2015

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The Canadian equity market will likely lag the U.S. in 2015, but a potentially strong second half recovery in the energy sector could tilt the scales in Canada's favour

Consensus 2015 earnings growth expectations for the S&P/TSX Composite Index, which currently stand at 3.5% YoY, seem to be getting hit from multiple sides as analysts revise assumptions lower. The three most heavily weighted sectors, Financials, Energy, and Materials, account for almost 70% of the overall capitalization of the Index, and each is suffering from its own set of circumstances. Low bond yields are weighing down net interest margins for the banks, dramatically lower oil prices could result in up to 25% lower income for the energy sector, and few positive near-term catalysts exist for the materials sector. The good news in this rather somber outlook for 2015 is that equity prices seem to be already discounting these views, in our opinion. We think the biggest wildcard, and opportunity, in 2015 will be oil prices and energy sector. While we see few immediate catalysts to drive the sector higher, we expect oil prices to begin firming in the second half of 2015. With expectations for mid-single digit price appreciation for the TSX, our top 10 list for 2015 (see Exhibit 1) has a greater emphasis on dividend yield than in prior years. A brief summary of our top 10 picks is included later in this report.

Exhibit 1 - Canadian Top 10 Picks for 2015

Company	Sector	Symbol	Price 31-Dec-14	Dividend	Dividend Yield	Bloomberg Consensus Target	Potential Total Return	Bloomberg Ratings Buy	Hold	Sell	Market Cap ($Bln)
Royal Bank of Canada	Financial - Bank	RY	80.24	3.00	3.7%	87.45	13%	10	11	0	116
Power Corporation of Canada	Financial - Diversified	POW	31.76	1.16	3.7%	34.64	13%	5	5	0	15
Brookfield Property Partners LP	Financial - Real estate	BPY.un	26.45	1.16	4.4%	28.94	14%	2	0	0	7
Cenovus Energy	Energy - Integrated	CVE	23.97	1.06	4.4%	28.02	21%	11	12	1	19
Canadian Natural Resources	Energy - E&P	CNQ	35.92	0.90	2.5%	44.25	26%	19	3	2	40
Pembina Pipeline	Energy - Infrastructure	PPL	42.34	1.74	4.1%	51.58	26%	8	5	1	14
Brookfield Renewable Energy Partners LP	Utilities	BEP.un	35.90	1.80	5.0%	37.34	9%	8	3	2	5
Empire Company	Consumer Staple	EMP.a	87.62	1.08	1.2%	90.15	4%	5	5	1	8
Linamar	Industrial	LNR	70.95	0.40	0.6%	75.43	7%	7	1	0	5
Lundin Mining	Materials- Base Metals	LUN	5.72	0.00	0.0%	7.54	32%	20	4	2	4
Average					3.0%		16.4%				23

Source: Bloomberg, ScotiaMcLeod PAG

With top line under pressure and emphasis on cost controls the Canadian banking sector will likely see 2015 earnings growth in the 4%-6%% range, well below the long run average. Within the bank group, Royal Bank's (RY) strong retail and capital markets franchises should allow for sector leading earnings growth in 2015. Power Corp's (POW) large discount to net asset value and improving fundamentals in its life insurance subsidiary make it a preferred pick. Despite a strong showing in 2014, we think Brookfield Property Partners (BEP.un) should outperform the real estate sector again as it continues to trade at a meaningful discount to net asset value and its U.S.-centric portfolio should benefit from improving fundamentals in that market.

Our previous year's top 10 list was spared much of the carnage in the energy sector because our three energy picks were defensive in nature (two midstream/pipelines and one integrated producer). With oil prices virtually halved, we see a brighter outlook for the energy sector in 2015. Our top 10 list this year includes three energy picks: an integrated producer (Cenovus, CVE), a senior E&P (Canadian Natural Resources, CNQ), and a midstream/pipeline company (Pembina Pipeline, PPL). Although we are more constructive on the sector at current levels, it is worth noting that our picks this year still have defensive qualities that should result in relatively less volatility.

Brookfield Renewable Energy Partners (BEP.un) and Empire (EMP.a), a utility and grocery chain, respectively, are low beta stocks whose defensive qualities should reduce portfolio volatility. We like BEP.un for expected dividend growth in early 2015, and EMP.a for a gradual return to same-store sales growth.

Our two growth picks are Linamar (LNR) and Lundin Mining (LUN). Linamar replaces Magna International (on our top 10 list in 2012, 2013, 2014) as we remain constructive on the auto sector but are concerned about the economic conditions in Europe (16% of Linamar's revenues are derived from Europe versus 42% for Magna). Lundin Mining is a base metal mining company (copper, zinc, nickel) with a clean balance sheet, attractive valuation, and above average production growth. The company's expected transition to free cash flow generation in 2015 could result in the implementation of a dividend this year.

The 2014 list of top picks significantly outperformed the S&P/TSX Composite Index

We entered 2014 with expectations for modest returns for the S&P/TSX Composite Index, and suggested that outperformance would come mainly from company specific attributes. Overall 2014 index returns were indeed modest (S&P/TSX Composite Index up 7.4%), but the three most heavily weighted sectors (Financials, Energy, Materials) were the worst performers, confirming that stock selection was the key to outperformance. Our top 10 picks last year delivered an average price-only return of 24% compared with the S&P/TSX Composite's 7.4%, a substantial outperformance of 1662 basis points. Nine of our 2014 picks ended in positive territory, and 8 of 10 outperformed the Index, many by a wide margin (see Exhibit 2).

The top performing stock on our 2014 list was Alimentation Couche-Tard (ATD.b), which we had chosen for its attractive valuation, non-CAD exposure, and its track record for accretive acquisitions. The stars did indeed align for the company in 2014 as its forward P/E multiple expanded 6 multiple points to the current 22.3x, it was added to the well-followed S&P/TSX 60 Index, and it announced a $2.0 billion acquisition of The Pantry (PTRY). While we like the company's business model and defensive qualities, the current valuation has prevented us from renewing it on this year's list.

Exhibit 2 - Performance of 2014 Canadian Top 10 List

Company	Ticker	Price 12/31/13	Price 12/31/14	See notes	Change
Agrium	AGU	97.17	112.42	2	15.69%
Alimentation Couche-Tard	ATD/B	26.63	48.69		82.86%
Enbridge	ENB	46.41	59.74		28.72%
Intact Financial	IFC	69.37	83.85		20.87%
Magna International	MG	87.10	125.89		44.54%
Manulife	MFC	20.96	22.18		5.82%
Pembina Pipeline	PPL	37.42	41.98	1	12.19%
Suncor	SU	37.24	36.90		(0.91%)
TD Bank	TD	50.06	55.51		10.90%
WestJet Airlines	WJA	27.85	33.36		19.78%
Average price-only return for top 10 list					24.05% *
S&P / TSX Composite Index		13,621.5	14,632.4		7.42%
Outperformance (Underperformance)					*16.62%*

Notes:

1 - Closing price as of March 31, 2014, when removed from PAG recommended list

2 - Closing price as of November 24, 2014, when removed from PAG recommended list

* Top 10 list average return would have been 23.89% if all candidates were held until Dec 31, 2014

Source: Bloomberg, ScotiaMcLeod PAG

Magna International (MG), which has been on our top 10 list for three consecutive years (for a combined price appreciation of 270%!), was the second best performer. A recovery in U.S. auto sales to pre-recession levels has lifted Magna's top line and margins. While valuation remains relatively attractive (10.6x NTM P/E, 6.2x NTM EV/EBITDA) and prospects for further traction in its U.S. business exists, we are concerned about its European operations which account for over 40% of revenue. It is for this latter reason that Magna did not make our 2015 list, and was replaced with Linamar (LNR) instead.

We did not foresee the collapse in oil prices and the broad energy sector in 2014. Though our 2014 list was overweight energy (3 picks out of 10), we were fortunate in selecting defensive names that held up very well. Suncor (SU), the worst performer among our 2014 picks, declined 0.9% in 2014 while other oil producers witnessed material drops in share price. Our other two energy picks, Enbridge (ENB) and Pembina (PPL), are inherently more defensive due to their limited commodity price exposure. After a burst out of the gate, we recommended taking profit on PPL at the end of March 2014 after the stock appreciated 12%. PPL would go on to gain as much as 41% during the year but then declined amidst the energy sector sell-off and has returned almost to where it was at the end of March. Due to a visible growth pipeline and reasonable valuation, PPL has made it back to our 2015 list.

Within the financial sector, TD Bank (TD) and Manulife (MFC) turned in respectable performance that was in line with our expectations. Intact Financial (IFC), a home and auto insurer, pulled ahead due to consistent earnings improvement and lower interest rate sensitivity compared with TD and MFC.

Agrium (AGU) and WestJet (WJA) proved to be solid picks, though they oscillated between loss and gain territory throughout the year. We recommended taking profit on AGU in late-November, and the stock has traded modestly below our selling price since.

Royal Bank of Canada (RY – TSX)

Description:

- Based on market capitalization, RY is one of the largest banks in both Canada and the world. A diversified financial services company, RY serves more than 16 million personal, business, public sector and institutional clients through offices in Canada, the U.S. and 38 other countries.

Investment Thesis:

- The only Canadian bank in the Top 10 list this year, we believe RY's scale serves it well relative to smaller peers in a slower revenue growth environment.
- The bank's diversified business mix is a competitive advantage. Notably, RY's capital markets segment, the bank's second-largest by earnings contribution, derives ~70% of its revenue from outside of Canada which may better protect the bank's top line from a commodities slump compared to Canadian peers.
- These characteristics, in addition to RY's attractive EPS growth profile (consensus estimate +5.8% YOY in F15 versus the Canadian bank group average of +5.3%), justify the shares' premium valuation, in our view.
- Bloomberg consensus: 10 buys, 11 holds, and no sells; average 12-month share price target $87.45.

Power Corporation of Canada (POW – TSX)

Description:

- Power Corporation of Canada is a diversified international management and holding company with interests in companies in the financial services, communications and other business sectors. Its primary asset is a nearly two-thirds interest in Power Financial Corporation (PWF), which itself controls Great-West Lifeco Inc. (GWO) and IGM Financial Inc. (IGM).

Investment Thesis:

- Over the past year POW has underperformed the TSX by a wide margin, despite the Power Group's improving fundamentals. At GWO, which represents approximately three quarters of POW's earnings, Q3F14 results showed improving sales trends at asset manager Putnam investments, a solid contribution from Irish Life (acquired last year), an improving regulatory capital (MCCSR) ratio, and declining leverage. Meanwhile, the underperformance of IGM (representing much of the balance of POW's earnings) likely has run its course for now, underscored by improved fund flows, greater visibility regarding the impact of pending regulatory change, and a recent dividend increase.
- POW shares trade at an attractive discount to NAV and the shares yield 3.7%. Based on forecasts of rising earnings and a declining payout ratio, POW could be in a position to resume dividend increases commencing in 2015.
- Bloomberg consensus: 5 buys, 5 holds, and 0 sells, with an average 12-month share price target of $34.64.

Brookfield Property Partners LP (BPY.un – TSX)

Description:

- Brookfield Property Partners is a global commercial property company that owns, operates and invests in office, retail, multifamily and industrial assets. Nearly 70% of BPY's invested capital is allocated to the U.S.

Investment Thesis:

- BPY units offer a rare combination of below-average valuation (13% NAV discount versus the peer group average at 5%, according to Dec. 19/2014 Scotiabank GBM estimates) and above-average growth (19% AFFO per unit CAGR F14E-F16E versus the peer group average at 6%).
- A number of catalysts could support near-term unit price upside, including full stabilization of Brookfield Place New York, kick-starting the office component of BPY's Manhattan West development site, and a potential distribution increase (which the Scotiabank GBM analyst estimates could be 5%).
- We expect increased analyst coverage of BPY could also be a catalyst for reducing the discount at which it trades.
- BPY targets distribution growth of 5%-8% per annum and an FFO payout ratio of 80%, and the units currently yield 4.4%.
- Bloomberg consensus: 2 buys, 0 holds, and 0 sells, with an average 12-month share price target of $28.94.

Cenovus Energy Inc. (CVE – TSX)

Description:

- Cenovus is an integrated energy company with production focused on the Canadian oil sands.

Investment Thesis:

- We view CVE as a high quality, defensive energy company, in part because its integrated status reduces the company's susceptibility to commodity price swings. Moreover it has a conservative balance sheet, with Scotiabank GBM analysts estimating leverage would rise to only 2.4x debt/cash flow by the end of 2016 assuming US$60/bbl WTI. While the total payout ratio would rise to nearly 180% under the same scenario, for the time being we view dividend sustainability as high, and the shares yield 4.4%.
- CVE also has some of the lowest supply costs (US$35-US$65/barrel) among oil sands producers and is committed to maintaining low capital costs, targeting $8-$10/barrel over the long term.
- Long-term growth prospects are underscored by CVE's production outlook, with oil production expected to reach 500,000 bbls/d over the next decade from F14 guidance of 198,000 bbls/d, driven primarily by additional phases of existing projects.
- The company expects to make a decision on how to maximize the value of its freehold mineral interests in early 2015, which could serve as a near-term share price catalyst.
- Bloomberg consensus: 11 buys, 12 holds, and 1 sell, with an average 12-month share price target of $28.02.

Canadian Natural Resources Ltd. (CNQ – TSX)

Description:

- CNRL is one of the largest independent crude oil and natural gas producers in the world. While assets and production are concentrated in North America, the company also has interests in the North Sea and offshore Africa.

Investment Thesis:

- We are including CNQ in our Top 10 list given that among the highest-quality Canadian energy exploration and production companies, it likely offers attractive upside to a rebound in crude oil prices. While we expect oil prices to remain volatile in the near term, our medium- and long-term view of the commodity is more constructive and we believe prices could begin to rebound by mid-2015.
- CNQ's defensive posture is underscored by its balance sheet. Scotiabank GBM analysts estimate leverage would rise to only 2.8x debt/cash flow by the end of 2015 assuming US$60/bbl WTI, with a corresponding total payout ratio of 140%. (These figures would rise to 3.6x and 159%, respectively, were this price scenario to persist through 2016.) For the time being, however, we believe the dividend is sustainable and the shares yield 2.5%.
- CNQ's 2015 capex budget of $8.6B prudently (in our view) includes $2B of discretionary capital, providing flexibility in an uncertain commodity price environment, while also supporting 11% YOY production growth to ~884,000 boe/d based on consensus estimates.
- The company expects to announce a strategy for its royalty interests in the coming months, which could serve as a near-term share price catalyst.
- Bloomberg consensus: 19 buys, 3 holds, 2 sells, with an average 12-month share price target of $44.25

Pembina Pipeline Corporation (PPL – TSX)

Description:

- PPL is an energy transportation and midstream service provider in Canada and the U.S.

Investment Thesis:

- We view PPL as one of the most attractive investment opportunities in the Canadian pipeline and midstream space owing to its enviable suite of long-term, fee-for-service growth projects (which are expected to drive 16% EBITDA CAGR based on F14-F16 consensus estimates) and 4.1% dividend yield. On F16 estimates, the shares trade at 12.9x EV/EBITDA, slightly above the 10-year average of 11.8x but justified in our view by PPL's growth profile.
- The YTD total return for PPL shares has lagged peers, but shares now appear to be rebounding from technically oversold levels.
- Bloomberg consensus: 8 buys, 5 holds, and 1 sell; average 12-month share price target $51.58.

Brookfield Renewable Energy Partners LP (BEP.un – TSX)

***Description*:**

- Brookfield Renewable is one of the largest publically traded pure-play renewable energy producers in the world.

***Investment Thesis*:**

- BEP.un has 6,700 MW of installed generating capacity, geographically diversified across North and South America and Europe. Hydro, arguably the highest quality renewable asset, represents 85% of BEP.un's power generation. Power purchase agreements for BEP.un's assets have a weighted-average remaining duration of 18 years, providing long-term cash flow stability and visibility.
- Reflecting strong organic growth potential and a robust development pipeline, in September 2014 BEP.un raised its distribution growth guidance to 5%-9% annually from 3%-5% previously, while maintaining a target payout ratio of 60% to 70% of funds from operations. The units currently yield 5.0%.
- As at Dec. 20, 2014, BEP.un units traded at an 8.0% FCF yield based on Scotiabank GBM F15 analyst estimates, a discount to the peer group average of 7.7%.
- Bloomberg consensus: 8 buys, 3 holds, 2 sells with an average 12-month share price target of $37.34.

Empire Company Limited (EMP.a – TSX)

***Description*:**

- Empire Company Limited operates a chain of food retailers and partially owns related real estate. The grocery business is operated through its wholly owned subsidiary Sobeys Inc., while the real estate is managed through its interests in Crombie REIT and Genstar.

***Investment Thesis*:**

- EMP.a makes our list this year due to its defensive characteristics and attractively valued growth profile.
- Based on consensus estimates, EMP.a is expected to deliver YOY EPS growth of 15.8% (year ended Apr 2016), ahead of peers Loblaw (+14.8% ended Dec 2015) and Metro (+12.3% ended Sep 2015). Growth should be supported by an ongoing turnaround in same-store sales growth (+1.7% in Q2F15) and realization of synergies related to the Canada Safeway acquisition.
- Despite this growth, EMP.a shares delivered a 22.5% total return in 2014, lagging peers and the S&P/TSX Consumer Staples Index (+49%). Consequently, on NTM consensus EPS estimates, EMP.a shares trade at 14.5x, an appealing discount to peers L and MRU at 17.9x and 15.8x, respectively.
- Bloomberg consensus: 5 buys, 5 holds, 1 sell with an average 12-month share price target of $90.15

Linamar Corporation (LNR – TSX)

Description:

- Linamar Corporation manufactures precision machine components, assemblies, and castings primarily for the automotive industry, and also offers its own line of *Skyjack* self-propelled scissor lifts.

Investment Thesis:

- LNR has significant exposure to favourable North American consumer and automotive sales trends with a limited footprint (~16% of 2013 revenue) in Europe, where we believe the outlook is more challenging. This sets LNR apart from its larger Canadian peer Magna International, for which Europe represents over 40% of sales.
- Linamar has an enviable track record of exceeding earnings expectations, having done so in each of the past seven quarters. Analyst estimates have steadily risen over this time period, and alongside its most recent earnings report, LNR saw fit to raise its F14 and F15 margin guidance.
- Earnings visibility is backstopped by a strong book of business, which now sits at $5.8B through 2018.
- On F15 consensus estimates, LNR shares trade at 6.4x EV/EBITDA, in line with the peer group average despite LNR's superior profitability (F15E EBITDA margin 15.5%, one of the highest amongst its peers). The company is conservatively financed in our view with net debt/EBITDA only 0.5x as at Q3F14.
- Bloomberg consensus: 7 buys, 1 hold, 0 sells with an average 12-month share price target of $75.43.

Lundin Mining Corporation (LUN – TSX)

Description:

- Lundin Mining Corporation is a copper/nickel/zinc/lead producer with operating assets in the United States, Chile, Portugal, Spain, and Sweden.

Investment Thesis:

- Scotiabank GBM analysts expect copper-equivalent production growth of 92% YOY in F15, driven by the recent acquisition of the Candelaria copper mine in Chile, the Eagle nickel-copper mine in Michigan coming online, and the ongoing ramp-up of zinc production at the Neves-Corvo mine in Portugal.
- With no significant development projects to fund, this should drive free cash flow generation of nearly US$300M annually in F15 and F16, based on consensus estimates. With a strong balance sheet (0.7x net debt / EBITDA as at Q3F14), LUN could be in a position to implement a dividend by mid-2015, according to Scotiabank GBM analysts.
- In our view, LUN shares do not yet fully reflect rising F15 consensus estimates and therefore trade at 3.7x NTM EV/EBITDA, at the low end of the historical valuation range and well below the 10-year average of 6.3x.
- Bloomberg consensus: 20 buys, 4 holds, 2 sells with an average 12-month share price target of $7.54.

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None.

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We have a three-tiered system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.

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The rating assigned to each security covered in this report is based on the Scotiabank GBM research analyst's 12-month view on the security. Analysts may sometimes express to traders, salespeople and certain clients their shorter-term views on these securities that differ from their 12-month view due to several factors, including but not limited to the inherent volatility of the marketplace.

Ratings	*Risk Rankings*
Focus Stock (FS) *The stock represents an analyst's best idea(s); stocks in this category are expected to significantly outperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.* *Sector Outperform (SO)* *The stock is expected to outperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.* *Sector Perform (SP)* *The stock is expected to perform approximately in line with the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.* *Sector Underperform (SU)* *The stock is expected to underperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.* *Other Ratings* *Tender – Investors are guided to tender to the terms of the takeover offer.* *Under Review – The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.*	*Low* *Low financial and operational risk, high predictability of financial results, low stock volatility.* *Medium* *Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.* *High* *High financial and/or operational risk, low predictability of financial results, high stock volatility.* *Speculative* *Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk-tolerant investors only.*