

# PALOS

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## Weekly Commentary

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*By Charles Marleau, CIM*

## Transcontinental – Not your Average Printing Company

Transcontinental Inc. (TSX: TCL/A) is Canada's largest printing company and a major player in the North American market. The company prints newspapers, direct marketing materials, magazines, catalogs, and directories. While TCL is renowned for its printing business, the company has made great strides in expanding its flexible packaging operations, which now accounts for more than half of revenues.

In mid-April, TCL released an update regarding the impact of COVID-19 on its business operations. Management announced that action was being taken to address matters concerning employee safety, securing of supply chains, and business contingencies. With the packaging business playing a critical role in consumer products like food and beverage, authorities deemed these operations as essential services. Important to note is that roughly 95% of the packaging business is directly related to consumer products.

With regards to the non-essential component of TCL's printing services, management reacted quickly by temporarily laying off 1,600 employees - approximately 40% of its workforce. A conservative approach was taken in terms of expenditures, new projects, and cash management. TCL management stated that despite the challenging environment, the printing business is expected to maintain positive cash flows.

The printing industry is characterized as both a maturing and economically sensitive industry, given its correlation with the business cycle. On the contrary, the consumer staples sector (which includes packaging) is classified as defensive. What differentiates a defensive sector such as consumer staples, is the fact that during times of economic softness, demand for consumer products like food, beverages and personal products remains resilient. TCL's successful expansion into packaging provides both a naturally defensive diversification. TCL's strong financial position and sector diversification should give the company a competitive edge versus non-diversified printers.

In early June, we began to accumulate shares in TCL. Our conviction was backed by our belief that the company's June 10th earnings report would confirm stronger packaging revenues than analysts were forecasting. Our expectation was that lower input costs would further provide a tailwind. What we did not expect was the welcome news that the printing segment would surprise to the upside. Top line declines of

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approximately 25% were expected but came in lower, at -20%. In the quarterly management report, it was revealed that 600 employees were recalled due to a recovery in printing. Management sees a better second half and hinted that barring a severe 'second wave', printing revenues could recover by 80 percent.

The March/April correction in TCL stock brought us to a price level we found attractive. Looking forward to the second half 2020 and 2021, we saw significant value. TCL trades at an estimated 4.5x EV/EBIDATA for 2020 compared to a blended peer average of 8x. The leverage is at 2x, and the company continues to generate impressive levels of Free Cash Flow (FCF). We are estimating \$235 million of FCF for 2020. We see significant value in Transcontinental, and we are of the opinion that the consumer packaging business is in a long-term uptrend. The packaging group should continue to be a runway for revenue growth.

*Disclaimer: Palos Funds are shareholders of TCL/A.*

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) <sup>1</sup>	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$7.10	-13.72%
Palos Equity Income Fund - RRSP	PAL101	\$5.04	-11.27%
Palos Merchant Fund L.P. (Dec 31, 2019) <sup>2</sup>	PAL500	\$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	\$6.95	-9.28%
Palos-Mitchell Alpha Fund <sup>3</sup>	PAL300	\$8.25	-20.52%
S&P TSX Composite (Total Return with dividends reinvested)			-9.18%
S&P 500 (Total Return with dividends reinvested)			-4.98%
S&P TSX Venture (Total Return with dividends reinvested)			-3.76%
Chart 2: Market Data <sup>1</sup>			Value
US Government 10-Year			0.70%
Canadian Government 10-Year			0.54%
Crude Oil Spot			US \$36.26
Gold Spot			US \$1,729.30
US Gov't10-Year/Moody BAA Corp. Spread			290 bps
USD/CAD Exchange Rate Spot			US \$0.7360

<sup>1</sup> Period ending June 12, 2020. Data extracted from Bloomberg

<sup>2</sup> Fund is priced annually

<sup>3</sup> Fund is priced weekly on Tuesdays

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# PALOS

1 Place Ville Marie, Suite 1670  
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188

F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504  
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110

F. +1 (647) 343-7772

[www.palos.ca](http://www.palos.ca)