

# PALOS

## CONTENTS

## Weekly Commentary

Issue No. 39 | SEPTEMBER 14, 2020

|  |   |
|--|---|
| Sleep Country Canada – Helping Canadians get a Better Night’s Sleep! | 1 |
| Palos Funds vs. Benchmarks (Total Returns)                           | 3 |
| Disclaimer & Contacts  | 4 |

By Charles Marleau, CIM

## Sleep Country Canada – Helping Canadians get a Better Night’s Sleep!

**Sleep Country Canada Holdings Inc.** (TSX: ZZZ) is a leader in the mattress, bedding, and sleep related accessories market in Canada. The company, which has a 25-year history in Canada, operates under the **Sleep Country** banner nationwide, **Dormez-vous?** in Quebec, and through its online bed-in-a-box retailer **Endy**, which is Canada’s largest and most profitable online mattress retailer. In fiscal year 2019, Sleep Country (SCC) grew its market share to approximately 33%, up from 28% in the previous year. The company also achieved the highest revenues in company history, with five-year sequential growth in both Gross Profits and Gross Margins.

The company released Q2/2020 results on August 7. On the earnings call with analysts, CEO David Friesema acknowledged that the quarter presented “amongst the most challenging conditions” in the company’s history. The impact of COVID-19 was material with Q2/2020 showing a 31% revenue decline and a 25.6% drop in gross profits, compared with Q2/2019. While significant, these declines were understandable given that stores nationwide were closed for 54% of the quarter. We note that this is likely to be a one-time event as all stores had reopened by June 24. As of August 6, SCC has 280 stores and 17 distribution centers across the country. Only 11 stores are located inside a mall.

Management has proactively implemented cost saving measures, temporarily suspended the dividend, halted the stock buyback program, and reduced compensation to executives and the board. Cash position in Q2/2020 was \$99.8 million compared to \$14.9 million from the previous year’s Q2 - a welcomed improvement. Management also secured an expanded senior secured debt facility which could provide additional liquidity should funds be required to help weather the storm. With eligibility for the Canadian Emergency Wage Subsidy, the company retained 100% of its 1,500 retail associates while stores were closed.

Despite the challenges, management pointed to the company’s digital platform and eCommerce partnerships as benefiting from stay-at-home shoppers and “cocooning”. The eCommerce segment delivered triple-digit growth which helped offset the impact of store closures. SCC’s digital platform was strengthened in 2019 through a strategic partnership with Walmart Canada, whereby online shoppers have access to SCC’s Bloom mattress-in-a-box collection, which has a dedicated Bloom storefront at Walmart.ca. Also in 2019, the company launched its cloud-based Oracle eCommerce platform which provides customers with a best in class online shopping experience.

*By Charles Marleau, CIM*

Measures were also taken to enhance the online shopping experience which included initiatives like Sleep Expert Chat, an interactive toll designed to enhance customer engagement. This helps to solidify the company's image as a trusted, best in class retailer. The company's stated goal is to serve Canada's sleep needs by exceeding expectations and providing a superior experience. This includes a commitment to support communities and families in need, including a commitment to supply \$1.5 million worth of bedding essentials to the vulnerable Canadians.

Similar to peers in the retail sector, ZZZ shares experienced a significant decline during the February/March pandemic driven correction. Since the March 23 bottom, ZZZ shares have risen 135%. We are attracted to the stock's valuation, dividend growth objectives, and SCC's defensive characteristics. We currently hold ZZZ shares in the Palos Income Fund portfolio.

*Disclaimer: Palos Funds are shareholders of ZZZ.*

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| <b>Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) <sup>1</sup></b> | <b>FundServ</b> | <b>NAVPS</b> | <b>YTD Returns</b> |
|---|-----------------|--------------|--------------------|
| Palos Income Fund L.P.  | PAL100          | \$7.62       | -4.70%             |
| Palos Equity Income Fund - RRSP   | PAL101          | \$5.48       | -3.07%             |
| Palos Merchant Fund L.P. (Dec 31, 2019) <sup>2</sup>                                | PAL500          | \$1.71       | 20.15%             |
| Palos WP Growth Fund - RRSP   | PAL210          | \$9.00       | 17.51%             |
| Palos-Mitchell Alpha Fund <sup>3</sup>  | PAL300          | \$8.74       | -15.76%            |
| S&P TSX Composite (Total Return with dividends reinvested)                          |                 |              | -2.72%             |
| S&P 500 (Total Return with dividends reinvested)                                    |                 |              | 4.80%              |
| S&P TSX Venture (Total Return with dividends reinvested)                            |                 |              | 27.26%             |
| <b>Chart 2: Market Data <sup>1</sup></b>  |                 |              | <b>Value</b>       |
| US Government 10-Year   |                 |              | 0.67%              |
| Canadian Government 10-Year   |                 |              | 0.55%              |
| Crude Oil Spot  |                 |              | US \$37.33         |
| Gold Spot   |                 |              | US \$1939.50       |
| US Gov't10-Year/Moody BAA Corp. Spread  |                 |              | 269 bps            |
| USD/CAD Exchange Rate Spot  |                 |              | US \$0.7589        |

<sup>1</sup> Period ending September 11, 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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