

PALOS

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Palos Weekly Commentary

Issue No. 15 | APRIL 11 2019

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Palos Funds

By Charles Marleau, CIM
& Joany Pagé, CFA

NFI Group Strong Fundamentals

NFI Group (TSX: NFI) is North America's leading bus manufacturer with facilities across Canada and the U.S. The company pays a dividend yield of 5%, has a free cash flow yield of 12%, has 2.5 years of revenue in backlog, and has a strong balance sheet. Despite all of this, the company is down 37.5% in the past 12 months. The following factors have contributed to its decline:

- Startup costs at the Shepherdsville facility negatively affected adjusted EBITDA
- Mark-to-market losses on pre-owned coach inventory
- Fear that the competitive landscape in the motor coach segment may lead to lower volumes
- General market sell-off and fear of cyclical businesses

The startup costs at the Shepherdsville facility are a short-term negative as the facility is expected to start generating positive EBITDA by the end of 2019. The EBITDA pressure from the pre-owned coach inventory will also subside as almost all the inventory has now been cleared. The motor coach segment, on the other hand, only represents about 20% of EBITDA. Even if volumes were to drop by 50% and add 0% to 2020 EBITDA, using an 8x EV/EBITDA multiple, the valuation of NFI still stands at 33\$/per share, which is in line with its current stock price. This therefore implies that the market is discounting this kind of weakness in the segment, which is unlikely. NFI has a leading market position in motor coach with its 45% market share. Additionally, 19% of NFI's coach deliveries are for public transit which are typically more stable as orders are a function of government funding.

We view the market's reaction as overdone given the quality of NFI's balance sheet, competitive positioning and revenue visibility. In the first quarter, NFI traded at a 6-year EV/EBITDA multiple low of about 6x while its average is 8.2x. We do not believe this two-turn discount is warranted and we have been taking advantage of this weakness to add to our position in the funds.

Disclaimer: Palos Funds are shareholders of NFI.

| Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹ | FundServ | NAVPS | YTD Returns |
|--|----------|---------|---------------|
| Palos Income Fund L.P. | PAL100 | \$8.75 | 13.40% |
| Palos Equity Income Fund - RRSP | PAL101 | \$5.84 | 11.05% |
| Palos Merchant Fund L.P. (Dec 31, 2018) ² | PAL500 | \$1.82 | 6.59% |
| Palos WP Growth Fund - RRSP | PAL210 | \$8.34 | 17.86% |
| Palos-Mitchell Alpha Fund (Fund Initiated on Jan 29, 2019) | PAL300 | \$10.69 | 6.86% |
| S&P TSX Composite (Total Return with dividends reinvested) | | | 15.46% |
| S&P 500 (Total Return with dividends reinvested) | | | 15.89% |
| S&P TSX Venture (Total Return with dividends reinvested) | | | 12.99% |
| Chart 2: Market Data ¹ | | | Value |
| US Government 10-Year | | | 2.46% |
| Canadian Government 10-Year | | | 1.68% |
| Crude Oil Spot | | | US \$64.61 |
| Gold Spot | | | US \$1,309.10 |
| US Gov't10-Year/Moody BAA Corp. Spread | | | 220 bps |
| USD/CAD Exchange Rate Spot | | | US \$0.7509 |

¹ Period ending Apr 10, 2019. Data extracted from Bloomberg

² Fund is priced annually

³ 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) 276-0110

www.palos.ca