Middlefield Canadian Income

MCT allows investors to access a high-yielding market prospering from high commodity prices at an attractive discount...

Update
12 May 2022

Overview

Middlefield Canadian Income (MCT) offers exposure to the high dividend and growth potential in Canadian equities. Canada is a net energy exporter and its market has a high weighting to energy stocks, as well as to companies producing some key hard and soft commodities that are currently in high demand. The market is heavily weighted to financials, which benefit from a rising interest rate environment, and MCT has a structural overweight to REITs, which offer decent inflation protection. As a result, the market and MCT's portfolio have significant value tilts which complement the growth-heavy S&P 500 while also offering economic exposure to the US through the importance of the US's revenues for Canadian companies. MCT's manager Dean Orrico points out that Canada also has some belated reopening beta to offer thanks to being behind the US and UK as regards its vaccination programme and lifting of restrictions, adding to the sense that Canada is in a sweet spot.

Thanks to these tailwinds, MCT has been the best-performing North American trust over the last 12 months, generating an NAV total return of 32.7% (as we discuss under **Performance**). MCT currently yields 3.8%, having historically yielded more than the global equity income space, with Dean and co-manager Rob Lauzon highlighting the compelling case for the future growth in underlying revenue generation and dividends (see **Dividend**). The managers aim to generate a high and growing dividend, and will often use a falling yield as a valuation signal.

Despite this strong performance and the portfolio's positive exposure to an inflationary environment, MCT trades on a wide **Discount** compared to its peers, which is currently 11.4%.

Analysts:

David Johnson
david@keplerpartners.com

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Analyst's View

Canada offers compelling advantages in the current inflationary environment, and MCT's income strategy and key sectoral biases mean it is well positioned for this. The portfolio has a strong value and cyclical bias, and its positioning in financials and energy in particular makes it well positioned to capitalise on both inflation and rising interest rates. In this regard Canada has a lot in common with the Latin American region, through offering greater political stability, better corporate governance and a more mature set of companies and sectors. We therefore think it could be the safer bet for investors who believe that the current inflationary environment is more than a short-term blip, and that it offers an intriguing way to keep exposure to North America while moderating the significant growth bias in the S&P 500. We think that MCT's double-digit discount reflects the fact that investors have not caught on to this yet, and that it may offer an attractive long-term entry point as well as allowing investors to 'lock in' a higher share price yield.

For income investors Canada is unlikely to be a major exposure, meaning MCT offers geographical diversification. The high exposure to REITs and the strength of the Canadian real estate market are other differentiating factors, while the depth of opportunities across energy producers and midstream pipelines is hard to find elsewhere.

BULL
High dividend profile with strong underlying revenue generation
Discount offers attractive entry point
Canadian market is well suited to the current macro environment

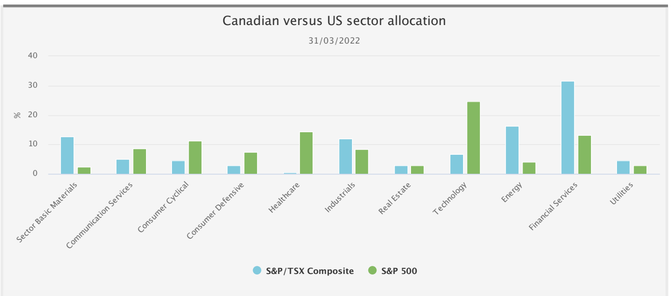
BEAR
Gearing can enhance losses on the downside
High OCF compared to that of peers
May underperform global markets during strong growth-stock rallies

Portfolio

Middlefield Canadian Income (MCT) aims to generate high dividends and capital growth by investing in the Canadian equity market, which offers an intriguing set of diversifying exposures to the US market. These have been highly advantageous in recent quarters as the three areas of structural focus within the portfolio – REITs, energy and financials – have all been supported by global macroeconomic trends which look set to continue.

The Canadian market is highly differentiated from the US equity market, and the chart below shows a comparison of the two countries' sector exposures. While the S&P 500 has a high weighting to growth – and specifically to technology – the Canadian market is far more value-oriented, with financials its largest sector and the market having a significant weighting to energy. This means that the Canadian equity market has a much stronger cyclicality than the US market, allowing it to potentially outperform in periods of rising interest rates or global economic recoveries. In these periods growth stocks might be expected to underperform, which means the Canadian equity market can offer strong diversification potential against the US market, as we discuss in the **Performance section**.

Fig.1: Sector Allocations



Source: Morningstar

The tailwinds behind Canadian equities have grown particularly strong in recent quarters as high commodity and energy prices have put energy exporters like Canada in a strong position. When we met with manager Dean Orrico recently, he told us he believes this inflationary period is likely to persist for an extended period. Another near-term support for the Canadian market comes from the fact that Canada's recovery from the pandemic has lagged behind both the UK's and US's recovery. Canada has been later in lifting restrictions, meaning the country could see a reopening surge in economic activity which has already been seen elsewhere. Dean also points to the strong consumer in Canada, who has record levels of savings to spend.

There are three core pillars to MCT's portfolio, reflecting the structure of the Canadian market and where Dean and co-manager Rob Lauzon find high-quality, dividend-paying businesses. The three pillars are financials, real estate and energy.

Financials

MCT's allocation to financials is largely through Canada's major banking institutions, with banks making up four of MCT's top five holdings and equalling c. 19% of MCT's portfolio. While financials also make up a large proportion of Canada's equity market, Dean highlights the generally high-quality nature of these institutions, with Canada being home to six of the safest banks in North America. Dean also highlights the relative resilience of Canada's banking sector when compared to its American and British peers, with Canadian banks having avoided cutting or suspending dividends during both the COVID-19 crisis and the global financial crisis – a key factor in ensuring MCT is able to pay a high and sustained dividend even during painful market environments.

Canadian banks continue to make inroads into the US banking sector, allowing them to both diversify their revenue stream and capitalise on increasingly strong US consumer demand, and this is highlighted by the fact that TD Bank is soon to be counted as America's sixth-largest bank. Canadian banks are also becoming increasingly diversified by business revenues, with a wider variety of borrowers and an increasing presence in the global wealth management market. Canadian banks have now had their COVID-19 dividend restrictions lifted, with Dean and Rob believing that all of MCT's financial holdings are likely to resume their prior track record of dividend growth.

Real estate

MCT's large overweight to REITs is both a reflection of REITs' income potential and of the strong underlying demand for the sector, given demographic tailwinds and the post-COVID-19 demand surge. MCT's largest allocation is to the retail sector, which makes up c. 50% of the trust's real estate allocation. While Canadian retail is seeing the same decline as the rest of the developed world has seen in brick-and-mortar retail outlets in some areas such as enclosed shopping malls, the managers still believe there remain very attractive opportunities in open-air, necessity-based retail. These retail sites include large grocery stores, which act as an anchor for smaller stores that rent retail space. Importantly, these types of renters benefit from rising consumer consumption but have not been impacted by the same headwinds as other retail stores, such as the rise in e-commerce. Dean is still finding very attractive valuations in the sector, and he highlights that rent collections are nearly at their pre-pandemic levels. He also highlights that open-air sites are increasingly shifting into residential real estate given their opportune locations and growth potential embedded in their large undeveloped land holdings, allowing for a potential uptick in returns. In the case of RioCan REIT, one of MCT's largest holdings, Dean expects 10–12% annual returns with a 4–5% dividend yield thanks to the REIT's expansion into mixed-use developments with a particular focus on multi-family rental real estate.

The rest of MCT's real estate allocation is split across industrial, healthcare, residential and office REITs, with industrials being by far the largest of these four at c. 25% of MCT's REIT allocation. Dean and Rob's preference for industrial REITs follows something of a similar rationale to their preference for necessity-based retail, as many of the industrial REITs are beneficiaries of the boom in e-commerce. In the case of the Canadian market, the growth in demand for 'last mile' logistics (the final stage of product distribution) is rapidly outpacing supply, leading to both higher rental yields and higher valuations.

Energy

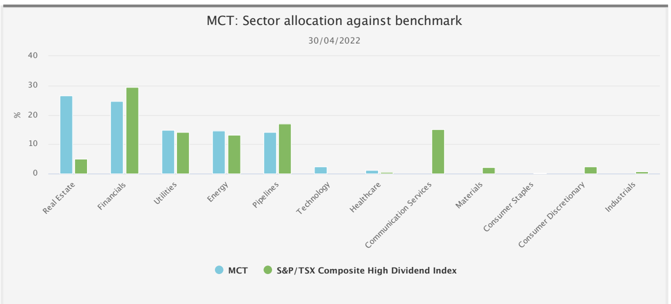
MCT's energy allocation is split between the more cyclical and price-sensitive producers and more stable, price-insensitive pipelines. Dean and Rob have also diversified into clean energy, recognising that this is the future (albeit only after a lengthy transition period). In practice this means that MCT will hold companies like Topaz Energy, whose portfolio of natural gas assets allows it to have a c. 5% yield and 12% annual dividend growth; and Brookfield Energy, which is one of the world's largest pure-play renewable energy platforms.

Dean and Rob believe the market is mispricing oil and gas during the transition to clean energy, and believe that the market is basing its long-term projections on short-term historical prices, with oil having been negatively priced only two years ago. Based on historical prices and consumption, the team believe oil and natural prices will remain relatively high due to strong demand and a lack of investment in new supply, a boon for any energy-exporting nation.

MCT's only major sectoral overweight is to real estate, and it has a corresponding underweight to communications, a reflection of the relative attractiveness of the income opportunities perceived by the team. However, this allocation is nonetheless a substantial deviation from MCT's benchmark, the S&P/TSX Composite High Dividend Index, as can be seen below. We also note that MCT does have a small c. 5% allocation to US stocks.

Generally speaking, MCT's allocation is a reflection of the broader Canadian income universe, given the dominance of both financials and broader energy within the index. However, there are far more noticeable differences between the S&P/TSX Composite High Dividend Index (and by extension MCT) and the broader S&P/TSX Composite Index. The high-dividend index has a much larger allocation to defensive industries like energy and communications, while the broader S&P/TSX Composite Index contains the lower-yielding cyclical sectors such as industrials and materials, which have a near-zero presence in the high-yield index. This implies that the broader Canadian market will have a greater degree of economic sensitivity than MCT. Yet with respect to either index MCT has a substantial overweight to real estate, as both indexes have less than a 6% exposure to that sector.

Fig.2: Sector Allocation Against Benchmark



Source: Middlefield

The approach to portfolio construction combines both top-down and bottom-up considerations, whereby an understanding of the prevailing macroeconomic environment helps inform what sectors MCT is exposed to. Stock selection is based around an assessment of a company's quality, valuation, management quality and earnings momentum. Importantly, each company selected must offer a high and sustainable dividend yield: something which is often a characteristic of high-quality companies and disciplined management teams.

Gearing

MCT currently has net gearing of 18% (as of 31/03/2022), in line with its long-term average gearing but substantially wider than its peer group's 3% simple average gearing. MCT has the capacity to be geared to up to 25% of net assets, though in practice this ranges from 0% to 20%. MCT's gearing is achieved solely through the use of a revolving credit facility, which currently has a maximum drawdown of the lesser of CA$65m or 25% of NAV.

MCT's high gearing level reflects the team's bullish outlook on Canadian equities, as we describe in the **Portfolio section**. The team use gearing in a structural, long-term manner, with its utilisation being a reflection of the team's long-term views on market opportunities. A 10–20% level of gearing would reflect a relatively constructive market outlook by the team. However, they are open to taking net gearing down to 0% in the most bearish of scenarios.

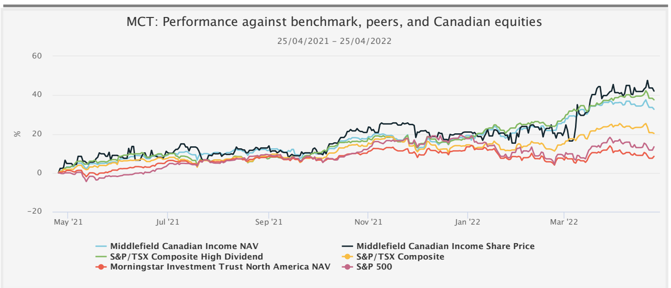
Performance

Canadian equities offer attractive diversification potential compared to the US equity market, which have dominated global returns in recent years.

Over the last 12 months the Canadian equity market has performed strongly and outperformed the S&P 500, helped by the rotation from growth to value, and in particular by rising energy and material prices. MCT has returned 32.7% in NAV total return terms over this period, and a 42.1% share price total return. MCT has comfortably outperformed the S&P/TSX Composite Index of Canadian equities, which returned 20.3%, the S&P 500 Index, which returned 13.4%, and its own peer group which generated a simple average NAV return of 8.5%. That being said, the benchmark S&P/TSX Composite High Dividend Index returned more at 37.6% (as at 25/04/2022).

MCT has benefitted from rising global inflation and interest rates, coupled with a global throttling of energy supplies due to the war in Ukraine. MCT's large position in financials has been a direct beneficiary of this rise in interest rates, with financials' strong exposure to the US market meaning they have been able to capitalise on the policies of an increasingly hawkish federal reserve. They have also been able to capitalise on a largely robust US consumer, as well as on their own rising domestic interest rates. Canada has benefitted from rising global energy prices just as many other energy-exporting nations have, and the team highlight that Canadian energy stocks have performed particularly well recently given their close proximity to the US, which is increasingly looking to guarantee its own energy supplies in light of increased geopolitical risks. We note that these factors are predominantly near-term occurrences, with MCT having also benefitted from the structural growth trends within Canada over the last 12 months, such as its delayed COVID-19 recovery, which we outline in the **Portfolio section**.

Fig.3: 12-Month Performance



Source: Morningstar

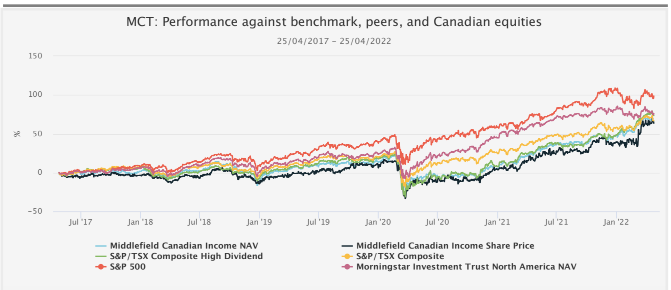
Past performance is not a reliable indicator of future results.

However, over a longer five-year time period the Canadian equity market has underperformed the US market, with the S&P/TSX Composite Index returning 66.6% over the last five years compared to the 98.6% of the S&P 500. This compares to the 65.5% NAV total return and 63.7% share price return generated by MCT over the same period, whereas MCT's benchmark the S&P/TSX Composite High Dividend Index returned 73.3% and the AIC North America peer group returned 76.2% (as at 25/04/2022).

The underperformance of MCT and the Canadian equity market versus the US is a direct result of the inherent make-up of their markets, with the Canadian market being dominated by financials and energy. The US equity markets have instead been able to reap the benefits of their much larger exposure to high-growth companies, with US mega-cap technology, communications and consumer stocks having long driven the performance of US equity markets and the wider global equity market. Such aggressive, high-growth companies have little presence in the Canadian market. In fact, the three largest US mega-cap tech stocks have a weighting in the MSCI ACWI that is three times larger than that of the entire Canadian equity market. This means that historically the US equity market has been better positioned to capitalise on the tailwinds behind technological adoption and rising consumer spending, factors which led the S&P 500 to outperform the S&P/TSX Composite Index in each year between 2017 and 2021.

While MCT has demonstrated the benefits of active management through having managed to outperform the S&P 500 in 2019 and 2021, it is nonetheless at the behest of the Canadian equity market, with MCT having a five-year beta of 1.0 to the S&P/TSX Composite Index and 0.9 to its benchmark. Thus the factors which explain the five-year underperformance of the wider Canadian market also explain the underperformance of MCT.

Fig.4: Five-Year Performance



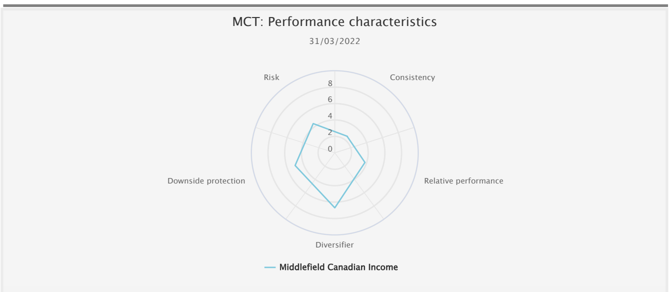
Source: Morningstar

Past performance is not a reliable indicator of future results.

Below is our proprietary KTI Spider Chart. This shows how MCT has performed versus an expanded peer group of all North America strategies, large and small, over the past five years in some key categories. Each category is scored out of ten based on rolling 12-month returns over the last five years, and scores are normalised to the peer group. Please note that the benchmark utilised in this chart is the Russell 1000, so as to capture the majority of the North

American equity market. As such, the below chart shows the profile of MCT relative to US equity strategies. As would be expected given the strong bull market in US equities, MCT ranks poorly on performance, risk and consistency as these factors are calculated using risk-adjusted performance statistics. However, MCT does rank well for diversification due to its inherently low correlation to US equities.

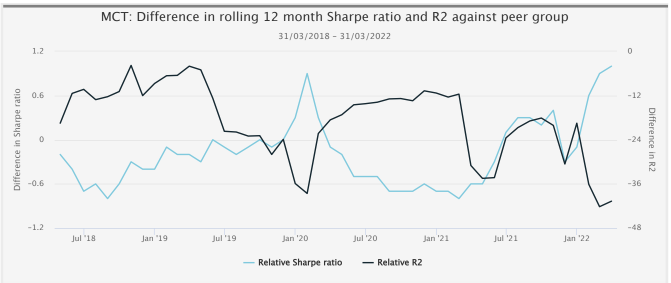
Fig.5: KTI Spider Chart



Sources: Kepler, Morningstar
Past performance is not a reliable indicator of future results.

However, the above chart reflects the past five-year period, and the current macroeconomic environment may be indicative of a regime change whereby we may be entering a period of structurally higher inflation and energy prices, which is increasingly benefitting MCT's return profile. This is shown in the below graph, which shows the relative Sharpe ratio of MCT (a measure of its risk/return profile) and its R^2 to global equities (with a lower value indicating greater diversification potential). Through this we can see that both MCT's risk/return profile and its diversification benefit have substantially improved over 2021 relative to other North American strategies. In fact, MCT has generated a five-year R^2 (a measure of diversification) of 72% compared to the MSCI ACWI, while the S&P 500 has an R^2 of 95% compared to the MSCI ACWI. MCT's diversification benefit is even better when compared to the S&P 500, with an R^2 of 68% allowing investors to directly capitalise on certain secular tailwinds within the US (as we point out in the **Portfolio section**) while still demonstrating superior diversification. If investors believe that the

Fig.6: Difference In Rolling 12-Month Sharpe Ratio And R Squared



Sources: Morningstar
R^2 is calculated relative to the MSCI ACWI
Past performance is not a reliable indicator of future results.

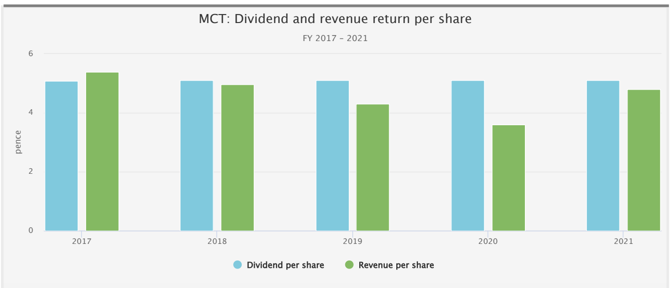
current environment is to continue, then MCT may now be a far more attractive investment opportunity, based on its improved diversification and risk/return potential.

Dividend

MCT operates with a dual mandate of income and capital growth, and to that end managers Dean Orrico and Rob Lauzon will account for the provision of income within the investment process. Given the nature of Canada's equity market, which is naturally weighted towards high-dividend-paying industries like energy and financials, it is no wonder that MCT has an attractive yield profile. MCT currently yields 3.8% on a historical basis. This compares to the 3.8% simple average yield of the global equity income sector, though it is slightly behind the 4.5% simple average yield of the UK equity income sector (as of 09/05/2022). We note that, if anything, MCT's yield will likely only be depressed over the near term, given the strong share price performance of its underlying assets.

The board has maintained a dividend of 5.1p per share for the last four years, which was sustained even through the COVID-19 crisis. The underlying revenue recovery of MCT post-COVID-19 has been so strong that its 2021 dividend is 95% covered by its revenues, up from 71% the year before. While MCT currently has no revenue reserves, it is able to pay out of its capital account to fund the dividend during periods when it is uncovered.

Fig.7: Dividend And Revenue Per Share

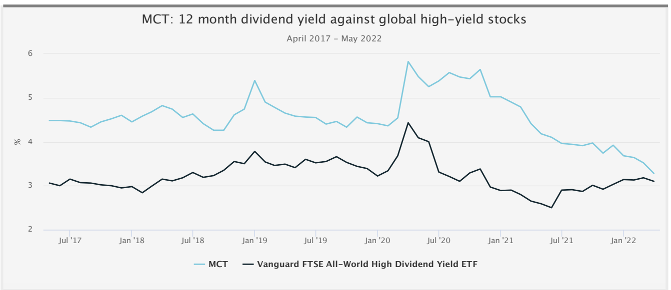


Source: Middlefield

Dean and Rob are particularly excited by the future for Canadian dividends, highlighting the across-the-board increases in the dividend announcements made by MCT's bank holdings over the past year. In total, more than 65% of MCT's portfolio holdings have already increased their dividend since June 2021.

MCT's dividend profile has historically been an advantage for income-seeking investors, as can be seen in the below graph. For much of the last five years MCT has been able to offer investors a yield which has been in excess of that of the wider global equity income universe, although in recent months MCT's yield has fallen in line with that of the wider market, a direct result of the yield compression brought about by its incredibly strong 12-month returns.

Fig.8: Historical Dividend Yield Against Global High-Yield Equities



Source: Morningstar

Management

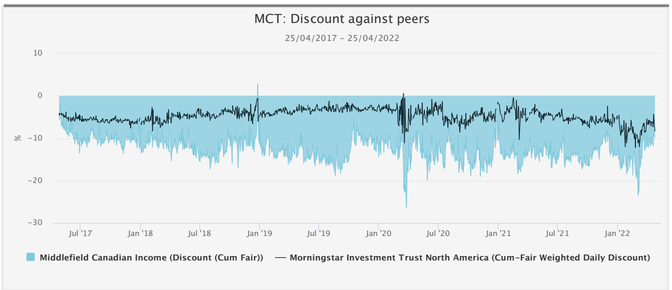
MCT is managed by Dean Orrico, who also serves as president and CEO of Middlefield Group. Dean brings with him over 35 years of investment experience, and joined Middlefield in 1996. In addition to MCT, Dean also serves as lead manager of Middlefield's real estate strategies. Dean works alongside eight other investment professionals, five of whom are portfolio managers. Middlefield runs a suite of equity income funds with various specialisations which are sold to North American investors, and Dean also manages Middlefield's dedicated REITs fund, thus adding to his knowledge and expertise in this important sector for MCT. Dean's co-manager is Rob Lauzon, managing director and CIO of Middlefield Group. Rob has 20 years' industry experience, having joined the company in 2002. He runs a range of income funds for Middlefield in addition to MCT.

Discount

At the time of writing MCT trades on a 11.4% discount, compared to its five-year average of 12.6% and its peer group's simple average 11.8% simple average. We note that the peer group's average is skewed by the 41% discount of Pershing Square, and if it is excluded the peer group trades on a 5.9% simple average (as of 09/05/2022). MCT's discount has shown signs of narrowing over the past year, generally trading in the high single or low double digits. We think the discount could narrow further if strong performance continues, although general risk aversion and recession fears could lead to some softness in the discount even if Canada outperforms on a relative basis.

We note that while the board has the capacity to operate a discount control mechanism, it has not done so in nearly five years. The board prefers instead to raise the profile of MCT so as to increase shareholder demand, with any narrowing of MCT's discount purely a reflection of the market's demand for its shares.

Fig.9: Five-Year Discount Against Peers



Source: Morningstar

Charges

MCT's latest ongoing charges figure (OCF) is 1.25%, and it has an annual management fee of 0.7%. This compares to the simple average 1.53% of its peers, though this is skewed upwards by the large OCF of one trust. We note that the high OCF of MCT is partly due to its small size (its current NAV is £161m). As the trust grows we would expect the benefits of its scale to be reflected in a falling OCF.

MCT has a KID RIY of 1.24%, compared to the 1.16% simple average of its peers. However, we caution that calculation methods can vary between trusts.

ESG

Managers Dean Orrico and Rob Lauzon always seek to ensure that ESG considerations are accounted for within their investment analysis. To that end they will incorporate a wide range of third-party ESG data for each company they analyse, as well as cross-referencing it against their own views around the company's ESG credentials. Middlefield's commitment to ESG is exemplified by the recent addition of Steve Erlichman as chair of ESG, as he is one of Canada's foremost experts on governance.

ESG analysis is used in both a positive and negative manner, not only informing the managers of which companies present the highest possible ESG risks (meaning that those companies are therefore avoided entirely), but also helping them to identify those companies whose strong ESG credentials offer a compelling investment case. This is made apparent by MCT's allocation to renewable energy and its investment in Enbridge, which is in the top 4% of Canadian equities in terms of its ESG credentials. The MCT team also take an active role in their investments and will engage with management teams on ESG issues where they believe that to be appropriate, typically with an eye to keeping companies on track in meeting their ESG targets. We also note that MCT will not invest in any tobacco or arms companies. Readers can find more details about MCT's ESG integration **here**.

Morningstar has rated MCT's sustainability as 'average' compared to its wider Canadian equity peers (both open- and closed-ended). We note that this is an arguably positive outcome, as MCT's income objective prevents the trust's team from investing in the lower-income, growth-oriented stocks that often screen better. These include stocks in technology and communications, which inherently have fewer environmental issues than those in the energy sector. This should hopefully allay any concerns income investors might have that their yield requirements may force them into unsustainable companies.

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