ANTARES
INVESTMENT MANAGEMENT

VALUE PORTFOLIO

The Antares Value Portfolio focuses on companies that, in our analysis, are underpriced in the stock market relative to their underlying worth as businesses. Our strategy aims first to protect investors' capital by not overpaying for a given company - holding fixed income or cash when bargains cannot be found - and second, to grow that capital through share price appreciation as the company's value gets properly recognized within the equity market.

The federal government inquiry into grocery store pricing was more about political theatrics than uncovering the truth.

Like any business, grocery stores have the right to protect their profits from rising costs.

Passing on costs is not only fair to shareholders, it also has social benefits such as allowing a grocer to increase pay to its staff.

MANAGER COMMENTARY

Why we are scared of debt, but not grocery store inquiries

Recently, "excessive" profits from grocery stores were in the headlines on a daily basis with accusations of price gouging coming mostly from politicians along with a demand that grocery store executives come to an inquiry conducted by the government. It is interesting to note that ONLY Canadian grocery company executives were called to the inquiry, but U.S. stores selling groceries (such as Wal-Mart) were somehow overlooked. That should have been the first clue that the inquiry was more for political gain than to reveal truth.

When it costs more to produce food (think extra transportation costs from higher fuel prices, cost of additional safety measures due to covid responses, higher fertilizer prices required for crops, and a shortage of migratory workers due to government limitations on mobility) food costs go up. It then simply costs more for the grocery store to purchase the goods it puts on the shelves.

	Base Scenario	Scenario #1 Costs passed on to consumers	Scenario #2 No increase to consumers
Sales	$1,000	$1,100 **Prices up 10%**	$1,000
Cost of Goods Sold	$700	$770 **Food costs up 10%**	$770 **Food costs up 10%**
Gross Profit	$300	$330	$230
Gross Margin	30%	30% **Same Gross margin**	23%
Rent/Labour/Interest on debt, etc.	$250	$270 **Can pay workers more**	$250 **Can not afford to pay workers more**
Operating Profit	$50	$60 **Increased profits**	-$20 **Loss**

The starting point for the table above is an operating profit of 5% ($50/$1000) – a thin margin compared to other industries. For these examples we assume food costs (to the store) have gone up 10% from $700 to $770.

If the store then also raises prices by 10% from $1000 to $1100 it will reap a $330 gross profit. From this, it can afford to raise wages and pay more rent and it still ends up with an increase in profitability. Profits are higher but the grocery store has only passed on the same 10% increase in costs that they incurred.

Many politicians suggested that store owners themselves should absorb the costs, rather than passing them on to consumers. Scenario #2 looks at the impact of this.

Assuming that higher food costs are not passed through to consumers, the grocery store would charge the same $1000 as before. But with a cost of $770 to get the goods into the store, they only have a gross profit of $230. Assuming that workers are not paid anything more, and they can keep their rent costs steady, the grocery store would lose money, as shown in the table. If they paid workers more, or rent costs went up, they would lose even more money. In summary, the difference between a profitable and a money-losing scenario requires that food costs be passed on to consumers. Money losing grocery stores are in no-one's best interest in the long run.

While consumers may be indifferent to the grocery store owner(s) plight in scenario #2, the question remains, why should the store owner offset the higher costs out of their own pocket? As grocery store owners yourselves (Loblaw Companies in your portfolio) your company can serve customers well by ensuring produce and products are fresh and the shelves are well stocked, provide a good livelihood for the many workers, AND serve you as owners well by providing a meaningful return on the money you have invested.

> In a world awash in debt, Canadians are second only to the Australians in terms of household debt.

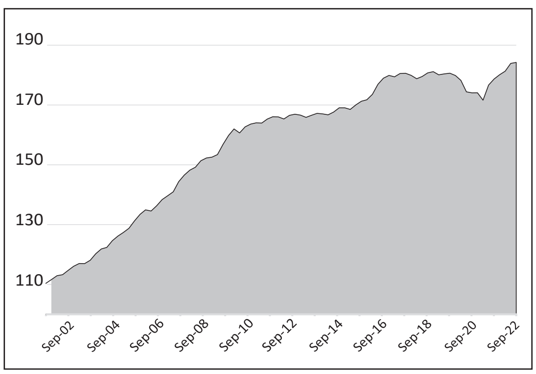
> The recent increase in interest rates means that debtors face much higher costs to service their debt.

> A recession seems probable. Companies in your portfolio are there because we believe they will withstand a slowdown.

In summary, good hard-working grocers providing the daily needs of Canadians is nothing to fear.

Debt, on the other hand, has been a concern for many years. Since the financial crisis in 2008, Canadians (and Canadian companies) have taken on more debt. The chart below shows the level of household debt in relation to the size of the economy in Canada. While much of the developed world reduced debt after 2008, Canadians continued to add to it. When interest rates were relatively low that was manageable, but with the rise in interest rates that began last year, the cost of carrying debt has increased significantly.

Canadian Household Debt as % of GDP



Source: Bloomberg

According to the IMF (International Monetary Fund)[1], Canadian households are the second most indebted in the world (Australia is first). Lower interest costs in past years made taking on debt less financially onerous and less psychologically daunting. It is likely that many Canadians would have already succumbed to their debts if it had not been for the massive government stimulus due to covid. However, it appears this was only a temporary reprieve to those in financial difficulty. The ability to service high debt is becoming harder with higher interest rates.

As an aside, it is ironic that the government spending to help avert financial crisis due to covid is likely causing a bigger financial crisis due to the $1 trillion (no, that is not a typo) of extra borrowing that fueled the spending that is now, in part, fueling inflation and higher interest rates.

So how does this impact your portfolio? I believe Loblaws is likely to do well in an inflationary environment because people are likely to continue to buy their goods no matter what happens in the world. Grocers will protect their gross profit margins by raising prices, which is not the same as price gouging as illustrated in the table.

The debt levels are concerning for two reasons. Firstly, more and more of a household's income will go towards paying for, and paying down, debt in the coming years. Higher interest rates have a way of focusing resolve to that end. With less money to spend on other areas, I believe it is entirely likely that we will experience a slowdown in the economy. The second impact will be from a likely increase in bankruptcies and insolvencies (when payment schedules are worked out with creditors in a formal way). That is likely to affect lenders in a negative way and further contribute to a slowing economy.

Your portfolio, with its current focus on companies that sell everyday goods and services while managing their own debt prudently, is likely to survive quite well no matter the economic turmoil. And those companies in your portfolio with extra cash in the bank will be able to take advantage of opportunities as they come up. This is not accidental, but rather by design. It is intended to protect what you have already saved and provide an opportunity for long-term growth.

Thank you for your continued trust and support,

Gerry Bettig, CFA

1. *imf.org*

VALUE PORTFOLIO

The Antares Value Portfolio is available to investors within a Separately Managed Account ("SMA") that holds securities directly, and through the Antares Value Pool ("Pool") which is held in the accounts of multiple investors. Data presented refer to the Pool. SMAs are customized and therefore their holdings and weights may diverge from those within the Pool. Sources for the data include: Bloomberg, NDEX, and Antares calculations. Unless otherwise stated, all data are as at quarter end.

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