RBC Capital Markets

US WEEKLY PORTFOLIO MANAGER'S SUMMARY

November 22, 2013

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Features of the Week

Four Consumer Discretionary Themes; by Jonathan Golub, November 18

- **Consumer Is King in a Weak Recovery** - Despite weak job growth and stagnant wages, Consumer Discretionary has been the best-performing sector throughout the recovery. Importantly, these returns are the result of superior earnings, rather than a shift in sentiment. We expect bottom-line results and stock price performance for the group to outpace the market again in 2014–15.
- **Themes 1 & 2: Durables and High-End Purchases Supported by Macro Tailwinds** - Over the past four years, Consumer Durables, i.e., Autos and Homebuilders, have been big winners on the back of attractive financing rates and low base effects (these groups were decimated during the downturn). While a backup in mortgage yields has been a challenge more recently, affordability remains quite elevated. Separately, income and wealth disparities have widened since the downturn, aiding both individuals and the business that service them.
- **Themes 3 & 4: Continued Success for Media; Challenges for Brick & Mortar** - Over the past several years, changes in Media, Technology, and Telecom have been a disruptive force, shifting consumer spending patterns. This is manifesting itself in an increase in on-line purchases as well as spending on connectivity and content. This has resulted in a more challenging environment for traditional brick & mortar Retailing, as well as Restaurants and Apparel. While these groups have generally performed in line with the broad market, secular changes make them less appealing than other areas within the Consumer space.

Four Consumer Discretionary Themes

Strategic Investment Ideas

Aerie Pharmaceuticals, Inc. (AERI) - Targeting glaucoma with a new mechanism of action; by Adnan Butt, November 18

- We are initiating coverage on Aerie Pharmaceuticals with an Outperform rating and a $20 price target. AERI is an ophthalmology focused company developing drugs for glaucoma, which affects millions of patients worldwide. We believe AERI's product candidates could demonstrate greater efficacy, safety and convenience than currently available glaucoma drugs. Clinical results expected in 2014, 2015 and 2016 could help determine the ultimate market potential of AERI's drugs and lead to value inflection opportunities as soon as mid-2014. There is potential for significant upside as both AR-13324 and PG324 use a new, first-in-class mechanism of action for the treatment of glaucoma, which is both needed by patients and potentially attractive for physicians. Given that ophthalmology remains an attractive therapeutic area, progress through clinical, regulatory and commercial milestones could all be upside catalysts.

Targeting glaucoma with a new mechanism of action

Gaming and Leisure Properties, Inc. (GLPI) - Born to Be Acquisitive; Initiating with an Outperform and $51 PT; by John Kempf, November 22

- GLPI is an attractively priced specialty REIT with a unique opportunity to drive significant AFFOPS growth via accretive acquisitions. GLPI has a strong balance sheet and a stable underlying CF stream via its master-lease with Penn. We expect GLPI will diversify its cash flow with ~$500MM of acquisitions over the next two years. In 2014, we expect GLPI will pay $2.57/sh in distributions, implying a 5.8% yield.

- **GLPI is a REIT, not a gaming operator.** Although it owns and operates two small gaming assets, its primary objective is to lease real estate to (initially) gaming and other leisure activity companies. As a result, we believe the valuation of GLPI should focus on the quality of the lease stream, its potential to drive earnings growth via accretive acquisitions, and the company's dividend payment.
- **Stable, visible lease income.** Despite the challenging regional gaming environment, the master-lease agreement between GLPI and Penn National Gaming has been conservatively structured to insulate GLPI from some of the downside risk, while allowing some participation in the upside. Furthermore, the master lease is senior to all of Penn's current and future liabilities and is protected by cross-default language at the property level.
- **Acquisitions provide avenue for accretive growth and further diversification.** Over the next two years, we estimate GLPI will complete $500MM worth of transactions. We estimate the discounted value of these transactions to shares of GLPI to be ~$6.25 per share.
- **Conservative and flexible capital structure.** Following the spin-off, GLPI is well capitalized with $2.4B of low-cost debt. The company has approximately $700MM of availability under its revolving-credit facility that bears interest at LIBOR + 175bp. In addition, its debt is currently split rated with investment-grade (BBB- from S&P and Ba1 from Moody's) ratings on one side.

Born to Be Acquisitive; Initiating with an Outperform and $51 PT

ASH Planner, Expectations, What To Look For: CELG, GILD, PCYC, INFI; by Michael Yee, November 17

- **ASH (Dec 7 -10):** Symposia are Friday but key datasets are Sat-Mon and key analyst events (CELG, PCYC, INFI) are Sun-Mon. Clinical updates are the key focus this year (CELG's MM-020, GILD's PhIII R/R CLL and many midcap updates INFI, GERN, KPTI, ONTX, AMBI) but commercial outlook for launches of targeted orals (PCYC, GILD) for leukemia is also center stage **Contact us for a copy of our ASH Planner with events and key data times**
- Inside we present a guide for investors of the key classes of compounds for the diseases that we think matter this year at ASH and a table of over 50 drugs and key presentations to follow.

ASH Planner, Expectations, What To Look For: CELG, GILD, PCYC, INFI

RBC Compass; 2014 North American Railroad Shipper Survey by Walter Spracklin, November 21

- **Survey taps into the sentiment of the railroads' top customers.** We are pleased to present the findings of our 2014 Shipper Survey. Key findings of our study focus on shippers' expectations for 2014 regarding: the direction of rail rates; volume growth; and service performance. In addition, we have added a set of questions this year to get shippers' perspective on the impact of recent management changes at CNR and CP.
- **Pricing gains to moderate, yet remain positive in 2014.** The largest group of respondents (42%) anticipate +1%-3% pricing growth, which is consistent with our yield assumptions of +1.4%-3.5% for the Class 1 railroads next year. We consider survey findings on price to have neutral implications for rail shares.
- **Shippers' volume outlook is improving.** Shippers' volume expectations once again converged on flat to modest growth (+1%-5%) as 68% aligned with this view; however the proportion of respondents forecasting significant volume growth (5%+) increased to 26% for 2014 (up from 15% for 2013). We see risk to the upside on anticipated freight volumes next year.
- **Shipper sentiment on rail service remains positive.** Shippers' perception of freight rail service has moderated this year, nonetheless a strong majority (64%) continue to rate the Class 1 railroads' service offering as "Good" or "Excellent". In our view, current sentiment supports steady rate increases for the foreseeable future.

RBC Compass

Sensors: Thinking About ST Implication Given Recent Moves By APH and TEL.; APH Acquires GE's Sensor Business, TEL Showcases $200M Sensor Asset. by Amit Daryanani, November 19

- **RBC Perspective:** We have fielded increasing numbers of questions from investors this week regarding implications to the sensor industry post recent acquisition by Amphenol (acquired GE's Sensor business) and TEL's comments at its analyst day about growth ambitions in sensors. We don't think APH and TEL entering the sensor market is a negative for ST, rather it's a validation of ST's core markets and the attractive content growth story. However, it does raise investor concerns around a) lack of deals at ST, and b) does increased competition create risks to the margin profile of ST ?

Sensors: Thinking About ST Implication Given Recent Moves By APH and TEL.

Top Tactical Trades

Yum! Brands, Inc. (YUM) - New segmentation today, higher growth and valuation tomorrow?; by David Palmer, November 21

- We believe Yum's new segment reporting will serve to bolster growth by enabling the sharing of each brand's best practices across geographies. We also believe the new structure will challenge investors to appropriately value each of the segments relative to their global peers.

- **How will this help or hurt growth?** One of the advantages of a global company is the sharing of best practices. In the past, it seemed that the US struggled with this sharing across brands. Can KFC US and Pizza Hut US gain insights and inspiration from their global market peers (and visa versa)? Can Pizza Hut International narrow the growth gap to Dominos now that it is the "growth vehicle" of the new global Pizza Hut?
- **How will investors value each of Yum Brands' new parts?** For instance, is Taco Bell worthy of a Wendy's EV/EBITDA multiple (which is 12x EV/EBITDA)? Is global KFC worthy of a Burger King multiple (which is 13.5x EV/EBITDA)? Will a global Pizza Hut be worthy of a Domino's multiple (14x EV/EBITDA)? These multiples imply that Yum Brands' non-China businesses could be valued at more than 13x EV/EBITDA.
- **What will the new Yum! look like?** We estimate that the new KFC, Pizza Hut, and Taco Bell segments will represent 22%, 19%, and 17% of global profit, respectively, with China accounting for the remaining 42% (see Exhibit 2).
- **Is one of these division presidents the next CEO?** With this change, David Novak has added three direct reports, each managing a substantial slice of the global Yum empire.
- **YUM is rated Outperform with an $80 price target:** Our price target is based on two methods: 1) DCF analysis, which yields an $80 value based upon a terminal growth rate of 1.6% and a WACC of 8.7%; and 2) a sum-of-the-parts analysis.

New segmentation today, higher growth and valuation tomorrow?

Rayonier, Inc. (RYN) - Dissolving Doubts – Time to Step In; by Paul Quinn, November 18

- Upgrading to Outperform (from Sector Perform) with ~23% potential upside to our $52 12-month price target as we have become more comfortable with likely specialty dissolving pulp (CS) prices in 2014. Acetate pulp demand (primarily for cigarette filter) appears stable and supply risks seem overblown. Additionally, we see the potential for meaningful earnings surprise (to the upside) over 2014/15 from the Real Estate (HBU) business.

- **With the stock down 25.0% since the Q3 call on October 24 (vs. 2.5% increase in the S&P500), we believe current valuation offers an attractive entry point.** While we could always look past the longer transition that RYN will have for the Jesup C-mill into CS (2017/18 now versus 2016 before), and RYN can get around the great tariff wall in China (21.7%) for its new viscose volumes by producing fluff again if need be, the magnitude of price declines for CS in 2014 had been our biggest concern holding us back at Sector Perform until now. After much discussion with several of our trade sources, we remain comfortable with the estimate we made post-Q3 results that RYN's CS prices will decline 5% y/y (-$95/tonne) in 2014.

Dissolving Doubts – Time to Step In

Macro Musings

Rotation to Financial and Discretionary laggards; by Robert Sluymer, November 18

- The current technical backdrop remains positive with more evidence of a supportive rotation taking hold within the equity market. Examples below include MET, BAC, JPM, HD, GM, WYN, LAMR and MON.
- The list of negatives listed in today's note (sentiment, VIX, etc.) remain legitimate concerns but we would need to see evidence that negative momentum and relative performance divergences are in place to conclude a correction is developing.
- At the equity index level a break below last week's lows would likely be required to create more concerning divergences while relative uptrend reversals by leadership sectors (Discretionary, Industrials, Healthcare or Financials) and stocks to bonds would be needed to conclude a correction is developing.

Rotation to Financial and Discretionary laggards

Q-Tips: Highlighting Quantitative Themes; by Ronald Dottin, November 22

- **We Believe the Cost/Productivity Side of Margins Remains Under-Appreciated.** S&P 500 companies spent nearly $600 billion on capital expenditures in 2012. It's unlikely that the full benefit of this spend has flowed through to earnings. The return on previous capex spend could contribute roughly 4–8% of 2014's profits—a primary reason that we're sticking with our increasing margins factor.
- **Margins & Sales Growth – An Attractive Tactical Idea for 1H14.** Seasonally, sales growth becomes the main focal point of investors as we enter a new calendar year. Investors' interest in it will likely increase beyond normal levels given the expectation of a global pick-up in economic activity. We believe that adding the "under-appreciated" theme of increasing margins should further boost the alpha generation of this portfolio. Please see Exhibit 3 for the current list of names.

Q-Tips: Highlighting Quantitative Themes

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Upcoming Conference

Silver Conference
December 10, 2013
New York, NY

Canadian Bank CEO Conference
January 14, 2014
Toronto

Global Healthcare Conference
February 25 - 26,
New York, NY

Non-Deal Roadshows

Covidien Plc (COV)
Europe
November 24 - 27, 2013

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