BMO Dividend Fund

Quarterly Commentary

Philip Harrington, CFA
Director & Portfolio Manager
Fundamental Canadian Equities
BMO Asset Management Inc.

Lutz Zeitler, CFA
Managing Director & Portfolio Manager
Fundamental Canadian Equities
BMO Asset Management Inc.

Smart Capital Allocation – The Power Behind Long-Term Returns

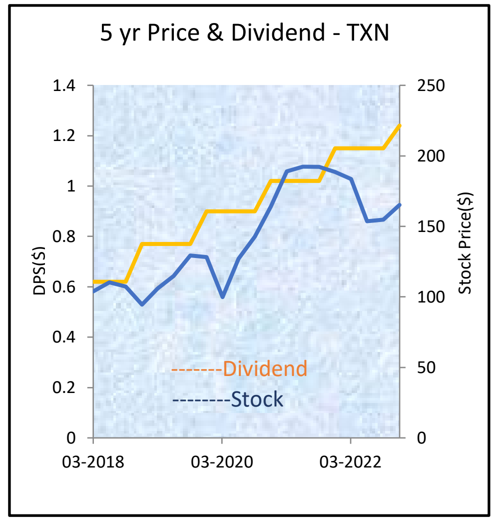
The last 3 years have witnessed the fastest economic contraction on record followed by the fastest recovery thanks to the massive doses of fiscal and monetary stimulus. The inflationary tsunami has driven central banks into equally unprecedented interest rate increases to keep the inflation genie in the bottle. This determination on the part of central banks points to the likelihood that an economic slowdown is quite high this year. Bloomberg economics sees global growth at just 2.4% for 2023 which would be the slowest annual pace going back to 1993, if we exclude the GFC and the Pandemic crisis events.

With a slow growth world as the potential backdrop for this year, smart capital allocation will be even more important in driving business success and value creation. Capital deployment is one of the most important roles of an executive team and board and is made a lot easier when a company has all of the other high-quality attributes that we look for such as durable competitive advantages, strong customer value propositions, flexible balance sheets, and abundant free cash flow generation. When it comes to capital allocation options there are a handful of tools that are available to all companies to differing degrees -

- Organic investment
- Strategic M&A
- Dividends
- Buybacks
- Debt paydown

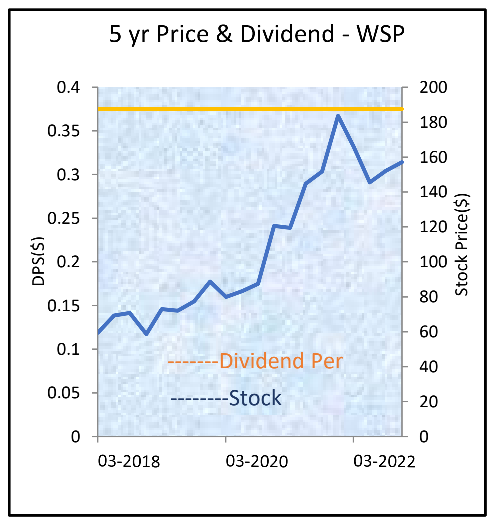
with each company having a unique decision tree depending on the attributes of the industry in which the company resides, the growth runway of the firm, the nature of business cycle and the prospective returns on each of the options. Navigating these decisions through the ups and downs of the business cycle can have tremendous implications for dividend sustainability and growth. As such, a large part of our fundamental due diligence is spent following the spending breadcrumbs and assessing the quality of past allocation decisions as well as assessing the framework for future decision making. Nothing can destroy value more than misguided allocation, so ensuring that management has a sound and consistent process for making good decisions is critical. There is ample evidence that some companies are better at it than others. Looking within the BMO Dividend Fund, Brookfield's asset manager spinoff, Intact Financial's RSA acquisition, and Metro's buyback strategy all come to mind as smart uses of capital that have resulted in lasting value creation. Other capital deployment standouts within the Fund include:

Texas Instruments Inc. (TXN) is the leading analog semiconductor manufacturer in the world and has been a longer term holding of the BMO Dividend Fund. Very few companies demonstrate a clear and well-articulated capital allocation framework like TXN does. With the strong belief that the growth of free cash flow per share is the primary driver of long-term value creation, the company's management team makes strategic decisions that not only build sustainable competitive advantages, but also reward shareholders over time. For example, through acquisitions, TXN has helped consolidate the analog semiconductor industry over time, resulting in a more rational competitive environment and increased profitability. Organic reinvestment in its core business is also a focus of management. Two new fabrication plants were inaugurated in 2022, and another two are under construction, taking advantage of the favourable economics and tax incentives recently brought by the CHIPS Act in the United States. Finally, TXN has a target to return all its free cash flow generated in the form of share repurchases and dividends. To that effect, the company recently announced an 8% dividend increase and an authorization to repurchase an additional $15 billion of its common stock over time (this is in addition to the $7 billion of previously authorized repurchases that remained at the end of September 2022). With its pristine balance sheet with $1.2 billion of net cash, we expect TXN to return in the next 3-4 years over 20% of its market cap to shareholders.



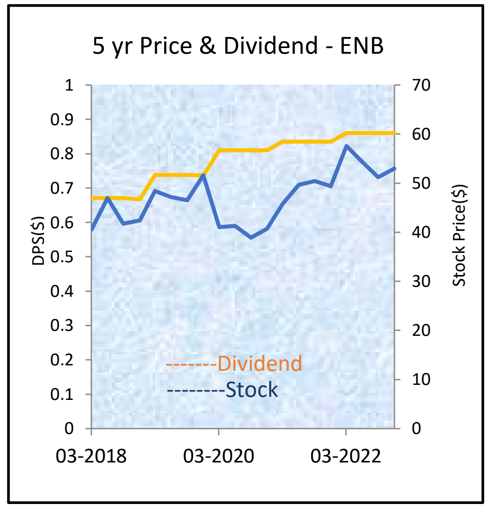
Source – Morningstar Direct.
Data as of December 31, 2022

WSP Global Inc. (WSP) WSP, one of the largest engineering- and design-focused companies in the world, is a mainstay holding in our fund. The company is well diversified across geographies and boasts strong market positions in infrastructure(-like) end markets such as Transportation and Infrastructure, Environmental, and Properties and Buildings. Despite global recession worries, we believe WSP's strong record backlogs in highly resilient infrastructure projects will enable the company to perform well over the upcoming years. Furthermore, we expect the resilience of WSP's business to enable its leadership to continue its long term, disciplined M&A strategy. In fact, the company recently made a commendable decision to walk away from a proposed acquisition of a UK-based design firm after a competing bid was made at undesirable valuations. Looking over the past five years, including the COVID-led pandemic, WSP's organic revenue averaged a commendable 2.5% per year. Meanwhile, WSP's exceptional M&A focus bolstered total revenue growth to 10.1% per year on average – four times the pace of organic revenue growth – resulting in total employee growth of 9% per annum through the end of 2021. Today, WSP employs an impressive ~65,000 employees as compared to just ~36,000 at the end of 2016. With a strong balance sheet and resilient business model, we continue to view WSP as a core holding.



Source – Morningstar Direct.
Data as of December 31, 2022

Enbridge Inc. (ENB) is a leading Canadian energy infrastructure company with a market cap of C$112.6 billion, involved in the transportation, distribution and related services of hydrocarbons and the generation of electricity through its Renewable Energy segment. Enbridge's business model is well positioned to benefit in the current environment as 98% of the revenues are Cost-of-service/Contracted, i.e., not impacted by the volatility in commodity prices and are relatively immune to inflation and economic slowdowns with 95% of the customers being investment grade. Over the years ENB has made effective use of a variety of capital allocation levers to advance shareholder value including organic development alongside the rapid growth in hydrocarbon development over the last two decades, strategic acquisitions such as Spectra Energy in 2017, asset sales, corporate roll-ups, and targeted debt reduction. Today, the company has entered into a period of stable growth with a capital allocation framework that provides the company with $5 billion-$6 billion of annual investable capacity. The capital allocation framework is divided between $3 billion-$4 billion for core allocation which will be used to fund the secured capital program of $17 billion, and the remaining ~$2 billion of excess allocation will be used to drive additional growth and value through share buybacks, M&A, and debt reduction etc. Enbridge has announced a number of M&A transactions in 2022 which included the acquisition of Tri Global Energy, increased its ownership interest in Gray Oak pipeline and Woodfibre LNG partnership. The company has renewed its NCIB program of $1.5 billion for 2023 and was able to purchase ~$150 million of shares in 2022. Lastly, we would like to highlight that the company offers a healthy dividend yield of 6.38% with a dividend growth rate expectation of 3% in the medium term.



Source – Morningstar Direct.
Data as of December 31, 2022

IMPORTANT DISCLAIMERS