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SEMI ANNUAL REVIEW PART 1-

GO WEST YOUNG MAN (AND WOMAN)

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At this time of the year, with the first half behind us, and also approximately the anniversary of when I began writing this column for the Income Investor back in 2005, it has become the custom to review how the various recommendations have been doing, both on the operational front, and in terms of performance. I have in the last couple of years divided them into two parts, one of which is chiefly influenced by interest rates and financial markets, comprising the financials, properties and those with a higher debt load, and the other mainly located in or having major portion its operations in the western provinces of Canada, which have tended to be dependent upon the energy and resource sectors. These two areas comprise almost 80% of the Canadian stock market in terms of market capitalization, and while such sectors as the auto industry and forest products are very important in terms of employment and economic output, they have little representation in the Canadian stock market and none in the recommendations that I have made. Lastly there are one or two stocks which do not fall smoothly into either of these categories.

Looking first at the resource oriented portion, the companies here fall into two groups; the first is energy companies, specifically, AltaGas, Canadian Oil Sands and Penn West Energy, while the second is comprised of companies that derive a large portion of their revenues from the western provinces or resources, such as Boardwalk Properties REIT, the largest residential landlord in the Prairies, Liquor Stores, the Alberta drinks retailer, the Keg Restaurants, CN Rail and Shaw Communications. The financial portion comprises Bank of Nova Scotia, Sun Life, Power Financial, the holding company for Great West Life and Investors Group, Davis + Henderson, the largest cheque printers, and from the property side, Primaris REIT, the shopping centre operator and Consumers Water Heater, the largest renter of hot water tanks in southern Ontario. Finally, in the last group, there is movie theatre operator Cineplex Galaxy.

Let's look at the energy stocks first. As I have noted since my very first recommendation of Canadian Oil Sands in March 2005, the success or otherwise of an investment in energy companies depends on the price of oil and gas. When oil is recording record highs, as it was this time last year at U$147 per barrel for West Texas Intermediate (WTI) oil, then oil stocks are doing well and increasing their payouts or expanding their operations. When oil has plummeted 75% to U$33 per barrel, as it did at the end of 2008, then oil stocks are cutting distributions, as happened with both Canadian Oil Sands (($1.25 per quarter to $0.15 between August 2008 and February 2009) and Penn West (($0.34 per month to $0.15 between January and April this year) and reining in their expansion. With oil having doubled from its lows to U$65 per barrel at the time of writing (week of July 10th) it appears as though these reduced levels are sustainable, and there is some feeling that managements have been deliberately conservative to ensure that they do not need to reduce them further. They are also positioning themselves for the disappearance of the tax exemptions of income trusts at the end of next year, although as noted, such large trusts as Penn West have enormous pools of tax allowances (C$5.9bn) which they can use to reduce their tax rate for the next few years.

Canadian Oil Sands reported record cash flow from operations (FFO) of C$4.67 per unit compared to $2.22 per unit for 2008 (C$2.2bn vs. $1.4bn) and record net income of C$3.17 per unit vs. $1.55 (C$1.5bn vs. $773m). So far this year it has reported C$0.10 per unit in Q1 compared with C$0.92 the previous year (C$50m vs. $441m) reflecting the 56% fall in the WTI price and higher costs (cost per barrel of C$38.58 vs. $35.93) on higher maintenance and labour costs and expanded mining activity, despite producing 103,000 barrels per day (bpd) vs. 99,000 bpd. Based on an average WTI oil price of U$50 per barrel for the whole of 2009, Canadian Oil Sands anticipates FFO of C$1.21 with output of 40m barrels (109,500 bpd) at a cost per barrel of C$33.50 and C$453m in capital expenditure. The early turnaround of Coker 8-3, which began in March was successfully completed by June 9th,, and the further falls in the price of natural gas to below U$4 per mbtu benefit the trust, as it uses gas to distill the bitumen from the oil sands into synthetic crude oil, so a higher oil price and lower gas price work in its favour. The trust announced it was suspending its Dividend Reinvestment Plan (DRIP), which it only instituted in January as of July 29th, as it no longer needs to preserve cash given the rising oil price and its U$500m note issue in May. Canadian Oil Sands has been the most successful of the recommendations, as it has risen 56% since March 2005 and together with its distributions, returned 93% against a 17% total return for the S&P/TSX Composite over the same period. It remains a buy at present levels, especially as distributions may be raised if oil stays above U$50 per barrel.

Penn West has been a less successful pick, as it is down 64% since being recommended just over 2 years ago although that has been mitigated somewhat by the 21% in total income that it has distributed, giving a negative total return of -43% since May 2007 against -24% for the S&P/TSX for the same period. After a record setting 2008, which saw FFO of C$6.75 per unit compared to $5.56 (C$2.5bn vs. $1.3bn) and net income of C$3.25 per unit vs. $0.73 (C$1.21bn vs. $175m, reflecting the effect of accounting for the introduction of taxation on trusts in 2007), FFO for Q1 2009 was C$0.87 per unit compared to C$1.76 (C$348m vs. C$632m), with production of 180,100 bpd of which 59 was oil and natural gas liquids (NGL). Penn West, the largest conventional oil and gas trust in North America, high graded its portfolio of properties by selling 4,900 barrels of oil equivalent (boe) while closing the purchase of Reece Energy Exploration in April by issuing 4.7m trust units to raise $101m which added 1,900 boe and 75,000 acres of undeveloped land. It issued C$250m of trust units at C$14.10 in February and C$250m of unsecured 5 and 10 year notes at an average yield of 8.9%. Penn West noted its costs per barrel were unusually high at C$14.93 per barrel due to extreme weather and the failure of suppliers to pass through cost reductions quickly but anticipated that the cost would fall rapidly in the second half which is why they had back loaded their $600m in capital expenditure, while the reductions in royalties by Alberta from April 1st would save it $35m this year and its hedging programme meant that 36% of its oil output for 2009 was locked in at U$80 per barrel. Finally, the CFO confirmed that Penn West would convert back to a corporation sometime in 2012. It remains a hold on the expectation that oil prices will remain above U$50.

AltaGas, the midstream gas pipeline and power company, has surprisingly been one of the weaker performers amongst my recommendations, with its price being 44% below the initial recommendation in October 2006, just before the Halloween change of tax treatment by the government, although here again the 17% in income reduces the negative total return to -27% against -9% for the S&P/TSX over the same period. Having earned record earnings of C$2.38 per unit compared to C$1.90 (C$168.3m vs. C$108.8m) in 2008, the trust issued $100m of equity in February at C$16.10 per unit, extended the term of C$250m in bank debt that was due to expire in September 2009 to August 2010, was upgraded from BBB- to BBB (stable) by S&P, raised $200m in 5 year notes at 7.42% in May and $100m in 7 year notes at 6.94% in June and announced a 20 year joint venture with Nova Chemicals to take the liquids or co-stream output from its Harmattan Co-Stream Project 250m mcf expansion. FFO for Q1 2009 was $0.75 per unit compared $0.87 (C$57m vs. $56.3m) and total debt was $540m, with debt to capitalization of 33.6% vs. 45% in March 2008 after the takeover of Taylor NGL. AltaGas has been expending in clean energy, and the towers and turbines for its Bear Mountain Wind Park in north eastern BC are being erected for a November 2009 start. It invested C$10m for a 5% stake in Magma Energy Corp, which would now be worth $17m after Magma's IPO in Toronto in June, and owns an 8MW geothermal plant in Nevada. It is a buy after its major underperformance in the first half of this year.

For the non oil and gas related western plays, Boardwalk REIT has produced a total return of 26% since recommendation 3 years ago in August 2006, against a fall in the S&P/TSX of -11% over that period. For 2008, the trust, which as a REIT will continue to enjoy its tax exempt status after 2011, continued to demonstrate strong performance on the back of the resource boom, although the management noted in its discussion that increases in rentals had slowed down dramatically from the torrid pace of 2006-07. FFO for 2008 was up 15.5% at C$2.39 per unit against $2.07 (C$129.9m vs. $116.5m, the FFO per unit being higher than the underlying income owing to Boardwalk repurchasing 2.3m units in 2008 at an average cost of $36.94). Rental revenue per unit across its 35,600 apartment portfolio was up 7.9% y-o-y, with costs up almost 50% more at 11.9% y-o-y, although Calgary and Edmonton, home to 15,500 units, saw q-o-q rental declines of 1% in Q4. The average monthly rental rose from $903 per unit to $978, compared to the going market rental of $1,047, down from $1,054 a year ago, meaning the loss to lease (the difference between what Boardwalk could have charged but chose not to) fell from $39m to $8m, while the vacancy rate was steady at 4.68% (2007 Q4 4.67%). The trust bought 297 units in Calgary in 2008 for $48.5m at 5.86% capitalization (cap) rate. Its debt of C$2.25bn, up from $1.95bn, was 61.3% of its gross enterprise value, with interest covered 2.29x compared to 2.31x in 2007, partially due to its ability to access National Housing Act insured mortgages at 3.6%, as it is a residential landlord.

In Q1 FFO per unit was up 14% to C$0.57 compared to $0.50 (C$30.5m vs. $27.7m), with a payout ratio of 78% compared to 88.2% last year, and while rental revenue was higher by only 4.9% compared to Q1 2008, costs actually fell 1.3% over the same period, while the vacancy rate rose to 5.34%, higher than Q4 due the large number of tenants moving at the end of the year but lower than the 5.65% in the same quarter in 2008. The trust is forecasting net operating income growth of 4-6% in 2009 from apartments occupied for longer than a year and FFO per unit of C$2.45-2.55, a range of 2.5-6.6% higher than 2008. Boardwalk remains a buy given the continued growth of the resource dependent western economies of BC, Alberta and Saskatchewan, a stabilization of cost pressures in the Prairies and a sharp reduction in the supply of condominiums for sale, an alternative to renting. Incidentally, if readers want a comprehensive yet very readable summary of how the Canadian economy is doing, they could do a great deal worse than read Boardwalk's quarterly management reports, which give a review of not only their own portfolio of apartments which are not just in the BC and the Prairies but also in London and Windsor ON and Montreal, but market rentals in all their major cities, employment, wage growth, migration and house prices (as the latter are alternatives to renting). The Q2 report will be released on August 14th.

The Liquor Stores and the Keg Restaurants are the two smallest companies I have recommended in the Income Investor, yet have not done noticeably worse in terms of total return against the other recommendations. While they are both down in price since being recommended in February and June 2006 respectively, by 40% and 28%, the Keg has actually delivered a positive return over that period (+1.5% vs. -17% for the S&P/TSX) and Liquor Stores is off -20% against -7% for the index, as they have both continued to pay their distributions and even raised them a bit. Liquor Stores has done worse as it has struggled to digest two major acquisitions in the last two years, the 54 store Alberta based Liquor Barn chain in June 2007 and the 19 store Brown Jug chain in Alaska in Q4 2008. Together with the 16 net new stores it opened in Alberta and BC last year (23 less the 7 that were closed), the chain had expanded to 223 stores at the end of 2008 from 195 a year earlier. Sales rose to C$483m, up 26% from $383m in 2007, reflecting the inclusion of Liquor Barn for a full year as opposed to 7 months and the Brown Jug acquisition, while same store sales (SSS) from the original Liquor Stores chain were up 2% for the 91 original shops. Distributable cash per unit was flat at C$1.72 compared to $1.71 (C$38.7m vs. $31.8m) excluding non recurring items such as a $3.2m foreign exchange gain from the Brown Jug takeover and store closure losses; including them saw a 5% increase per unit to C$1.76 from $1.67. Distributions of $1.62 were 94.2% of distributable cash. Q1 results were weaker, reflecting bad winter weather in BC, Easter falling in Q2 in 2009 as opposed to Q1 in 2008 and 1 fewer selling day as 2008 was a leap year. These seasonal factors accounted for 6% of the 8.5% same stores sales (SSS) decrease from $75m to $69m, even though total revenues rose 13% to $106m. Distributable cash before non recurring items fell 5.4% from $0.19 to $0.18, while distributions were $0.41 per unit. Q1 is always the weakest quarter of the year, just as Q4 is the strongest, although Q2 may also have suffered from the imposition of higher taxes on alcohol ($1.30 per 12 pack of beer and almost $3 per bottle of liquor) in the Alberta budget, since rescinded in July, but as noted a couple of months ago, business trusts such as Liquor Stores and the Keg are very likely to cut their distributions once they become taxable in 2011 given their high payout ratios. Liquor Stores is a hold on the recovery in resources.

The Keg reported record sales, earnings before interest, tax and depreciation (EBITDA), royalty income and distributable cash for 2008, with sales at the 96 restaurants (2007 95 restaurants) in the royalty pool rising 4.9% from C$413m to $433m, with SSS increasing 2% in Canada and declining 9% in the US over the period. After adjusting for changes in currency valuations, US restaurant SSS increased 0.4% for the year, while the income from the 4% royalty on gross sales the trust received rose 4% to $17.5m. Distributable cash per unit rose 0.6% to C$1.276 from $1.269, and distributions were $1.272, or 99.4% of distributable cash. With 6 new restaurants in the royalty pool from the beginning of 2009, making 102, sales were up 10% to C$121m from $112m in Q1, although SSS fell 1.5% in Canada and 4.9% in the US, before currency translation led to a 0.7% increase in C$ terms. Royalty income rose 9% to $4.9m and distributable cash per unit rose 2% to C$0.336 from $0.33, with distributions of $0.32 resulting in a 95.2% distribution rate. The Keg's resilience in the recession is impressive and its good value against more upmarket steakhouse chains but the introduction of tax and its that its high payout rate will likely mean a cut in distributions come 2011. As previously mentioned, all income from listed companies will be treated as dividend income an eligible for the dividend tax credit as of January 1st, 2011, so the Keg as with Liquors Stores, is a hold, as the net income to investors will probably be unchanged, but until the uncertainty is resolved neither can be regarded as a buy.

Lastly, two large cap companies that are probably at the opposite ends of the spectrum as far as their exposure to economic sensitivity is concerned, CN Rail and Shaw Communications, yet the more economically exposed railway has been one of the best performing recommendations since October 2005, with a price increase of 16% and a total return of 23% against the S&P/TSX return of only 6%, while the recession resistant cable company has returned -15% over the last year, admittedly a better return than the -23% delivered by the index. CN Rail has been affected by the recession in two of its major shipping categories, autos, with US auto sales down from a 16m to a 9m annual rate, and forestry, reflecting the collapse in the US housing market. Against these weaknesses, apparent already in 2007, 2008 saw strength in bulk commodities such as coal and bulk metals, and intermodal container traffic, for the first three quarters, although revenue ton miles, which measure the amount and value of goods shipped was down 3% for 2008 and 10% in the fourth quarter alone. For 2008, revenue was up 7% to C$8.5bn, half of which was due to the fuel surcharge used to offset higher diesel prices and higher volumes in the non auto and forestry categories, although expenses were up 11% to C$5.6bn, raising the operating ratio (costs as a %age of revenue) from 63.6 to 65.9, still by far the lowest in the industry. While 2008 earnings per share (EPS) were down 7% to C$3.95 from $4.25 (C$1.9bn vs. $2.2bn), after excluding exceptional items such as tax reductions, the sale of its Montreal HQ building and its stake in British freight railway EWS in 2007, adjusted EPS was up 9% from C$3.40 to $3.71.

In Q1, revenues declined 4% to C$1.859bn from C$1.927bn reflecting the effects of the recession as the drop in revenue ton miles accelerated to 14%, with carloadings down 16% to 954,000 from 1.13m although expenses also declined 2% due to lower fuel costs and cost reductions. Compared to a Q1 in 2008 that was badly affected by winter storms, EPS was up 40% to C$0.90 compared to $0.64, but when the effects of the sale of the Weston track routes in Toronto to the suburban GO Train network for $135m after tax plus reduced provincial taxes, less the $28m net cost of acquiring the Elgin, Joliet & Eastern (EJ&E) railroad in northern Chicago are stripped out, adjusted EPS came to C$0.64 against $0.62, a 3% improvement. The operating ratio slipped from 72.9 to 74.1, as Q1 is always the worst quarter due to weather, although CN benefited from the appreciation in the U$ against the loonie. Claude Mongeau, the CFO, was announced as the new CEO with effect from January 2010 to replace hard charging CEO Hunter Harrison, former Railroader and Canadian CEO of the Year, with Power Corp. executive Luc Jobin appointed as new CFO. CN announced that it had completed the clean up of the derailments at Lake Wabamun in AB and near Squamish in BC which occurred within 2 days of each other in August 2005, at a total cost of $140m and spent $10m on new equipment for the Algoma Canyon excursion train, the major tourist attraction for the city of Sault Ste Marie. CN has also asked the federal government to appoint a conciliator to negotiate a settlement with its 1,700 railroad engineers whose contract expired at the end of 2008. CN remains a buy, as the most efficient of the Big 6 railways in a recession, but also due to the efficiency improvements its purchase of the EJ&E will bring about to moving freight more rapidly around Chicago, a notorious rail bottleneck.

Finally Shaw Communications has been looked at in an earlier update but its net income for the quarter ending May 31st, 2009 was up 3% to C$0.31 from $0.30 (C$132m vs. $128m) on revenue up 9% to C$861m vs. $792m, while for the 9 months ending May 31st, 2009 revenue was up 10% to C$2.52bn from $2.3bn. While net income for the 9 months was down from C$1.25 to $0.96 (C$539m to $411m) this reflected the fact that the reduction of corporate tax rates only contributed $23m in 2008-09 as opposed to $199m and an additional $22m from lower duty on satellite receivers in the previous period. Excluding these exceptional items means that net income for Q3 and the 9 month periods would have been $131m and $381m vs. $117m and $327m, increases of 125 and 175 respectively. This growth was driven by increases of 10% in digital cable subscribers of 110,810 to 1,187,183, meaning digital penetration increased from 40% to 52% over the same quarter last year, 54,633 (7.5%) in Voice over Internet (VOIP) phone customers to 774,009 and 24,625 (1.5%) n internet to 1,650,959. even basic cable added 9,622 to 2,283,526 and its Starchoice satellite TV business added 1,580 to 898,223. The latter service now faces competition from Telus, the incumbent telephone company in western Canada, as it is bundling Bell's ExpressVu satellite service with its existing telephone, wireless and internet offerings to offer the same package as Shaw, proving the effectiveness of Shaw's marketing. Free cash flow after necessary capital expenditure almost doubled in the quarter to $154m from $81m and increased by a third for the 9 month period from $309m to $406m, one of the reasons Shaw has been able to raise its dividend by 52% over the last 3 years. It remains a buy, especially given its underperformance in the spring rally.

Next month I will review the financial portion of the recommendations.