GORDON PAPE INCOME INVESTOR AUGUST 2009-07-08

INTERESTING TIMES

Gavin Graham
Director of Investments
BMO Asset Management

The second part of the semi-annual review of the recommendations that I have made for the Income Investor over the last 4 and bit years includes those companies which are either in the financial sector or are especially sensitive to interest rates due to their relatively high debt levels as well as an industry specific company, Cineplex Galaxy, the movie theatre operator.

This has undoubtedly been the more disappointing portion of the recommendations, as financial stocks have been battered by the course of the economy, initially by rising interest rates, which caused banks and insurers to underperform the commodity based sectors of the S&P/TSX during its run up to an all time high of 15,000 last July, and then by the recession, which caused the stock markets to plummet and then the default rate on borrowings to start rising rapidly, even though interest rates fell to unprecedented lows at 0-0.25% in the US and 0.25% in Canada. While the initial bank that I recommended CIBC, produced a 46% total return between August 2005 and its sale in July 2007, the property and casualty insurer ING Canada (now renamed Inhance Financial) lost -32% as the insurance cycle turned negative, and their replacements, Bank of Nova Scotia and Sun Life, have returned –9% and -34% since recommending them in August 2007 and February 2008 (all returns to July 8th, 2009). This compares with falls of -21% and -24% respectively for the S&P/TSX over the same periods, so they have effectively matched the return from the index, but given that Canadian banks did not make sub prime loans to borrowers with bad credit, need to be bailed out by the government or cut their dividends, the halving of their share prices is a good example of markets reacting emotionally to the fact that they are North American banks with some exposure to the US and concluding that they must have the same problems as US banks! When the life insurers were hitting prices not seen since they demutualized back in 1999-2000 early in March, due to concerns about potential exposure to equity linked products, investors were offered a once in a decade chance to buy world class companies at valuations that ensured a positive return over the next 5 years, but worries about them being “the next AIG” prevented all but a few brave souls from taking advantage. By the way, whenever share prices plummet, there must always be a buyer for every seller to allow those panicked sellers out, otherwise the stock would just continue to fall with no trades.

I have reviewed Scotiabank and Sun Life in the last few months during the sell-off so will just update their most recent quarters here. Scotiabank saw EPS fall 16.5% to C$0.81 from $0.97 (C$872m vs. $980m) in the quarter ending April 30th, 2009, and by 10% to C$1.61 from $1.76 (C$1.74bn vs. $1.82bn) for the half year, although the bank reported record revenue up 12% from the corresponding quarter last year. Provision for credit losses more than tripled from last year up to $489m from $153m, and provisions as a percentage of assets rose from 0.32% to 0.73%, but Tier 1 Capital remained strong at 9.6%, unchanged from last year, and tangible common equity to risk weighted assets (leaving out goodwill and other intangibles) rose from 7.5% to 7.7%. The productivity ratio (costs to earnings) improved to 51.9%, as earnings from its investment bank, Scotia Capital were exceptionally strong, averaging 54.9% for the first half of this year against 55.6% for the first half of 2007-08 and ROE was a very healthy 17.6%, but down from 21.4%, a state of affairs that CEO Rick Waugh indicated may be the "new normal" in a recent speech. Finally, Scotiabank purchased another 24% of sixth largest Thai bank, Bank Thanachart, giving it the maximum permitted 49% for $270m. This continues Scotia's push into developing markets, which accounted for one third of its $3.6bn in net income in 2007-08. Just as one example, Scotiabank Mexico reported Q1 income of C$54m, meaning that on an annualized basis, Mexico, which Scotia only entered 15 years ago when it bought Bank Inverlat and became Mexico's sixth biggest bank, is now making almost C$250m a year in net earnings. Scotia is a Hold given the speed of the recovery from its depressed lows in March.

Sun Life recorded a loss of (C$0.38) per share in the quarter ending March 31st compared to earnings of $0.93 (C$(213m) vs. $533m) on strengthening of equity linked reserves (C$325m), reserve increases of $167m and $76m of equity and credit losses, as well as $27m of restructuring costs. The sale of its 37% stake in CI Financial to Scotiabank in Q4 for C$2.3bn meant Q1 earnings were reduced by $43m ($0.08 per share) and will be similarly affected for the rest of 2009. Despite the losses, Sun Life's capital position remained strong, with its Minimum Continuing Capital Surplus Requirement (MCCSR) remaining at 223% for Sun Life Canada and 357% for the Risk Based Capital Ratio of Sun Life US. Unlike Manulife (C$1.4bn) and Great West Life (C$1bn) Sun Life did not need to issue common equity in Q4 2008, due to the CI sale, and while it has issued C$250m of 6% resettable preferred shares in Q2 and $300m of 5.7% 2019 debentures, the cash raised by the sale allowed it to purchase the UK business of distressed US insurance company Lincoln National for $359m in June. The purchase complements Sun Life's existing UK business nicely, increasing its assets by 60% to $19bn and doubling the number of policies to 1.1m. CEO Donald Stewart noted that Sun Life's strong capital position allowed it to take advantage of these opportunities at a time when demographic and regulatory changes were moving in favour of providers of protected or guaranteed products such as life insurance companies. Sun Life remains a Buy given its underperformance during the sell-off and the subsequent recovery.

Power Financial has probably been the most disappointing recommendation over the last 4 years as it has produced a negative total return of -12% against a positive S&P/TSX return of 8%, and this over a 4 year period rather than just 1 year or 18 months. For the quarter ending March 31st, 2009, Power reported EPS of C$0.24 compared to C$0.80 in 2008 (C$195m vs. $586m) before exceptional items. These totalled charges of C$0.08 per share (C$57m) against earnings of $0.13 per share ($95m) both deriving from Power's holding in Pargesa, the European holding company for various investments such as minority stakes in Lafarge (cement), Pernod Ricard (alcohol) and Iberdrola (utilities). On an adjusted basis, EPS fell 52% from C$0.67 to $0.32. Great West Life's contribution to Power's earnings fell 41% from $377m to $224m, primarily reflecting the absence of extraordinary gains from selling its US health insurance business as well as reserve strengthening similar to Sun Life, while IGM (Investors and Mackenzie mutual funds) fell 43% from $119m to $68m, reflecting lower levels of assets under management. Power is a Buy, with its underperformance reflecting the discount which as a holding company it has always suffered from, but which the panic during the market's plunge late in 2008 caused to widen significantly and which should now narrow back in helped by improving fundamentals for its investment exposed subsidiaries.

Cheque printer Davis + Henderson has outperformed since being recommended in October 2007, with a negative total return of -19% against a -24% fall in the S&P/TSX. The slowdown in the housing market has affected electronic mortgage division Filogix, and the recession has hit cheque volumes for small businesses, with revenue in Q1 ending March 31st, 2009 only up 1.3%, below D+H's target of 3-5% revenue growth although EBITDA was up 4.8% to C$28.4m and adjusted earnings 5.7% to C$22.9m. The major news here was the agreed bid in June to purchase business service trust Resolve Business Outsourcing for C$123.5m, a 44% premium to Resolve's pre bid share price. Resolve had been one of the casualties of the trust tax, as well as some operational issues, so its shareholders will doubtless be happy to follow the advice to accept D+H's bid. With its network of call centres, Resolve will be able to widen and complement D+H's offerings in the financial services area. D+H remains a Buy as it is able to continue to grow its revenues even if by a small amount, while keeping costs under control, an area where its takeover of Resolve will give it plenty of scope to exercise.

The two recommendations with high debt levels are Consumers Water Heater and Primaris, the shopping centre REIT. Consumers has produced a disappointing negative -35% return against -6% for the S&P/TSX over the period since January 2006, as concerns over its heavy debt load and the accelerating competition from rivals such as privatized UE Waterheater causing higher erosion of its customer base (up from 2.3% in 2007 to 3.2% last year), the requirement to allow other heater rental companies to bill customers on former owner Enbridge's bills and the decision by the Ontario Energy Board to ban its (and others') smart metering business Stratacon (acquired in August 2008 for $21m and the assumption of $7.2m in debt) from installing meters in anything except condominiums have worried investors. In fact, Consumers will almost certainly have to reduce its distribution before the introduction of taxation January 2011, as in Q1, its $0.3225 distribution was 108.6% of distributable cash compared to 88.3% for the same quarter last year. While revenues were higher due to the 3.9% increase in rental rates in January, the acquisition of Thunder Bay Hydro's 5,960 portfolio in Q4 and the Stratacon business, EBITDA was down $1.6m to $35.6m mostly due to Stratacon's negative -$1.2m EBITDA and operating income was off 3.4% to $32m on higher expenses and interest. The latter was due Consumers' having to pay interest on bridge loans until it was able to refinance its $310m debt with $60m of 6.2% 3 year binds and $270m of 6.75% 5 year bonds in February, with DBRS and S&P both rating the issue A. Consumers expects that the higher interest and operating expenses will result in 2009's operating cash being lower than 2008, when it had reduced the payout ratio to 92.9% from 98.9% the previous year. Consumers is a Hold as the 20.7% running yield indicates that investors are already pricing in a cut in the distribution, therefore the bad news is already reflected, and the growth of Stratacon, where installations have grown from 35,600 to 44,000 in a year despite the ban on non-condominium installations in Ontario, the lower interest expense from the debt issue and some reduction in the aggressiveness of the competition should enable it to maintain the reduced payout.

Primaris has also done worse than the -19% return of the S&P/TSX since February 2007, with a -30% total return. Its exposure to shopping centres in secondary cities such as Guelph and Kelowna should make it a defensive play, but its FFO was down 4.4% from $0.363 to $0.347 for Q1 ($21.8 vs. $22.7m) although $0.4m of this was due to costs associated with the internalization of its property management co. which will come into force at the end of the year. Revenue was up 2.7% from $67.2m to $69m even though occupancy fell to 97.3% from 98.2% in Q4 (Q1 2008 97.3%) as the rental renewals for existing tenants saw a 6.2% increase. Sales per sq. foot, at $470, were down 1.8%, reflecting Primaris' lack of super regional malls which have the highest sales per sq. ft., so the industry average is $561 and therefore the International Council of Shopping Centres (ICSC) data saw sales actually increase 2.2% over the last year. Much of the difference is attributable to a couple of specific malls, such as that in Saguenay, where a Bay department store anchor tenant closed in June 2007 meaning Primaris needed to spend $10m and lose the sales for a year from that space and associated common areas while it reconfigured it to suit new, smaller tenants. The space reopened in the second half of last year and is now fully leased, but one vulnerability of shopping centres is their dependence on department stores as anchor tenants in an environment where consumers are spending less and when they do, are shopping at discounters. As at March 31st, the REIT had 978m of debt, equivalent to a debt to net enterprise value after netting out cash of $80m, of 58.3% and 49.1% to gross book value, as defined by its declaration of trust. Interest was covered 2.5x by EBITDA, the RIET spent a mere $14.6m on 3 small acquisitions in 2008, there is only one small maturity of $3.7m and $20m of principal repayments in the next 18 months, and the average term of 90% of the debt is 7.5 years with a weighted average interest rate of 5.7%. Primaris is a Buy given its under-performance and strong balance sheet.

Lastly, recent recommendation Cineplex has returned 19% since its recommendation in February this year, lagging the 28% rebound in the index. Distributable cash per unit was up 16% to $0.381 from $0.328 with adjusted EBITDA up 19% to $29.9m from $25.1m on record revenues up 11% to $211m from $189.8m. Attendance beat the industry increase of 7.2% by rising 9% to 16m from 14.6m, and revenues per movie rose 2.3% to $8.16 from $7.98 as more 3-D movies with premium ticket prices were shown and concession revenues also rose 2% to $3.95 from $3.87 despite the 1.6m members of the Scene loyalty card programme which gives a 10% discount on concession purchases. It is a slightly dispiriting thought that Paul Blart-Mall Cop beat Slumdog Millionaire as the most popular Canadian movie, but then Cineplex is very good at catering to all tastes. Cineplex remains a Buy.