

U.S. blue chips' time will come: Big companies getting little respect in market

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Illustration: Colour Photo: Peter Redman, National Post / Beutel Goodman equity analyst Ehren Mendum, left, and Stephen Clements, senior vice-president, say that while major U.S. companies have had improving earnings, P/E multiples have contracted.

Black & White Photo: David Mcnewm Getty Images, File / Burlington Northern Santa Fe GE C44-9W (Dash 9-44CW) diesel train engines. The company has a market cap of US\$28.2-billion.

Given the slowdown in the U.S. economy, there will be increasing investor focus on quality businesses that can produce predictable earnings growth, says value manager Stephen Clements, senior vice-president of the private client group at Toronto-based Beutel Goodman & Co.

For some time now, Clements and colleague Ehren Mendum, who manage a U.S. equity portfolio for Beutel Goodman's private clients, have been noting in this column that there is good value to be found among brand-name bigger cap U.S. companies.

"Major U.S. companies have been steadily growing earnings per share in recent years, yet the market has not given them recognition for this and P/E multiples have contracted," Clements says.

Of the macro-economic picture, Clements and Mendum, consider that the United States is in a mid-cycle slow down, which is unlikely to deteriorate into a recession. But it will, they say, result in lower long-term interest rates, which is positive for equities. Lower rates could lead to a P/E multiple expansion, say Clements and Mendum.

This economic backdrop, says Clements, is similar to that of 1985 and 1995, when the indexes did well.

As value managers, the Beutel Goodman private client team's discipline is to buy quality companies with good, long-term prospects that trade at reasonable valuations. An emphasis in stock selection is on companies able to generate significant free cash flow. The duo's U.S. equity portfolio has 30 names, making for a fairly concentrated portfolio.

The two managers continue to champion Cisco Systems Inc. The stock was one of the two managers' selections in the column March 2, 2006, when it traded at US\$21.06. In that column, Clements noted that he would not buy it over the US\$18 range, but would wait for a pullback. This stock, says Mendum, did fall below US\$18 and the two added to their position in it. It currently constitutes 3.5% of the

portfolio.

Recent additions to the portfolio include:

- Illinois Tool Works Inc. "This is a high quality company which generates significant free cash flow," Clements says.

The company has a market capitalization of US\$26.7-billion. Illinois Tool, based in Glenview, Ill., is a manufacturer of engineered products and specialist systems worldwide. Its products include fasteners, welding equipment and packaging equipment. It is the top or number two manufacturer in a number of its markets, Clements says.

Furthermore, Illinois Tool has higher profit margins than its rivals, "as its strategy is to focus on core customers and core products." It also produces the consumable items that go with the product, making for ongoing sales.

The consensus earnings per share estimate is US\$3 for 2006 and US\$3.30 for 2007. This puts the stock at roughly 14 times 2007 EPS estimates, "versus its historic P/E multiple of about 20 times." The stock has a dividend yield of 1.8%.

- Carnival Corp. This Miami-based cruise and travel company has 53% of the cruise market worldwide, Mendum says. Carnival has a total market cap of US\$40.9-billion.

It operates under a number of brands and in many parts of the globe. It is expanding capacity at "a measured pace."

Its business suffered last year, he says, with the hurricanes in the Caribbean and "the risk of further hurricanes is priced into the stock."

In the meantime, Carnival is benefiting from lower oil prices, which reduce both its own operating costs and increase consumers' disposable income.

The consensus EPS estimates are US\$2.73 for the fiscal year to November, 2006, US\$3.06 for fiscal 2007 and US\$3.58 for fiscal 2008. The company recently increased its dividend by 10%, Mendum says. The stock has a dividend yield of 2.3%.

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z Burlington Northern Santa Fe Corp. This major North American railway company, which is headquartered in Fort Worth, Tex., transports a wide range of commodities and products. The company has a market cap of US\$28.2-billion. The two managers bought this stock below US\$65 a share, and the stock has risen since.

"We think it offers good value below US\$70 a share," Clements says.

He likes North American railway companies. Over the past three years, the railways have been enjoying some pricing power. "This is the first time in almost a century, as there is no longer excess capacity in this industry. The stock is a play on the growth in international trade and it is also benefiting from the increase in thermal coal sold to power utilities," he says.

The consensus EPS estimate is US\$5.01 for 2006 and US\$5.70 for 2007. This puts the stock at a P/E multiple of 14 times 2007 estimates. The stock has a dividend yield of 1.3%.

The two managers took some profits in CVS Corp. Based in Woonsocket, R.I., this company operates a chain of drugstores. It offers pharmacy services and managed care drug programs. It also sells general merchandise.

"This is a core holding; we have held it for a while, but the stock had a good move and we considered it to be expensive," Clements says.

"We reduced our holding at US\$36 a share and at the time, the P/E multiple on the stock was 19 times 2007 estimates."

They have sold their holding in Tyco International Ltd. The company, which produces fire and safety equipment, health-care products, and electronics and telecommunications products, had its problems in the past. This resulted in a change at the top.

"The problem is that new management has not been that successful in growing the business," Clements says. There is a plan to break the company up into its four key segments, he says. "But this is unlikely to add to shareholder value and thereby boost the stock price."

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- Beutel, Goodman & Co. may hold positions in the securities mentioned.

SPOTLIGHT

BURLINGTON NORTHERN SANTA FE

Ticker: BNI/NYSE

Closing Price: US\$78.12

52-week range: US\$87.99 - US\$63.51

- - -

CARNIVAL CORP.

Ticker: CCL/NYSE

Closing Price: \$48.36

52-week range: US\$56.14 - US\$36.40

- - -

CISCO SYSTEMS

Ticker: CSCO/NASDAQ

Closing Price: US\$24.84

52-week range: US\$25.01 - US\$16.87

- - -

CVS CORP.

Ticker: CVS/NYSE

Closing Price: US\$29.93

52-week range: US\$36.14 - US\$26.06

- - -

ILLINOIS TOOL WORKS

Ticker: ITW/NYSE

Closing Price: US\$47.64

52-week range: US\$53.54 - US\$41.53

- - -

TYCO INTERNATIONAL

Ticker: TYC/NYSE

Closing Price: \$28.92

52-week range: US\$31.28 - US\$24.65