

National Post

Finding shine amid the tarnish

Thursday, August 16, 2007

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Section: Financial Post Investing

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Column: Buy & Sell

Source: Financial Post

Illustrations: Black & White Photo: Peter Redman, National Post File Photo / Gavin Ivory of Beutel, Goodman & Co. says when there are problems with a sector, investors tend to tarnish all the stocks within it.

Graphic/Diagram: / SPOTLIGHT.

The beleaguered financial services sector is providing select value opportunities, says global value manager Gavin Ivory, vice-president at Toronto-based Beutel, Goodman&Co.

"Investors recognize there are significant problems in the global credit market, but are unsure which companies are at risk, so are tarnishing the whole sector."

In this environment, it is possible to find quality names trading at attractively low valuations, he says.

Ivory and colleague Glenn Fortin are members of the global equity team at Beutel Goodman, which has assets under management of \$16-billion. This global team has been defensive for some time now. "The portfolio is significantly overweight consumer staples, health care and telecom services stocks," says Ivory. (The portfolio has 56 names.)

Fortin reports there are clear opportunities in more defensive areas of the market as well. For example, "in the consumer staples sector, there are top brand-name companies trading at valuations that are comfortably below historic levels."

In assessing a company, Beutel Goodman places considerable emphasis on its ability to generate sustainable free cash flow from operations less working capital needs and maintenance capital expenditure.

"We are particularly pleased to have companies with stable free cash flow in this challenging environment," Ivory says.

To qualify for inclusion in the portfolio, a stock must be capable of producing a total return of 50% during the following three years, Ivory says. The sell discipline is also rigorous. The team will sell one-third of the holding in the stock when it reaches the target price set for it. The stock is then re-evaluated and if the target price is not raised, the remainder of the holding is sold.

In the U.S. financial services sector, the global team recently bought American International Group Inc., which has "minimal exposure to the troubled areas of the global credit market," Ivory says.

New-York-based AIG, which has a market capitalization of US\$185-billion, is one of the largest property and casualty insurers in the United States

and a major provider of life insurance in the country.

The stock, he says, is also a play on emerging markets in that AIG has been operating in Asia, notably China, since 1919. In 2004-'05, AIG had its challenges with the securities regulators and the New York Attorney General, but it settled these matters, he notes. AIG brought in new senior management in 2005.

The stock currently represents good value, he says. It has historically traded at a P/E multiple of 17 times, yet the stock currently trades at about nine times forward earnings. On a stock price-to-book-value basis, the historic ratio is 2.5 times, yet the stock now trades at 1.5 times book value per share, he says. "The new management is committed to growing the company's dividend by 20% annually going forward. The current yield is 1.27%.

A U.S. stock that is classified as a technology company, though it could be construed as a financial services provider, that this duo likes: Western Union Co., which is the dominant player in the global money-transfer business. It has about 300,000 agencies in 200 countries and operates in 120 currencies.

The company has a market capitalization of almost US\$16-billion. The secular trend driving this business, says Fortin, is immigration patterns with people moving from lesser-developed countries to developed ones and sending money back to their families in their countries of origin.

"The company has a well-known brand and its extensive global network gives it a considerable edge over its competitors."

Western Union was spun out of First Data in late 2006 with a significant debt load. But it is an excellent cash flow generator. Over the past 12 months, it has recorded sales of US\$4.6-billion from which it has generated free cash of some US\$1.1-billion.

"This is a remarkable rate of conversion of sales into cash." Western Union can use this free cash to pay down its debt, buy back stock and/or raise its dividends, says Ivory. The stock trades at roughly 16 times 2008 EPS estimates.

A giant global consumer staples company that Ivory and Fortin recently added to the portfolio: Procter &

Gamble Co., which has a market capitalization of US\$205-billion.

Based in Cincinnati, Ohio, this company, says Fortin, "has a laundry list of top brands such as Tide, Gillette, Pampers and Crest."

It is, he says, highly skilled at managing and marketing its portfolio of brands and has 23 that generate revenues in excess of US\$1-billion. Its strategy is to introduce health-care and beauty products, which generally have a higher margin than food brands.

The company is a strong cash flow generator and has announced a sizeable share buyback program, he says. The stock trades at about 18 times EPS for the fiscal year to June, 2008. "This is not deep value, but this P/E multiple is low by historic standards and you are buying into a high-quality company," Fortin says.

The Beutel Goodman global team recently sold its holding in: Novo Nordisk A/S, which is a Danish pharmaceutical company specializing in diabetes treatments. The stock has an ADR on New York and trades under the ticker NVO. It was one of these managers' picks in the Buy & Sell column, July 19, 2006, when it traded at US\$61.60.

"This stock has shot up ahead of our expectations to provide us with a 50% gain and we recently sold it," Fortin says. "It is currently trading at 21 times 2007 EPS estimates and we think that it is overpriced."

Another recent sale from the portfolio: Cisco Systems Inc. Based in San Jose, Calif., this company is the leading supplier of networking equipment and network management for the Internet. "The stock has done well; it reached our target price of US\$32 a share and we sold it," Fortin says.

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

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