

Contrarian team bets on U.S. homebuilder

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Illustrations: Color Photo: Peter Redman, National Post / Gavin Ivory, vice-president, global equities at Beutel, Goodman, says there is now more value to be had among U.S. mid-cap stocks than large caps.

List: / SPOTLIGHT.

Value manager Gavin Ivory, vice-president, global equities, at Toronto-based Beutel, Goodman & Co., is finding opportunities in beaten-down areas such as U.S. homebuilders and global home-improvement retailers -- as well as in a fallen Canadian grocery chain.

Ivory, who manages a number of global mandates at Beutel Goodman, says there is now more value to be had in the mid-cap area of the U.S. equity market, where for almost two years it was the U.S. big caps that offered better relative value compared with their small-and mid-cap counterparts.

In its geographic exposure, the global portfolio has moved to an overweight position in U.S. stocks, says Ivory.

This manager and colleagues Glenn Fortin, KC Parker and Ehren Mendum are members of the global equity team at Beutel Goodman, which has \$16-billion under management.

Beutel Goodman uses a strict value discipline in managing all of its equity portfolios. An important consideration is a company's ability to generate free cash flow and then exercise strong discipline in spending that cash flow.

To qualify for inclusion in the portfolio, the stock must be capable of producing a total return of 50% during the next 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 rest of the holding is sold.

Recent additions to the team's global portfolios include:

- D.R. Horton Inc. Based in Fort Worth, Tex., this company is one of the largest homebuilders in the United States, operating in 27 states.

The Beutel Goodman global equity team followed this company for some time before buying in. "The valuation on the stock more than reflects the prospects of a long downturn in the U.S. housing market," Parker says.

The stock trades at just 0.8 times its book value per share. The company has a strong balance sheet and is

managing this downturn in the U.S. housing market well, he adds. D.R. Horton continues to sell its homes, albeit at lower prices, to generate cash flow and pay down its debt, he says. This company could also use its financial strength to purchase weaker rivals, he says.

- Kingfisher PLC. Based in the U.K., this company has 700 home-improvement stores in 11 countries across Europe and the U.K., where it has a 40% market share. Its geographic reach includes emerging economies such as Poland, Turkey, Taiwan and China.

Kingfisher operates its stores under a number of banners, including B & Q, Castorama and Brico Depot.

"It is the third-largest home improvement retailer globally," says Fortin.

The company is upgrading and refreshing its B & Q stores. "This is a long-term project so the benefits of the necessary capital expenditure are not evident in the short term," he says.

Like D.R. Horton, this company could be a consolidator in its sector, Fortin notes. The stock is trading at 0.8 times book value per share and 0.4 times sales, "which is cheap."

- Gardner Denver Inc. Based in Quincy, Ill., this company is a leading global manufacturer of compressors, pumps and blowers. Its global market niches include health care and the environment.

"The company is a consolidator in its niches," says Parker, in keeping with its strategy to growth through acquisitions. Gardner Denver has a strong balance sheet and generates a "consistently high return on capital." It also recently committed to returning some of its free cash flow to shareholders, he says.

The stock is "cheap." Its EV/ EBITDA is six times based on trailing numbers. It also has a cash flow yield of 7.5%.

Some of Beutel Goodman's global mandates allow for Canadian holdings and for these mandates, the global team has established a position in:

- Loblaw Cos. Ltd. This Toronto-based food distributor "represents compelling value at this stage in the context of leading food retailers globally,"

Ivory says. "It is a high-quality Canadian retailer which has made a number of missteps with its merchandising and distribution functions."

As well, he says, there is substantial additional competition in its market place, which has resulted in pressure on its profit margins. These margins "are unlikely to return to their previous levels."

The U.K. has already experienced this margin squeeze and the companies operating there have adjusted to lower profit margins, he says.

Loblaw's stock trades at 0.3 times sales, "reflecting the equity market's concerns about company's challenges." By contrast, U.K. companies that have successfully worked through the changed environment trade at almost one times sales, he says.

The global team sold their holding and took profits in global fast-food chain Mc-Donalds Corp. in early September. "The stock reached our target price of US\$54 and we considered it to be fully valued at that stage," Fortin says.

The team also sold its holding in SEGA SAMMY Holdings Ltd., which was one of its picks in the column of Dec. 28, 2006, when it traded at US\$6.70. This Japanese mid-cap company manufactures gaming equipment such as slot machines and video-game machines for commercial use.

"This sector in Japan is highly regulated and there was a recent regulatory change which adversely affects the fundamentals of the company," Ivory says.

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