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Bargains among battered financials

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Page: FP6

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Byline: Sonita Horvitch

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Illustrations: Color Photo: Tyler Anderson, National Post / Stephen Arpin, left, and Mark Thomson, managers of the Beutel Goodman Canadian Dividend Fund, say they are finding bargains in the hard-hit financial sector. ;

Value managers Stephen Arpin and Mark Thomson, partners at Toronto-based Beutel, Goodman & Co. Ltd., say that while the Canadian equity market had been registering new highs -- at least until yesterday -- the strength has been confined to a few stocks and to the energy sector.

At the same time, a number of key sectors have come under pressure and are trading at historically cheap valuations, they note.

"There is thus a bifurcation in the Canadian equity market, with some stocks at all-time highs and others that have been hard hit," says Thomson, director of research at the firm. He points to financials as a prime example of a sector that has been beaten back. "Although it has recovered from its lows in March, it still offers value."

Beutel Goodman, which has assets under management of \$16-billion, follows a strict value discipline. Arpin and Thomson have a range of responsibilities at the firm, including the Beutel Goodman Canadian Dividend Fund as well as other mandates for institutional investors.

The objective of the Beutel Goodman Dividend Fund, says Arpin, is to "achieve a balance between high dividend income and capital appreciation." The fund invests in blue-chip common stocks and to a lesser extent preferred shares, he notes. The portfolio has 28 names.

In assessing candidates for the fund, they pay attention to the dividend payout ratio at the target company. "This ratio is important as it shows how much money is being left in the company to grow the business and it also indicates the scope for future dividend increases," Arpin says.

Arpin and Thomson have been adding to their holdings of Canadian financial services stocks since the beginning of the year.

The two managers are selecting: - Manulife Financial Corp. This Toronto-based company provides a wide range of insurance and asset management services. It constitutes 6% of the portfolio. Thomson notes that Manulife has a significant international reach: 41% of its net income stems from the United States, 21% from Asia and the remaining 38% is from Canada.

"It is strong in all its product lines."

The company is generating a return on equity of 17%. It is trading at a price to book value per share of

2.3 times. The dividend payout ratio is 31%. The stock has a dividend yield of y%. - Great-West Lifeco Inc., which represents 4.3% of the portfolio. Based in Winnipeg, this major Canadian insurer, which also has significant operations in Europe and the United States, "is amongst the most profitable insurance companies in the world," Thomson says.

It has a strong balance sheet and is a significant free cash flow generator. The company has a return on equity of 21%. It is trading at a price to book value per share of 2.5 times and a payout ratio of 44%. The stock has a dividend yield of 4.1%.

They continue to champion: - Bank of Nova Scotia, which represents 5% of the portfolio. The stock was one of their selections in the column, Jan. 25, when it traded at \$46.75.

This bank, says Thomson, has the highest international exposure relative to its Canadian peers. It is well capitalized and has largely avoided the structured product problems that have afflicted other banks, he says.

The bank is generating a return on equity of 21%. It is trading at a price to book value of 2.6 times and its dividend payout ratio is 45%. The stock has a dividend yield of 4.3%.

Turning to energy, Arpin and Thomson are highlighting: - EnCana Corp. This Calgary-based natural gas and oil sands exploration and production company "has one of the most extensive inventories of prospects of any of its peers," Arpin says.

EnCana is one of the biggest natural gas producers in North America, with low finding and operational costs.

On the commodity price, the price of natural gas has significantly lagged that of oil, says Arpin, so there is the potential for further increases in the price of natural gas if oil remains at these lofty levels.

In May, 2008, the company announced a proposal to split its oil sands and gas operations. The gas operations will make up two-thirds of current production and proved reserves, while the oil sands company will consist of the company's oil sands assets in northern Alberta, its interest in two refineries in the United States, in addition to certain mature natural gas and oil projects in western Canada.

"This split," says Arpin, "should unlock significant

value as the two principal interests are significantly undervalued."

EnCana's estimated net asset value is \$120. The stock has a dividend yield of 1.8%. Finally, the two managers are selecting a Toronto-based Canadian drug/general merchandise retailing chain: - Shoppers Drug Mart Corp., "which is continuing to grow its operations and is securing higher profit margins by introducing more private label products and higher end merchandise into the mix," Arpin says.

The company is a strong free cash flow generator and has successfully used some of this to pay down its debt over the last number of years, he says. "It had a large debt load as the result of a leverage buyout deal which led to the subsequent listing of this stock."

This company has a dividend payout ratio of 30%. "It has been growing its dividend by 20% per annum over the past three years." The stock has a dividend yield of 1.6%.

Arpin and Thomson have trimmed and taken profits in their holding in Denver-based Molson Coors Canada Inc.

Their sell discipline is to review a stock when it reaches their target price. In the case of Molson Coors, it remains a top holding in the fund, says Arpen. "It is a stable business, management is successful at cost cutting."

For example, he says, the consolidation of Molson with Coors has generated US\$180-million in cost savings. Looking forward, the joint venture with London-based SABMiller PLC in the United States should produce extensive savings for both companies, he says.

shorvitch@nationalpost.com----- ---

SPOTLIGHT:

MANULIFE FINANCIAL CORP.

Ticker MFC/TSX

Close \$35.20, down 46¢

52-week range \$44.23-\$33.77

GREAT-WEST LIFECO INC.

Ticker GWO/TSX

Close \$28.54, down 62¢

52-week range \$37.67-\$27.46

BANK OF NOVA SCOTIA

Ticker BNS/TSX

Close \$45.86, down 81¢

52-week range \$53.50-\$42.00

ENCANA CORP.

Ticker ECA/TSX

Close \$91.17, down \$2.19

52-week range \$97.81-\$59.33

SHOPPERS DRUG MART CORP.

Ticker SC/TSX

Close \$55.19, down 70¢

52-week range \$58.23-\$46.63

MOLSON COORS CANADA INC.

Ticker TPXb/TSX

Close \$55.27, down 28¢

52-week range \$60.32-\$42.89