Reproduction without permission is illegal

Update Edition

THE INCOME INVESTOR

Volume 17, Number 5 **Issue #1905** **March 14, 2019**

IN THIS ISSUE

Dividend stocks are not bonds 1

Gordon Pape updates Northview REIT, Algonquin Power 3

Gavin Graham updates AltaGas Ltd. 4

Members' Corner: Model Portfolios 4

Editor and Publisher: Gordon Pape
Associate Publisher: Richard Croft
Associate Editor: Mike Keerma
Customer Service: Kendra Pape-Green, Terri Hooper

Copyright 2019 by Gordon Pape Enterprises Ltd.
All material in The Income Investor is copyright Gordon Pape Enterprises Ltd. and may not be reproduced in whole or in part in any form without written consent. All recommendations are based on information that is believed to be reliable. However, results are not guaranteed and the publishers and distributors of The Income Investor assume no liability whatsoever for any material losses that may occur. Readers are advised to consult a professional financial advisor before making any investment decisions. Contributors to The Income Investor and/or their companies or members of their families may hold and trade positions in securities mentioned in this newsletter. No compensation for recommending particular securities or financial advisors is solicited or accepted.
Reprint permissions: Contact customer service
Email: customer.service@buildingwealth.ca
Post: 16715-12 Yonge St. Suite 181, Newmarket, ON L3X 1X4

Next issue: March 28

Customer Service: 1-888-287-8229

DIVIDEND STOCKS ARE NOT BONDS

By Vitaliy Katsenelson, CFA

Like many professional investors, I love companies that pay dividends. Dividends bring tangible and intangible benefits: Over the last hundred years, half of total stock returns came from dividends.

In a world where earnings often represent the creative output of CFOs' imaginations, dividends are paid out of cash flows, and thus are proof that a company's earnings are real.

Finally, a company that pays out a significant dividend has to have much greater discipline in managing the business, because a significant dividend creates another cash cost, so management has less cash to burn in empire-building acquisitions.

Over the last decade, however, artificially low interest rates have turned dividends into a cult. If you own companies that pay dividends, then you are a "serious" investor. If dividends are not a centerpiece of your investment strategy, you are a heretic and need to apologetically explain why you don't pray in the high temple of dividends.

I completely understand why this cult has formed: Investors that used to rely on bonds for a constant flow of income are now forced to resort to dividend-paying companies.

The problem is that this cult creates the wrong incentives for leaders of publicly traded companies. If it is dividends investors want, then dividends they'll get. In recent years, companies started to game the system, squeezing out dividends even if it meant they had to borrow to pay for them.

The cult of dividends takes its toll

Take ExxonMobil for example. It's a very mature company whose oil production has declined nine out of the last ten quarters, and it is at the mercy of oil prices that have also been in decline. Despite all that, Exxon is putting on a brave face and raising its dividend every year. Never mind that it had to borrow money to pay the dividend in two out of the last four years.

I sympathize with ExxonMobil's management, who feel they have to do

Continued on page 2…

Dividend stocks – continued from page 1…

this because their growing dividend puts them into the exclusive club of "dividend aristocrats" – companies that have consistently raised dividends over the last 25 years. They run a mature, over-the-hill company with very erratic earnings that have not grown in ten years and that, based on its growth prospects, should not trade at its current 16 times earnings. ExxonMobil trades solely on being a dividend aristocrat.

It is assumed that a dividend that was raised for 25 years will continue to be raised (or at least maintained) for the next 25 years. That's not always true. General Electric, also a dividend aristocrat, raised its payout until the very end, when it cut it by half and then to a penny.

In a normal, semi-rational world, dividends should be a by-product of a thriving business; they should be a part of rational capital allocation by management. But low interest rates turned companies that pay dividends into a bond-like product, and now they must manufacture dividends, often at the expense of the future.

Let's take AT&T. Today, the company is saddled with $180 billion of debt, its DirecTV business is declining, and it is also losing its bread and butter post-paid wireless subscribers to competitors. It would be very rational for the company to divert the $13 billion it spends annually on dividends, using it to pay down debt, to de-risk the company and to increase the runway of its longevity. But the mere thought of a lowered or axed dividend would create an instant investor revolt, so AT&T will never lower its dividend, until, like GE, its external environment forces it to do so.

There is a very good reason why investors should be very careful in treating dividend-paying stocks as bond substitutes. Bonds are legally binding contracts, where interest payments and principal repayment are guaranteed by the company. If a company fails to make interest payments and/or repay principal at maturity, investors will put the company into bankruptcy. It is that simple.

When you start treating a stock as a bond substitute, you are making the mental assumption that the price you pay is what the stock is going to be worth at the time when you are done with it (when you sell it). Thus, your focus shifts to the shiny object you are destined to enjoy in the interim – the dividend. You begin to ignore that the price of that fine aristocrat might be less, perhaps a lot less, when you and the stampede of other aristocrat lovers will be selling it.

For the long period that interest rates declined not just in the U.S. but globally, you didn't have to worry about that. Dividend aristocrats have consistently outperformed the S&P 500 since 2008.

However, the bulk of the aristocrats' appreciation came from a single, unrepeatable, and highly reversible source: price to earnings expansion. If you are certain that interest rates are going lower, much lower, then you can stop reading this. Buy some aristocrats, and forget them, because they'll continue to behave like super-long-duration bonds with the added bonus of dividends that grow by a few pennies a year.

But if interest rates rise, as they did last year, the prices of dividend aristocrats are likely to act like those of long-term bonds. The price-to-earnings pendulum will swing in the opposite direction, wiping out a decade of gains.

Analyze management, not dividends

What should investors do? View dividends not as a magnetic, shiny object but as just one part in a multivariable analytical equation, and never the only variable in the equation. Value a company as if it did not pay a dividend – after all, a dividend is just a capital-allocation decision.

I know tens of billions of dollars have been destroyed by management's misallocation of capital, be it through share buybacks or bad acquisitions. But as corporate management continues trying to please dividend-hungry investors, value will also be destroyed when companies pay out more in dividends than they can afford.

This is why analyzing corporate management is so important. A lot of management teams will tell you the right thing. They'll sound smart and thoughtful, but their decisions will fail a very simple test. Here is the test: If this management owned 10% or 20% of the company, would they be making the same decisions?

Would GE, ExxonMobil, or AT&T have been run differently if they were run by CEOs who owned 10% or 20% of their respective stocks? It's safe to say they would have put their billions in dividend payments to a very different, more profitable use.

Vitaliy N. Katsenelson, CFA, is Chief Investment Officer at Investment Management Associates in Denver, Colorado (http://imausa.com). He is the author of Active Value Investing *and* The Little Book of Sideways Markets*, both published by John Wiley and Sons and translated into eight languages.* Forbes *magazine called him "The new Benjamin Graham." Subscribe to Vitaliy's new podcast on iPhone and Android or listen online at investor.fm, on my YouTube channel, or in your podcast app of your choice: Spotify, Stitcher, and SoundCloud.*

All Rights Reserved

Reproduction without permission is illegal

GORDON PAPE'S UPDATES

Note: Prices are as of the close on March 8.

Northview Apartment REIT (TSX: NVU.UN, OTC: NPRUF)

Type: Real estate investment trust
Price: C$28.67, US$21.40
Originally recommended: Nov. 22/04 at C$15.36
Annual payout: $1.63
Yield: 5.7%
Risk Rating: Moderate risk
Website: www.northviewreit.com

Comments: Northview's price moved sharply higher following the release of fourth-quarter and year-end results on Feb. 27.

The REIT reported an 11% increase in fourth-quarter revenue to just over $94 million. For the full year, revenue was up 10% to $364 million, compared to $331 million in 2017.

Net operating income (NOI) was $53.8 million in the quarter, up 13.4% from $47.4 million in the same period of the prior year. For all of 2018, NOI was $212.1 million, compared to $189.3 million the year before.

Funds from operations (FFO), one of the key components in assessing a REIT's financial health, was $32.2 million in the fourth quarter, an improvement of 10.4% from $29.1 million the prior year period. For the full year, FFO was $130.7 million ($2.11 per unit, fully diluted) compared to $118.6 million ($2.08 per unit) in 2018.

Occupancy rates continued to show improvement, reaching the best levels since 2013. The fourth-quarter rate was 93.9%, an improvement of 40 basis point (bps) compared to the previous quarter and 60 bps compared to the same period of 2017.

Ontario and Northern Canada remained strong at 97% and 96.8% respectively during the quarter. Western Canada occupancy was 88.2%, a 160 bps increase compared to the prior three months and a 170 bps increase compared to the same period of 2017.

Northview is one of Canada's largest publicly traded multi-family REITs with a portfolio of approximately 27,000 residential units and 1.2 million square feet of commercial space in over 60 markets across eight provinces and two territories.

The REIT originally had almost all its assets in Alberta and the Territories, but it has been aggressively extending its footprint to other parts of Canada in recent years. In December, Northview acquired a portfolio consisting of 644 units in six apartment properties in Ontario for $131.9 million with a weighted average cap rate of 4.2%. This acquisition expands Northview's presence in Ontario with opportunities to generate growth through identified high-end renovation units.

The price is up by $4.16 since the time of my last review in December, when I rated it a Buy. That's a big move for a REIT in such a short time. RBC Capital Markets has raised its price target on the units by $2, to $30.

Action now: Buy. The yield is down due to the price increase, but it is still attractive at the current level.

Algonquin Power and Utilities (TSX, NYSE: AQN)

Type: Common stock
Price: C$14.90, US$11.14
Originally recommended: July 18/16 at C$12.45, US$9.45
Annual payout: US$0.5128
Yield: 4.6%
Risk: Moderate risk
Website: www.apucorp.com

Comments: This utility's share price moved higher following the release of fourth-quarter and year-end results. The fourth quarter was a little soft, but the full year results showed significant gains in key areas.

Revenue for the year was over $1.64 billion, up 8% from $1.52 billion in 2017 (Algonquin reports in U.S. dollars). Adjusted net earnings were $312.2 million ($0.66 per share) compared to $225 million ($0.57 per share) the year before. That was a 16% improvement on a per share basis.

Algonquin, which is based in Oakville, Ontario, continues to expand both organically and by acquisition. In December, the company announced it is acquiring New Brunswick Gas from Enbridge for $331 million. The deal is expected to close some time this year after final regulatory approvals are obtained.

Subsequent to year-end, the company acquired a 9.8% ownership interest in a new electricity transmission project under development in Northwestern Ontario, the Wataynikaneyap Power Transmission Project.

The company has been raising capital to fund future acquisitions by issuing new equity. There were two such issues in 2018, for $444.4 million and $172.5 million. The new stock diluted existing shares, but the price has not

Continued on page 4…

All Rights Reserved

Reproduction without permission is illegal

Gordon Pape's updates – continued from page 3…

suffered, suggesting that investors feel management is deploying the money in an effective way. The stock pays a quarterly dividend of US$0.1282 (US$0.5128 per year). If there is to be a dividend increase this year (the company has raised its payout each year since 2011) look for an announcement in the second quarter.

Action now: Buy.

GAVIN GRAHAM'S UPDATES

AltaGas Ltd. (TSX: ALA, OTC: ATGFF)

Type: Common stock
Exchanges: TSX, OTC
Trading symbols: ALA, ATGFF
Price: $17.67, US$13.18
Originally recommended: Oct. 18/06 at $28.10
Annual payout: $0.96
Yield: 5.4%
Risk: Moderate risk
Recommended by: Gavin Graham
Website: www.altagas.com

Comments: Canadian energy company AltaGas has grown from an operator of mid-stream pipelines to a diversified utility with three divisions, consisting of power, gas, and pipelines. Its power stations are almost entirely run by clean sources of fuel such as hydro, wind, and natural gas. Its acquisition of Washington, D.C. utility WGL in early 2017 for $9.3 billion more than doubled the size of the company, but the size of the deal and the 18-month period to close the transaction at a time of rising interest rates led to stresses on its balance sheet. This resulted in the sale of several operations, the flotation of its Canadian utility business as AltaGas Canada in October, and a 56% cut in its dividend, to $0.96 a share from $2.19.

Understandably, this set of circumstances saw the share price under severe pressure. Quite apart from the $2.61 billion in new equity that AltaGas issued to fund the WGL deal, the high leverage that resulted and the sense that the company was being forced to sell assets saw the share price drop more than 50% from $28.45 as recently last July to $11.87 at the end of December. The share price has subsequently rebounded to $17.67, meaning the stock trades at a dividend yield of about 5.4%.

When I last reviewed the company in November, I noted that the yield of over 10% was indicating that investors were anticipating a dividend cut, which indeed materialized. I suggested those uncomfortable with the situation should consider switching to AltaGas Canada (TSX: ACI).

In January, AltaGas announced the sale of its remaining 55% interest in its B.C. hydro-electric facilities for $1.37 billion to Axium Infrastructure and Manulife Financial. The total raised from the sale of assets by AltaGas since closing the WGL acquisition last July 2018 is $3.8 billion. CEO Randy Crawford stated the company intends to sell an additional $1.5-$2 billion in targeted non-core assets in 2019 to further deleverage. AltaGas is left with its mid-stream assets in Alberta, B.C., and Pennsylvania, and gas and power operations in Alaska, Michigan, Maryland, Virginia, and Washington, D.C., with over 1.6 million customers. The expansion of its Northeastern B.C. operations continues with the Ridley Island Propane Export Terminal slated to come on stream in the first half of this year.

Action now: The WGL acquisition shows how risky it can be to make major deals rather than smaller accretive ones that complement existing operations. While AltaGas is a much larger and more diversified business than before the deal, it also has a lot more debt, the need to de-lever further through asset sales this year, and an investor base that is unhappy with the dividend cut. As with TransCanada when it cut its dividend 20 years ago, it will take a couple of years at least to rebuild credibility. Sell for a net loss of 43% after taking dividends into account.

MEMBERS' CORNER

Model portfolios

Member comment: In issue #1904 of Income Investor you are selling Inter Pipeline, saying that you were "not happy". Please tell me what you were unhappy about before I sell my position. – Vito L.

Response: Inter Pipeline was dropped from the RRIF Portfolio but is still on our Recommended List. I replaced it in the Portfolio with Pembina Pipeline, which has been a much steadier performer and is my number one pipeline pick at this time. Inter Pipeline is a quality company that is rated a Hold at present. Pembina is rated a Buy. We aim to include only top-rated securities in the portfolios. – G.P.

 All Rights Reserved