internet WEALTH builder

Vol. 28 No. 03
January 23, 2023

Editor and Publisher: Gordon Pape
Associate Publisher: Richard N. Croft

BEATING INFLATION

By Gordon Pape, Editor and Publisher

Inflation seems to be the only thing people are talking about these days.

Skyrocketing food prices. The cost of filling the gas tank. Rising mortgage costs. The list goes on. Even with the rate of inflation gradually declining, pocketbooks are hurting.

The Bank of Canada and other central banks are contributing to the problem by steadily increasing interest rates to dampen demand and slow the economy, to the point where the CPI will slip back towards the 2% target range. Rate hikes are a crude weapon because of the misery they inflict on businesses and individuals, but they seem to be the best weapon the central banks can wield in this situation.

Rising interest rates were the main contributor to the woes of the stock markets in 2022. Interest sensitive

Continued on page 2...

IN THIS ISSUE

Next issue Jan. 30

Inflation—continued from page 1...

securities like REITs, utilities, telecoms, and bonds all tumbled as rates marched steadily higher. Combined with the collapse of tech stocks as the stay-at-home pandemic economy dissipated, we ended up with all the major stock markets in the red and the Canadian bond market experiencing its worst loss in four decades.

But there were some inflation-beaters. These securities thrived in a rising price environment and are still doing well, although momentum is slowing. Here are some examples.

Fossil fuel companies. The price at the pumps has dropped in recent weeks as oil prices have eased, but the big producers are still making bucket loads of cash at current levels. We haven't seen year-end results from any of the major companies yet, but ExxonMobil reported nine-month 2022 profits of just under US$43 billion (US$10.17 per share) compared to US$14.2 billion (US$3.31 per share) in the same period last year. Year-end results are due Jan. 31.

It's the same story in Canada, albeit on a smaller scale. Canadian Natural Resources reported a nine-month adjusted profit of $10.7 billion ($9.20 per diluted share), up from $4.8 billion ($4.04 per share) the year before.

The TSX Capped Energy Index ended the year with a gain of 48.4% and many companies were well ahead of that including Enerplus (+79.2%), Cenovus Energy (+69.4%), and Tourmaline Oil (+67.3%). Oil service companies also did well – Precision Drilling shares gained 132.1% in 2022.

So far, 2023 is off to a positive start for the sector. As of Jan. 19, the S&P/TSX Capped Energy Index was ahead 2.09%. I don't expect this year's gains to be anywhere near as robust as those of 2022, but the energy sector should continue to be a source of profits for investors.

Food retailers. They have become the number one villain for shoppers and politicians. They claim the rising costs of everything from vegetables to milk is not their fault, but their profits keep rising nonetheless.

Loblaw Companies reported third quarter net earnings attributable to shareholders of $556 million, an increase of $125 million or 29% from last year. Diluted earnings per share were $1.69, an increase of $0.42, or 33.1%.

Empire Group, which owns Sobeys, Farm Boy, etc., reported second quarter 2023 profits (to Nov. 5) of $189.9 million ($0.73 a share), up from $175.4 million ($0.66 a share) in the previous year. That works out to a gain of 10.6% on a per share basis.

Metro Inc., which had a Sept. 24 year end, reported fiscal 2022 profits of $849.5 million ($3.51 per diluted share)

Continued on page 3...

Inflation—continued from page 2...

compared to $825.7 million ($3.33 per share) in the previous year. That was a gain of 5.4% on a per share basis.

Both Metro and Loblaw posted decent gains in their share price last year, of 11.4% and 15.5% respectively. Empire shares actually lost 7.5% in 2022. So far this year, Empire shares are marginally ahead while Loblaw and Metro have slipped slightly.

Looking at the overall picture, inflation has had a modestly positive impact on the food retailers but nothing as dramatic as we saw in the energy sector. Looking forward, public and political pressure will likely force these companies to maintain or even slightly reduce their already thin profit margins this year. Any profit increases will be modest, as will gains in the share price.

Gold. Here's a late comer to the inflation party. Gold is typically a refuge in inflationary times but rising interest rates put downward pressure on the metal. (Gold pays no interest so the higher rates rise, the greater the loss in potential interest for owners.) As a result, the S&P/TSX Global Gold Index was down 4.9% last year.

But as the tightening cycle appears to be nearing an end, or at least a pause, gold has regained its lustre and investors are buying. The price has moved to US$1,928 an ounce and the Global Gold Index is up 10.2% so far this month. A price of US$2,000 an ounce within the next few weeks is a real possibility.

My go-to stock in the gold sector is Franco-Nevada (TSX, NYSE: FNV), which I have owned for years. It's a royalty streaming company, which means it provides financing to other miners in exchange for a small percentage of the output. This means it bears no exploration, construction, or closing risks. Several other companies operate on this model, but I regard FNV as the preferred choice.

The stock touched a one-year low of $151.07 in September but the recent turnaround in the gold price has pushed it up quickly. It closed Friday at $196.67, up almost 30% from the September low.

Last week, the company announced a 6.25% increase in its quarterly dividend to US$0.34 a share (US$1.36 a year). The stock yields 0.9% at that price – not a lot but there is good upside potential in the share price if gold moves higher.

Results for the first nine months of 2022 showed adjusted net income of $532.7 million ($2.78 per share), up 5% from the year before. The company will release final 2022 results on March 15.

Follow Gordon Pape on Twitter @GPUpdates and on Facebook at www.facebook.com/GordonPapeMoney

RYAN IRVINE UPDATES THREE WINNERS

Hammond Power Solutions TSX: HPS.A

BUY

Originally recommended on Jan. 28/13 (#21304) at $8.60. Closed Friday at $23.99.

Background: Founded in 1917, Hammond Power designs and manufactures custom electrical engineered magnetics, standard electrical dry type, cast resin and liquid filled transformers. The company offers a wide range of transformers and unitized substations. It serves the oil and gas, mining, steel, waste and water treatment, solar, EV, and wind power-generation industries. Hammond Power has manufacturing plants in Canada, the United States, Mexico, and India.

Recent financials: Third quarter revenue rose 55.9% to $148.95 million from $95.53 million in 2021. Year-to-date sales increased 56.9% to $414.21 million compared to $263.93 million in 2021. Earnings jumped 192.1% to $11.53 million ($0.97 per share) from $3.95 million ($0.34 per share) in 2021. The improvement in earnings is a result of the increased sales and higher gross margin dollar contribution, partially offset by greater selling, distribution, general and administrative expenses, and additional foreign exchange losses.

Record high backlog: Hammond Power saw a significant order backlog increase of 141.3% over the quarter. The combination of price increases, a stronger U.S. dollar, market demand, and some delayed shipments due to material availability continue to contribute to the record high backlog. Bookings continue to increase across several market and geographical segments.

Conclusion: The positive momentum continued for Hammond Power despite the growing global challenges around the business. During 2021, the company implemented four price increases, which were necessary to offset rapidly increasing costs in commodities (copper, aluminum, and electrical steel), freight, and other components critical to manufacturing transformers.

The company began to see the effect of those increases in the first quarter of 2022 and continued to see the impact through the second and third quarters.

Continued on page 5...

Hammond Power—continued from page 4...

That was a significant contributor to the increased sales values over the prior year. The company also implemented two more price increases in 2022. The cost increases were mainly the result of continued supply chain constraints. There have been improvements in material availability in the current quarter, allowing higher volumes to be shipped to customers.

Valuation: On a trailing basis (over the last 12 months) Hammond Power trades at low valuations despite a significant rise in its share price. The company holds a trailing p/e of 8.34, EV/Adj. EBITDA of 3.21, and a P/FFO of 4.66 with strong growth and backlog.

We expect strong numbers to continue near term given the backlog and as price increases continue to take hold. Again, valuations are low and with Hammond Power poised to produce in the range of $3 in EPS for 2022, one could argue the business remains undervalued. Based on an eight times EPS multiple, fair value is likely in the range of $24.

The risks include the potential of its customers building inventory temporarily due to global supply chain fears and the potential of a North American recession. We will continue to evaluate the business outlook into 2023, which will produce difficult comparables to last year.

Action now: We maintain our Buy rating on the stock near term as it approaches fair value.

YOUR QUESTIONS Meme stocks

Q – In a recent article, there were references to meme stocks. I don't have a clue what that term means. What is a meme stock? – Jane R.

A – A meme stock is one that becomes popular with retail investors through social media. They become the topic of on-line discussion groups, who sometimes use their collective buying power to purchase shares in a company to drive up the price. The results can be astounding. On Jan. 27, 2020, shares in GameStop (NYSE: GME) reached a high of US$86.88, up 134% from the day before. The company wasn't worth anything like that, either from a financial or business perspective. Needless to say, the inflated price didn't last long. Investors took profits and the shares plunged. By year-end, they were down to US$4.82.

We still see periodic social media activity around GameStop and other meme stocks. GME traded as high as US$49.85 in 2022. As I write, it's at US$21.80. I don't recommend GME or any other meme stock but some young investors love playing them, as if they were video games. The US Securities and Exchange Commission has investigated but took no action, beyond issuing a report. – G.P.

Polaris Infrastructure Inc. TSX: PIF

BUY

Originally recommended on Sept. 9/19 (#21932) at $13.50. Closed Friday at $14.64.

Background: Polaris is a renewable power producer with a focus on Latin America. The company's operations are in five Latin American countries and include a geothermal plant (about 72 MW), four run-of-river hydroelectric plants (33 MW), one solar (photovoltaic) project in operation (25 MW), and two solar projects with an expected total capacity of approximately 10 MW, currently under construction. PIF's largest asset is the San Jacinto geothermal facility in Nicaragua.

Recent financials: Third quarter revenue was $14.5 million (including $0.4 million from the sale of carbon credits), compared to $14.8 million in the same period in 2021. Adjusted EBITDA was $10 million, compared to $10.9 million. Note that the company reports in US dollars.

Results were negatively impacted by planned major maintenance performed in Nicaragua and Peru, as well as lower hydrology in Peru due to dry weather conditions. The lower power production was partially offset by contributions from the solar project in the Dominican Republic (acquired in June) and the hydroelectric project in Ecuador (acquired in September).

Balance sheet: PIF ended the quarter with total debt of $189.1 million and cash of $36.8 million (net debt of $152.3 million). The net debt-to-EBITDA is 3.4 times based on the trailing 12 month adjusted EBITDA of $44.3 million and 2.5 times based on the expected 2023 adjusted EBITDA of $62 million.

Valuation: PIF currently trades at an enterprise value of approximately six times based on the midpoint of forecasted 2023 adjusted EBITDA ($62 million). This is approximately half the EV/EBITDA valuation of most renewable power producers listed on North American exchanges.

We estimate operating cash flow in the range of approximately $1.80 per share (C$2.33 at 0.78 US/CAN exchange rate). We are adjusting our fair value assessment to $21 per share, which implies a justified EV/EBITDA of eight times and a justified price/cash flow multiple of nine times, based on our estimates for next year. These valuation multiples continue to reflect a significant discount to the renewable power peer group.

Conclusion: We see an attractive opportunity in PIF at the current price and valuation. Our investment thesis is

Continued on page 8...

Firan Technology TSX: FTG, OTC: FTGFF

BUY

Originally recommended on Nov. 7/15 (#21540) at C$2.11, US$1.77. Closed Friday at C$2.40, US$1.73.

Background: Firan (FTG) is an aerospace and defense electronics product and subsystem supplier to customers around the globe. FTG has two operating units. FTG Circuits is a manufacturer of high technology, high reliability printed circuit boards. Customers are leaders in the aviation, defense, and high technology industries. FTG Circuits has operations in Toronto, Ontario, Chatsworth, California, Fredericksburg, Virginia, and a joint venture in Tianjin, China.

FTG Aerospace manufactures and repairs illuminated cockpit panels, keyboards and sub-assemblies for original equipment manufacturers of aerospace and defense equipment. FTG Aerospace has operations in Toronto, Ontario, Chatsworth, California, and Tianjin, China.

Recent financials: Third quarter revenues jumped 17% from $19.7 million to $23.1 million, as the market conditions for aerospace and defense electronics have improved considerably since last year. Trailing twelve month (TTM) earnings before interest, tax, depreciation, and amortization (EBITDA) was $8.5 million, of which $2.8 million was generated in the quarter.

Backlog: Total backlog as of the end of the third quarter was $55.8 million, up 57% from 2021 and up from $49.6 million as of the end of the previous quarter.

Discussion: The company played defense during nearly a complete two-year shutdown in activity in the midst of the global pandemic in its aerospace business. Firan cut costs, wisely took advantage of government subsidies, pulled back on growth spending, and significantly improved its balance sheet position. Today, with its defense business continuing to show strength and aerospace showing signs of a recovery, the company appears poised to return to growth, barring a significant recession.

The company entered the fourth quarter of 2022 with a backlog of $55.8 million, which is the highest value since before the pandemic. With the two acquisitions announced since our last update, Firan has moved quickly to execute on allocating capital to produce what should prove to be solidly accretive acquisitions over time.

While Firan does not provide guidance, we estimate that the company is positioned to post 2022 revenues in the low to mid $90 million range with

Continued on page 8...

Firan—continued from page 7...

EBITDA margins of 8-9% improving throughout the year to the point where the company is in the 10% range heading into 2023.

On an EV/EBITDA basis, the company's multiple is 7.16, which is well below its 10-year high of about 15 reached in 2017. The company's trailing price to cash flow is 9.48, which should improve into 2023.

In our last update, we stated Firan's near-term fair value was in the range of $2.50. The company has hit this range. With Firan's recent acquisitions (if completed), we expect normalized annual growth to be in the range of 40-50%. Management has not commented on near-term integration costs, but we expect some initial one-time integration expenses and efficiencies to begin to bear fruit in the second half of 2024 and beyond if execution is solid.

There is an upside. As the aerospace industry recovers, the company will add to factory throughput and gain efficiencies. This will produce better profitability. Foreign exchange (strong US dollar) remains in Firan's favour.

Fair value near-term is suspended pending guidance from management on the accretion from the Holaday acquisition, but we like the recovery story of Firan over the next 1-3 years if the North American economy does not enter a very significant recession. We expect growth to continue into 2023, but a significant recession does present risk mid-term.

In our last update, we stated that long-term the $1.50-$2.00 range should mark lows for the stock and readers have had an opportunity to buy initial positions in that range. Filling a full position or initiating a new half position in the current range with a long-term outlook is prudent at present. If we look 18-36 months forward with a recovery in aerospace, the company should be able to drive its share price back to the $3.00-$3.50 range.

Action now: Buy.

Polaris—continued from page 6...

based on continued stable cash flow from existing operations and a gradual narrowing of the valuation discount between PIF and the renewable peer group as the company continues to advance its growth and diversification strategy. The company made significant progress on its strategy in 2022 and we expect to see the benefits of these investments in 2023.

Action now: We are maintaining coverage on Polaris Renewable Power (PIF) with a rating of Buy.

GORDON PAPE'S UPDATES

Recommendations are colour-coded:
Green indicates Buy
Yellow indicates Hold
Red indicates Sell

ARK Innovation ETF NYSE: ARKK

HOLD

Originally recommended on Feb. 22/21 (#22108) at $151.73. Closed Friday at $36.50. (All figures in US dollars.)

Background: This is a disruptive technology ETF under the direction of high-profile manager Catherine Wood.

Performance: What can I say? This fund has been a terrible disappointment. Ms. Wood was flying high through the early years of the pandemic and tech stocks soared to the stratosphere. But when society reopened, those stocks collectively plunged. The units are now down to $36.50.

Key metrics: The fund was launched on Oct. 31, 2014. When we last reviewed the fund in last April it had almost $12.5 billion in assets under management. That's now down to $7.5 billion. The expense ratio is a hefty 0.75%.

Portfolio: Top holdings include Exact Sciences Corp. (9.74%), which has staged a strong rebound recently; Zoom Video Communications (8.51%), which despite seemingly used by everyone is still trending down; and Tesla (6.95%), which Elon Musk seems determined to destroy, even though it's his own creation. The stock is down about 66% from its one-year high.

Other large positions (4%+) include Roku Inc., Block Inc., Uipath Inc., Shopify, Teledoc Health, and Coinbase Global.

Outlook: Most of the major holdings are sound companies but it's going to take a long time (if ever) for them to come anywhere near their pandemic highs. If you want to hold on until then, settle in for the long haul. That said, the portfolio has more upside than downside at this point, although a recession could result in some short-term losses.

Action now: Hold. If you've hung in for this long, you may as well wait it out.

BMO Clean Energy Index ETF TSX: ZCLN

BUY

Originally recommended on Sept. 12/22 (#22233) at $23. Closed Friday at $21.13.

Background: This fund invests in companies that are involved in the production of clean energy, such as solar, wind, and hydro. Its benchmark is the S&P 500 Global Clean Energy Index, which includes small-, mid-, and large-cap companies in developed and emerging markets. The fund is passively managed.

Performance: After dropping below $19, the fund (and the clean energy sector) has staged a modest rally in recent weeks, although the market price is still down from the original recommendation.

Key metrics: The fund was launched in January 2021, so we only have a brief history, which doesn't tell us a lot. The one-year return to the end of December was -1.7%. The fund has about $86.5 million in assets under management, which is down from $118 million at the time of our original recommendation. The management expense ratio (MER) is 0.4%.

Portfolio: There are 97 holdings in the portfolio. The largest position (7.47% of the portfolio) is in Denmark's Vestas Wind Systems, which has been performing well recently after experiencing a deep slump last fall. US solar power firm Emphase Energy, which was the largest holding at the time of the original recommendation, has had its position cut back to 6.96%. The stock has been in a steep decline since November.

Other major holdings are Spanish-based Imberdrola SA, Consolidated Edison, Solaredge Technologies, and First Solar. This portfolio is quite different from the one we looked at last September, an indication of the volatility in the clean energy business. About one-third of the assets are in the US. There are 98 stocks in the portfolio, none of which appear to be hydrocarbon companies.

In terms of sector breakdowns, 26.8% is in electric utilities, 16.48% in semiconductor equipment, and 14.97% in renewable electricity.

Distributions: Payments are made annually and are small. The total for 2022 was $0.19 per unit.

Tax implications: Based on 2021, most of the distribution is treated as foreign income, which is fully taxable if the units are held in a non-registered account.

Risks: Investors seem to be leery about the immediate prospects for green energy and the sector has underperformed, although we've seen some encouraging signs recently. BMO gives this ETF a risk rating of High.

Summary: This is a decent choice for investors who want to put their money to

Continued on page 11…

iShares Global Agricultural Index ETF TSX: COW

BUY

Originally recommended on Sept. 12/22 (#22233) at $39.08. Closed Friday at $70.03.

Background: This is a global ETF that invests in companies involved in the production of agricultural products, fertilizers, agricultural chemicals, farm machinery, and packaged foods and meats.

Performance: The fund was originally recommended in September as one of three that I felt were overlooked and offered good promise for the future. The others were ZCLN, reviewed above, and the BMO Global Infrastructure Index ETF (TSX: ZGI). All three have broken even or posted small losses since then, which is not bad considering the state of the markets.

Key metrics: The ETF was launched in late 2007, so we have 15 years of history to work with. In recent years, it has only been in the red once, a decline of 13.7% in 2018. Otherwise, calendar year returns since 2017 have been in double-digits. In 2022, the ETF gained 12.47%, an excellent return in a weak market. The fund has $507 million in assets under management and an MER of 0.71%.

Portfolio: The fund holds 36 positions. The top spot at 9.33% is Archer-Daniels-Midland, which is a recommendation of this newsletter. Other large holdings are agriscience company Corteva at 9.05% and fertilizer producer Mosaic (7.53%).

Distributions: The fund makes semi-annual distributions. Last year, investors received about $1.40 per unit.

Tax implications: They vary from year to year, but in 2021 most of the payment was classified as capital gains for tax purposes.

Risks: Market risks need to be considered and the price for potash and other fertilizers will impact some companies in the portfolio. BlackRock Canada assigns a medium risk rating to the fund.

Summary: The world will always need food and this fund has positions in many of the leading companies in the industry. This ETF has an average annual compound rate of return of just over 13% over the past decade, which is very impressive.

Action now: Buy. This is a high-quality ETF, suitable for most portfolios.

ZCLN—continued from page 10...

work in support of green energy and who are willing to accept the risks involved.

Action now: The fund is a buy for those who wish to support industries working to slow climate change. For everyone else, there are better options.