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The Best - and Worst - Canadian Stocks Now

by **Roger S. Conrad**

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CANADIAN STOCKS HAVE underperformed this year, weighed down by a litany of challenges: oil and gas pipeline bottlenecks that have depressed price realizations for producers; a finance minister intent on squelching speculation in the real estate market; increasing competition for investment capital from the surging US market; and a worrisome wave of dividend cuts among former royalty trusts.

The Canadian dollar's recent weakness has magnified the damage to US investors' portfolios. The loony fetched a slight premium to the US dollar at the beginning of 2013, but the Canadian dollar subsequently slipped below parity and continues to trade at a discount. This discount persisted even after Statistics Canada announced that the country's gross domestic product expanded at a faster-than-expected rate in February 2013.

Fluctuations in the exchange rate have a corresponding impact on the US dollar value of Canadian shares and dividends. In the nine years that I ran Canadian Edge, the loony's value has fluctuated, peaking at USD1.10 and bottoming at USD0.72.

Odds are that Canada's resource wealth, superior fiscal health, sound banking system and conservative financial policies eventually will restore the loony's multiyear uptrend; getting paid in Canadian dollars is still a major incentive for US-based investors.

The long-term case for buying Canadian stocks also remains intact, especially for income-seeking investors. The launch of a new generation of royalty trusts–including Focus List holding Twin Butte Energy (TSX: TBE, OTC: TBTEF)–is a clear sign that dividend-paying culture is as strong as ever north of the border.

Canadian corporations' financial policies also remain conservative relative to their US counterparts. The majority of companies that I will cover in Energy & Income Advisor and the forthcoming generalist advisory Capitalist Times have no debt maturities between now and the end of 2014, providing ample protection against any disruptions to the capital markets.

Structural trends are also supportive, especially in the energy patch

Huge resource development projects in the oil sands and elsewhere continue to move forward, supported by deep-pocketed operators that can afford to take the long view. Meanwhile, massive investments in infrastructure will build the logistics needed to deliver oil, natural gas and other resources to international markets, especially Asia. Even renewable-energy companies have fared reasonably well, bolstered by government support for harvesting wind and solar power.

The fate of TransCanada Corp's (TSX: TRP, NYSE: TRP) controversial Keystone XL pipeline still hangs in limbo as US regulators decide whether to approve the project. Regardless of whether the pipeline receives the go-ahead, Canada's oil will flow–if not to the US, then to Asia and Europe. With the money in place to develop the oil sands, the necessary logistics to transport this hydrocarbon to end-users will be built.

Given the well-publicized uncertainty surrounding Keystone XL, shares of companies that stand to benefit from the development of Western Canada's vast oil sands. **Cenovus Energy (TSX: CVE, NYSE: CVE)** remains our top pick for investors seeking exposure to this long-term growth trend. The integrated Canadian oil company posted solid first-quarter results and remains on track to achieve its ambitious, long-term production goals.

Buy Cenovus Energy up to USD40 per share.

However, investors looking for Cenovus Energy and other names leveraged to Canada's oil sands to deliver live up to their full potential will need to be patient. Concerns about the prices Canadian energy producers will receive for their oil and gas volumes this year are well-founded; insufficient takeaway capacity continues to depress local crude-oil prices relative to West Texas Intermediate (WTI) and other varietals. A recent rash of dividend cuts among indebted former trusts seeking to strengthen their balance sheets will also weigh on the sector.

Daunting Differentials

Western Canada Select (WCS), a heavy-sour crude-oil blend produced primarily in Alberta and delivered to Port Hardisty for export, traditionally has traded at a discount to West Texas Intermediate (WTI), the light-sweet varietal that trades primarily at the hub in Cushing, Okla., and underpins futures contracts traded on the New York Mercantile Exchange. Denser and more viscous than light crude oil, heavy varietals require additional processing to refine them into usable products such as gasoline and diesel.

The price spread between WTI and WCS has averaged USD16 per barrel since 2008. But in fall 2012 and early 2013, this differential widened considerably, peaking at USD42.50 per barrel on Dec. 14, 2012.

This anomaly reflected temporary midstream and downstream capacity outages, not a durable trend.

In late October and early November, TransCanada reduced throughput on its Keystone pipeline, which transports oil from western Canada to Illinois, to investigate whether the system had sprung a leak. Fellow midstream operator Enbridge (TSX: ENB, NYSE: ENB) likewise announced that an excess of demand had forced the firm to ration capacity on one of its pipelines that stretches from western Canada to the Midwest.

Meanwhile, BP (LSE: BP, NYSE: BP) curtailed operations at its refinery in Whiting, Ind., for maintenance and repairs prior to a planned expansion of the facility that will come onstream in mid-2013. Designed to process lower-quality grades of crude oil, this facility refines large volumes of imported WCS.

Pipeline bottlenecks and reduced throughput at Whiting will ensure that the differential between the price of WCS and WTI remains elevated in the near term. However, this spread should continue tighten in 2013, when BP's upgraded Whiting facility comes onstream and Marathon Petroleum Corp (NYSE: MPC) completes an expansion to its refinery outside Detroit.

With downstream operators in the Midwest expected to expand their capacity to process heavy-sour crude significantly in the next few years, the price of WCS should recover from its swoon.

In the meantime, many Canadian oil producers posted disappointing fourth-quarter results because of depressed price realizations on their output. However, with key basis differentials improving, the handful of upstream operators that have reported first-quarter results sounded an encouraging note.

PetroBakken Energy (TSX: PBN, OTC: PBKEF)

Like Focus List holding **Crescent Point Energy Corp (TSX: CPG, OTC: CSCTF)**, PetroBakken Energy's production mix is weighted heavily toward light oil.

Since its hype-fueled spin out from Petrobank Energy and Resources (TSX: PBG, OTC: PBGEF) in late 2009, the stock has frustrated investors who were excited by the promise of an above-average yield and accelerating development of the Canadian portion of the Bakken Shale.

However, PetroBakken Energy hasn't lived up to these lofty expectations, with the shares giving up almost three-quarters of their value since the initial public offering (IPO).

This downtrend has accelerated of late, with the stock down almost 20 percent year to date and 40 percent over the past 12 months.

PetroBakken Energy's disappointing performance in the first year after its IPO reflects the company's failure to deliver on its ambitious production goals. However, the stock's recent decline stemmed from a wave of Petrobank Energy and Resources shareholders cashing out shares they received as part of the divestiture.

There's no way to know how long this selling pressure will persist. That being said, several insiders that already hold significant positions in PetroBakken Energy have added aggressively to their holdings since the start of the year.

We don't need to speculate about PetroBakken Energy's first-quarter results, which largely met management's expectations. The company grew its hydrocarbon output by 4 percent sequentially, while funds from operations (FFO) increased by 5 percent, to CAD0.92 per share. This strong performance translated into a payout ratio of 26 percent.

Although PetroBakken Energy posted solid results in the Bakken Shale, the company sank more wells in the oil-bearing Cardium formation of western Alberta–a play that drove growth in the firm's hydrocarbon output.

At the end of the first quarter, the company had drawn CAD1.1 billion of its CAD1.4 billion credit facility, which the firm in April increased to CAD1.5 billion with the same interest rates and covenants.

The company's debt-to-annualized cash flow ratio is about 3.2, well above that of most dividend-paying exploration and production companies and one of the reasons the stock remains cheap. Investors are concerned that this leverage will threaten the dividend if energy prices drop sharply. PetroBakken Energy will need to grow production consistently to reduce its debt burden.

To this end, recent developments have been encouraging. This year's spring breakup, the annual thaw that forces Canada's oil and gas industry to idle production, has proved less disruptive and should result in higher second-quarter output relative to year-ago levels. PetroBakken Energy has spent about half of its planned capital expenditures for this year, while shipping crude oil by rail has helped to shrink price differentials in the first quarter, boosting netbacks by 5 percent sequentially.

Yielding more than 11 percent, shares of PetroBakken Energy have priced in a potential dividend cut. Nevertheless, 12 of 22 analysts who cover the stock rate it a buy and only two have a sell rating on the shares. This positive outlook is based on the bounty that the company has in the ground.

A more aggressive play than Crescent Point Energy, PetroBakken Energy rates a buy up to USD10.00 per share for investors who can tolerate the diminished but real risk of a reduced dividend.

Vermilion Energy (TSX: VET, NYSE: VET)

Vermilion Energy yields 4.7 percent at the stock's current quote and should have no problem maintaining its monthly payout, thanks to a favorable production mix and favorable price realizations.

The upstream operator sold about 40 percent of its first-quarter oil volumes at prices linked to Brent crude oil, an international benchmark that reflects global supply and demand conditions. Brent crude oil has commanded a significant premium to the sweet blended varietals priced at the hub in Edmonton, though this spread has narrowed in recent months.

High-netback natural gas marketed in Europe also accounted for about 18 percent of Vermilion Energy's total production in the first quarter, including volumes sold in the Netherlands at more than CAD10.00 per thousand cubic feet.

With overall hydrocarbon output up 7 percent year over year and superior price realizations, Vermilion Energy grew its first-quarter FFO by 15 percent from year-ago levels. Management reiterated its goal of growing oil-equivalent production volumes by 30 percent and cash flow by 40 percent between now and 2015. The Corrib project offshore Ireland, which is slated to come onstream in late 2014, will account for much of this growth.

Vermilion Energy rates a buy up to USD52.00 per share for investors seeking a monthly income stream.

ARC Resources (TSX: ARX, OTC: AETUF)

ARC Resources managed to grow its first-quarter FFO by 12 percent from year-ago levels and lowered its payout ratio to 46 percent–an impressive feat in a challenging environment for commodity prices. The company also reduced its net debt outstanding by 13.8 percent over this three-month period, while expanding its capital expenditures by 24.3 percent.

On a year-over-year basis, the company increased its first-quarter hydrocarbon production by about half a percentage point, as higher volumes of crude oil and natural gas liquids (NGL) offset declining condensate and natural-gas output. Average price realizations ticked up 3.5 percent from year-ago levels, fueled by a 26 percent upsurge in natural-gas prices that made up for weaker oil and NGL prices.

The bottom line also benefited from efforts to control operating expenses, which dipped to CAD8.70 per barrel of oil equivalent.

Natural gas accounts for more than 60 percent of ARC Resources' energy-equivalent production, providing ample leverage to the recent recovery in North American natural-gas prices. Declining exports of Canadian natural gas to the US–a product of the shale oil and gas revolution south of the border–will remain a headwind, but ARC Resources has taken advantage of the uptick in gas prices to pad its hedge book.

Beginning on May 31, ARC Resources will offer US and Canadian investors the option of receiving their dividends in the form of stock instead of a cash disbursement, making the shares a better vehicle for long-term savers.

Yielding 4.5 percent at the current quote, shares of ARC Resources rate a buy up to USD26.00.

TransForce (TSX: TFI, OTC: TFIFF)

Shares of TransForce, a Canada-based provider of transportation and logistics services, have slipped below my buy target of USD20.00 after peaking at more than USD23.00 in early February.

Excluding fuel charges passed through to customers, the company's first-quarter revenue slipped by 5.2 percent from year-ago levels, despite positive contributions from acquisitions. But cash flow margin was steady, and earnings, adjusted for one-time items, were actually higher by 4 percent.

TransForce operates several divisions, which has helped to offset slackening demand for rig relocation and other energy-related services that in 2012 accounted for 21 percent of the company's revenue.

Much of this weakness stems from a precipitous decline in the number of rigs actively drilling for oil and gas in Canadian energy plays–a product of declining price realizations, increasing efficiency in unconventional basins and producers' unwillingness to outspend shrinking cash flows.

Against this backdrop, the company's specialized services segment saw its first-quarter revenue drop by 23.7 percent from year-ago levels and its margins contracted to 3.6 percent from 12.5 percent. Operating profits within the division plummeted by 77.9 percent. Management expects this headwind to continue throughout 2013, with revenue from the rig relocation business expected decline to about CAD20 million this year from about CAD50 million last year.

The company has moved aggressively to stem these losses, shutting two of its five terminals in this business line, selling equipment and reducing its exposure in the US.

Improvement in TransForce's other operating segments helped to offset some of weakness in its energy-related business lines. The package and courier division, for example, grew its net income by 23.7 percent, while the less-than-truckload segment doubled its earnings and dramatically bolstered its margin.

And even as TransForce pares back its energy logistics business, the company is pursuing other growth opportunities, including a joint venture with Amazon.com (NSDQ: AMZN) that stands to benefit from the expansion of e-commerce. Moreover, the company expects to grow earnings per share by a decent magnitude this year, thanks to cost efficiencies, debt reduction and stock buybacks.

Yielding 2.6 percent, shares of TransForce rate a buy up to USD20.00.

Newalta Corp (TSX: NAL, OTC: NWLTF)

Newalta Corp provides a wide range of environmental services, including the processing of waste products from oil-field operations and the sale of recovered hydrocarbon volumes.

The company's first-quarter revenue ticked up about 3 percent from year-ago levels, but gross profit as a percentage of revenue, dropped to 22 percent from 26 percent. Per share funds from operations tumbled by 38 percent, elevating the company's payout ratio (excluding capital expenditures) to 23.5 percent. In total, Newalta's capital expenditures and dividends amounted to about 110 percent of cash flow–roughly even with the first three months of 2012.

These results reflected ongoing weakness in commodity prices that carried over from the end of last year, weighing on revenue from the sale of recycled products and reducing drilling activity. Nevertheless, Newalta's expansion of its US operations led to an increase in overall sales.

Management's view that continued expansion on the top line would flow to the bottom line was behind the decision to boost dividends by 10 percent. And although business conditions have deteriorated, Newalta still allocated CAD16.9 million in growth capital during the quarter.

The company's guidance calls for major projects in the oil sands and its US endeavors to lift cash flow by "at least 20 percent" from last year. Whereas smaller Canadian producers are curtailing activity to bring capital expenditures in line with cash flow, oil sands projects are largely the province of well-capitalized major oil companies–names that can afford to take the long view and forge ahead despite unfavorable basis differentials.

Newalta is in prime position to benefit from this expansion. And the company continues to develop other opportunities, including last month's buyout of Bioteq Environmental Tech's (TSX: BQE) stake in a mobile industrial wastewater treatment plant.

Newalta continues to post solid earnings growth and build its franchise in a less-than-ideal operating environment; the stock rates a buy up to USD15.00 per share for aggressive investors who don't own a position already.

AltaGas (TSX: ALA, OTC: ATGFF)

Canadian companies that own pipelines and other midstream infrastructure–capacity on which is allocated to customers under long-term, fee-based contracts–have been largely unaffected by the decline in commodity prices. In fact, widening basis differentials reflect the huge growth opportunity for companies that own and operate energy infrastructure: Much of the local weakness in oil and gas prices reflects a critical shortage midstream capacity.

AltaGas is a diversified energy company that owns and operates a gas-distribution business (28 percent of 2012 revenue), power-generation assets (14 percent) and midstream infrastructure capable of handling 2 billion cubic feet per day of natural gas (58 percent of 2012 revenue).

In the first quarter, AltaGas posted normalized net income of CAD0.53 per share–up 17.8 percent from a year ago–while FFO surged 40 percent to CAD1.16 per share, enabling the company to boost its monthly dividend by 4.2 percent. With a payout ratio of 32.3 percent after this payout hike, AltaGas is a solid bet for investors seeking a reliable, monthly income stream.

All three of the company's operating segments benefited from acquisitions, the biggest of which was last year's purchase of natural-gas distribution assets in Alaska and Michigan. AltaGas also added biomass- and gas-fired power plants.

More recently, the company has inked a joint venture with Idemitsu Kosan (Tokyo: 5019, OTC: IDKOY) to export liquefied natural gas and liquefied petroleum gas to Asia and acquired a 507-megawatt gas-fired power plant in California with an adjoining transmission line. Management expects the latter deal to be accretive to FFO in 2014, the first full year after the transaction closes.

Meanwhile, all of AltaGas' ongoing construction projects appear to be on schedule and on budget. These growth initiatives are supported by an extremely low cost of capital.

Not only have the company's recent acquisitions and slate of organic growth projects thus far offset the impact of lower NGL volumes and volatile commodity prices, but these investments should also drive FFO and dividend growth for years to come. Although shares of AltaGas have rallied 26 percent thus far in 2013, investors haven't bid up the stock to the same extent as other midstream names.

Buy AltaGas when the stock dips to less than USD36.00 per share.

Three to Sell

In 27 years as an investment analyst, I've never run away from a bad pick. Although I no longer have any association with Canadian Edge, I'm not running away from any of the fallen stocks that I covered in my former publication.

Extendicare (TSX: EXE, OTC: EXETF)

Extendicare, which owns a network of health care centers, recently joined the ranks of former Canadian royalty trusts that have slashed their dividends, reducing its monthly payout to $0.04 per share from $0.07 per share. The stock price tumbled after this announcement but has stabilized in subsequent trading sessions. Management's guidance calls for first-quarter earnings of CAD0.21 per share, suggesting that the dividend isn't at risk of another cut.

Extendicare's lower payout comes after more than a year of hard work by management to cut costs, refinance debt and reduce operating risk. CEO Tim Lukenda attributed the dividend cut to headwinds faced by its operations south of the border, noting that "the U.S. operating environment has changed substantially due to significant reductions in government funding, increases in alternative care settings and increased regulation." In this environment, a conservative payout ratio and financial flexibility are critical.

At the same time, the stock could face further selling pressure once the Affordable Care Act kicks in next year.

Investors who hold Extendicare should take their losses and move on.

Colabor Group (TSX: GCL, OTC: COLFF)

Colbor Group didn't cut its quarterly payout, but the food distributor did announce first-quarter results that dramatically increased the risk of a lower dividend. Comparable sales, a metric that excludes acquisitions, declined by 1.8 percent from year-ago levels, while profit margins contracted to 0.8 percent of revenue from 1.8 percent.

Management attributed these disappointing results to intensifying competition, which has become a consistent challenge. That being said, Colabor appeared to have turned a corner, boosting profitability through added scale and reduced costs. The company also added a deep-pocketed investor in the Caisse de depot et placement du Quebec, one of North America's largest institutional fund managers.

Fourth-quarter and full-year results released March 25 gave little indication of the trouble to come; management emphasized that “key elements” of its “action plan” were “executed on schedule.” More important, comparable sales and overall sales ticked up from the prior year. Although Colabor did “not expect the business environment to improve materially in 2013,” management also asserted that “increased flexibility and dynamism will enable it to leverage the initiatives it has taken to remain a major player in the consolidation of its industry, while creating value for its shareholders.”

Fast-forward to May 1, when management announced “disappointing results” for the first quarter–the product of “a kind of perfect storm” that included two less days in the quarter owning to the calendar, “limited” consumer discretionary purchasing power, high fuel costs and higher taxes. Moreover, CEO Claude Gariepy warned that the company has “little control over these factors” and that “this situation is not going away yet.”

To be sure, the news isn’t all bad. Colabor continues to make progress building its private-label brand. But the company’s debt-to-cash flow ratio hit 4.66-to-1, exceeding the thresholds set by its loan covenants and forcing the firm to seek an exemption from its banking syndicate. Fortunately, solid interest coverage helped Colabor obtain a stay of execution. Investors, however, should be forewarned that reducing the dividend would be the most expedient way for the company to comply with its loan covenants.

Although Colabor has ample scope to grow its franchise and consolidate a fragmented industry, a dividend cut appears increasingly likely.

Selling Colabor Group now may result in a painful loss, but things will likely get worse before they get better.

IBI Group (TSX: IBG, OTC: IBIBF)

I’m also throwing in the towel on IBI Group. **Although management has adamantly denied that another dividend cut is in the cards, a challenging operating environment means that investors should sell the stock before IBI Group announces first-quarter earnings on May 9.** I will continue to track the stock in Energy & Income Advisor’s Canadian Energy Stocks table.

Sticking with It

Atlantic Power Corp (TSX: ATP, NYSE: AT)

When Atlantic Power cut its dividend in early March, I set several benchmarks the company would have to meet by mid-2013 for me to maintain by Hold rating on the stock: 1.) complete the sale its Florida plants at the stated price; 2.) successfully syndicate the Canadian Hills financing; 3.) announce at least one new project; 4.) close the sale of the Path 15 power line; and 5.) generate sufficient funds from operations to meet management’s guidance for the payout ratio.

In the intervening weeks, the company has delivered on three of these five criteria.

On April 15, the company completed the sale of its three Florida power plants for net cash proceeds of USD117 million. Atlantic Power last week closed the sale of its interest in the Path 15 transmission line in California, removing USD137.5 million of debt from its books and netting the company USD56 million in cash.

The firm also announced the syndication of its USD44 million tax equity investment in the Canadian Hills wind project. This transaction provides another USD42 million in net cash proceeds and completes the sale of all tax equity interests in the 300-megawatt wind power plant.

I also like the hiring of Edward Hall, a former executive with AES Corp (NYSE: AES), as executive vice president and chief operating officer. Hall worked for AES in various positions during its well-documented turnaround and has the experience needed to maximize value from Atlantic Power’s far-flung assets and strengthen its balance sheet. Recent moves suggest the company is headed in the right direction. Atlantic Power sold its 17 percent stake in a Texas power plant, extracting cash from an asset with little potential for leverage.

The company has two more benchmarks to meet: a solid first-quarter payout ratio and the announcement of a project that can replace the cash flow lost through recent divestments. We’ll know a lot more when Atlantic Power announces results on May 8.

Although Atlantic Power’s bonds have held their value through the recent turmoil, the stock sank to a 52-week low this week, reflecting investors’ skepticism about the company’s ability to deliver in the first quarter and concerns about a wave of shareholder lawsuits.

I will continue to track the stock as a hold in my Canadian Energy Stocks table, though investors should note that this name is no longer suitable for income investors and is more of a high-risk, deep-value play.

Just Energy (TSX: JE, NYSE: JE)

Just Energy won't announce earnings until mid- to late May. Management, however, did open its books in late March to an unprecedented extent, offering insight on the contracts that underlie business. The company also reaffirmed its cash flow guidance for fiscal 2014 of CAD1.57 per share–enough to cover the monthly dividend of CAD0.07 by an almost 2-to-1 margin.

Like Atlantic Power, Just Energy continues to grapple with weak wholesale power prices. However, both companies enjoyed a welcome lift from the recent recovery in natural-gas prices and the corresponding uptick in spot-market power prices in many parts of the country.

Yielding almost 13 percent, shares of Just Energy have priced in the dividend cut that the firm announced in April and reflect the market's skepticism about the company's prospects. On the other hand, the stock could stage a rally if the firm manages to meet its guidance for fiscal 2014.

Just Energy rates a buy up to USD8.00 per share for aggressive investors.