To subscribe to our Newsletters **www.palos.ca/register**

PALOS

CONTENTS

Palos Weekly Commentary

Issue **No. 35** | **AUGUST 29,** 2019

Palos Funds

By Charles Marleau, CIM
& Joany Pagé, CFA

Whitecap's Dividend Just Got Stronger

Investors have been ignoring energy stocks for the past few years. This has created one of biggest buyer strikes in history. Energy stock prices have fallen to the point where companies are not able to access capital markets to fund their growth. This means that energy companies need to adapt to a new reality. Unfortunately, many companies are not able to adapt, as they struggle to keep their production flat, let alone growing it within their cashflow (CF).

However, there are a few intermediate companies that are bucking the trend, as they are generating free cash flow (FCF) and are returning that cash to shareholders via buybacks and dividends. There is comfort in knowing that these stronger companies are only getting stronger, as they are concentrating on FCF and not solemnly growth, just for the sake of growing. When growth takes a back seat, corporate declines tend to improve. This is due to the fact that initial production rates of new wells will become significantly less of total production. The treadmill slows down as responsible growth bring sustainability to the business plan.

Whitecap Resources Inc (TSX: WCP) is a poster child of this discipline. On August 26, 2019 WCP reduced its 2019 second half program by $50 million, while maintaining full year production to 70-72 mboe/d. The company made a choice, in that strengthening the balance sheet and dividend was more important than growing production, especially given that the market is not paying for growth at this time. In return for minimal growth, investors get low decline, low debt, buyback, and an eye-popping sustainable dividend of 9% (total payout ratio is 79%).

Palos Funds cont.

By Charles Marleau, CIM
& Joany Pagé, CFA

If the commodity environment worsens, the company is well positioned to navigate through any given turbulence. On the other hand, if commodity prices improve, WCP is able to easily increase their capital. Additionally, WCP is trading at a historical low evaluation. For example, WCP is trading 3.3x 2020 EV/DACF and its peers are 4.6x.

In conclusion the Baa bonds are yielding 4% and the non-investment grade bonds, also know as "junk bonds", are yielding 6%. When you compare the yield on a after tax return, the spread yield between WCP and the Baa/junk bonds are ridiculous. The 9% dividend yield equates to a 12% interest yield. Which is 3x the Baa and 2x the junk. I'm sure some investors would push back that WCP is a riskier asset class than junk or Baa. However, if that is true, why did the bank just issue an incremental $200 million of term debt at 3.25%?

Disclaimer: Palos Funds are shareholders of WCP.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.00	6.24%
Palos Equity Income Fund - RRSP	PAL101	$5.46	5.73%
Palos Merchant Fund L.P. (Dec 31, 2018) [2]	PAL500	$1.82	6.59%
Palos WP Growth Fund - RRSP	PAL210	$7.05	-0.34%
Palos-Mitchell Alpha Fund (Fund Initiated on Jan 29, 2019) [3]	PAL300	$8.94	-4.93%
S&P TSX Composite (Total Return with dividends reinvested)			15.81%
S&P 500 (Total Return with dividends reinvested)			16.75%
S&P TSX Venture (Total Return with dividends reinvested)			4.94%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			1.48%
Canadian Government 10-Year			1.13%
Crude Oil Spot			US $55.78
Gold Spot			US $1,542.80
US Gov't10-Year/Moody BAA Corp. Spread			228 bps
USD/CAD Exchange Rate Spot			US $0.7515

[1] Period ending August 28, 2019. Data extracted from Bloomberg

[2] Fund is priced annually

[3] Fund is priced weekly on Tuesdays

Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca