

# PALOS

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## Weekly Commentary

Issue No. 21 | MAY 11, 2020

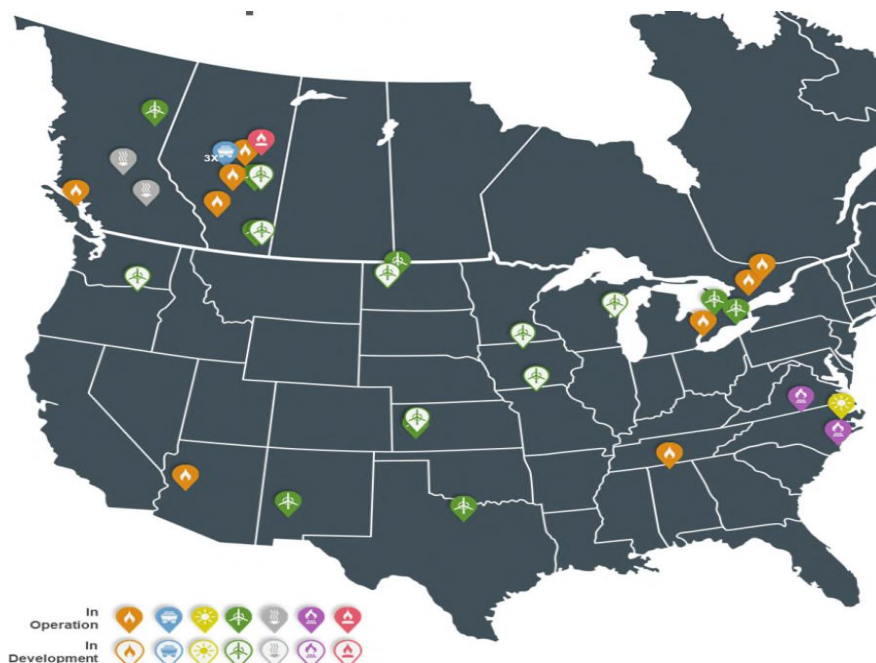
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By Charles Marleau, CIM

## A Value Play in Power Generation

Capital Power Corporation (TSX: CPX) is a Canadian company that acquires, owns, and operates a diversified portfolio of power generating facilities across North America. The Company was originally spun off from government-owned EPCOR Utilities in 2009. CPX owns power generating plants in western Canada (Alberta & B.C.), Connecticut, Maine, and Rhode Island as well as shared interests across North America.

CPX reported its 2020 first quarter results on May 4th and from my observations on the stock's price action prior to the earnings report, I got the feeling there were investor concerns surrounding Capital Power's exposure to the Alberta merchant market. While these concerns may have been warranted 10 years ago when the company had much greater exposure to Alberta, I believe the story has changed. Over the past decade, CPX has wisely diversified its portfolio away from the Alberta merchant market by adding to its interests in the U.S. and by turning attention to renewables. Management expects that for 2020, approximately half of the company's EBITDA will be generated by long-term service agreements outside of Alberta.



*By Charles Marleau, CIM*

The Alberta merchant market now represents approximately 17% of forecasted EBITDA. While management has commented that reduced demand resulting from the COVID-19 pandemic has put pressure on prices, they also disclosed that over 90% of merchant exposure was hedged for the remainder of 2020. Funds from operations (AFFO) should remain within its forecasted range.

Management has also stated that CPX has a \$1.0 billion credit facility upon which only \$100 million has been drawn and with most planned outages completed for the year, the company expects to generate positive cash flow for 2020. With the exception of a possible refinancing of \$250mm in debt maturing in November, the company has no plans to access capital markets. Stable cash flow, low counterparty risk and long-term contracting has CPX in a very strong position. The company has reiterated its 2020 guidance, including EBITDA of \$935-\$985 million, AFFO of \$500-\$550 million, and has confirmed its 7% dividend growth guidance through 2021, and 5% growth for 2022.



With Q1 reporting in the books and forward guidance confirmed, I believe that CPX offers is a deep value investment. There is significant divergence between CPX and other companies in the utilities/renewables sector/sub-sector. This is clearly demonstrated in the chart above which displays a comparative analysis of CPX shares and the iShares S&P/TSX Capped Utilities Index (TSX: XUT).

*By Charles Marleau, CIM*

While a relative chart measuring performance is one thing, what I find compelling is that the fundamentals are also indicating a deep value opportunity when compared to peers. For example, CPX is trading at a multiple of 7.4x on 2020 EV/EBIDTA versus its peers at an average of 10x. I believe the market is overlooking that fact that CPX is not the same company it was 10 years ago. Of further interest to me regarding the Alberta power market, is news that Brookfield Asset Management (TSX: BAM), a senior player in the sector, has accumulated more than 10% in Transalta Corp (TSX: TA) over the past month. TA is another company that has 62% exposure to the Albert market, and currently trades at 8.5x EV/EBITDA, which is a premium to CPX.

*Disclaimer: Palos Funds are shareholders of CPX and BAM.*

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) <sup>1</sup>	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$6.54	-18.94%
Palos Equity Income Fund - RRSP	PAL101	\$4.71	-15.66%
Palos Merchant Fund L.P. (Dec 31, 2019) <sup>2</sup>	PAL500	\$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	\$6.17	-15.40%
Palos-Mitchell Alpha Fund <sup>3</sup>	PAL300	\$7.43	-28.71%
S&P TSX Composite (Total Return with dividends reinvested)			-11.25%
S&P 500 (Total Return with dividends reinvested)			-8.69%
S&P TSX Venture (Total Return with dividends reinvested)			-14.69%
Chart 2: Market Data <sup>1</sup>			Value
US Government 10-Year			0.68%
Canadian Government 10-Year			0.58%
Crude Oil Spot			US \$24.74
Gold Spot			US \$1,713.90
US Gov't 10-Year/Moody BAA Corp. Spread			333 bps
USD/CAD Exchange Rate Spot			US \$0.7180

<sup>1</sup> Period ending May 8, 2020. Data extracted from Bloomberg

<sup>2</sup> Fund is priced annually

<sup>3</sup> Fund is priced weekly on Tuesdays

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# 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](http://www.palos.ca)