

Market Observations

June 1st, 2009

Telecom sector: offense, defense, AND dividends

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The overall S&P/TSX Composite Index has rallied 37% from its March lows, led by sectors such as Financials and Energy. The capital rotation from a more defensive stance to cyclical and high-beta sectors has been prominent in recent weeks. Consequently, one of the laggards throughout this rally has been the telecom sector, as the S&P/TSX Telecom Services Index has increased a mere 10% over that same period. This material underperformance, in our opinion, was unwarranted and has left a gaping investment opportunity that encompasses various attributes including: income through dividends, attractive valuation relative to historical standards and U.S. peers; and, a rare combination that offers defensive characteristics and exposure to discretionary and business spending (thereby positioning for an eventual economic recovery). Below we highlight 6 reasons for exploring investment opportunities in the telecommunications sector.

1. Dividend increases over the course of the economic turmoil has emphasized the stability of the business model and also exemplified confidence in the operations going forward. All three of Canada's major telecommunications firms have raised dividends in recent months.

		Quarterly Dividend Rate					Implied Yield	
		Q4 '07	Q1 '08	Q2 '08	Q3 '08	Q4 '08	Q1 '09	(June 1/09)
BCE	BCE Inc.	0.37	0.37	n.a.	n.a.	0.37	0.39	6.2%
RCL.B	Rogers Comm.	0.13	0.25	0.25	0.25	0.25	0.29	3.5%
T	Telus	0.45	0.45	0.45	0.45	0.48	0.48	5.8%

Dividend increase

Source: Bloomberg, Scotia McLeod

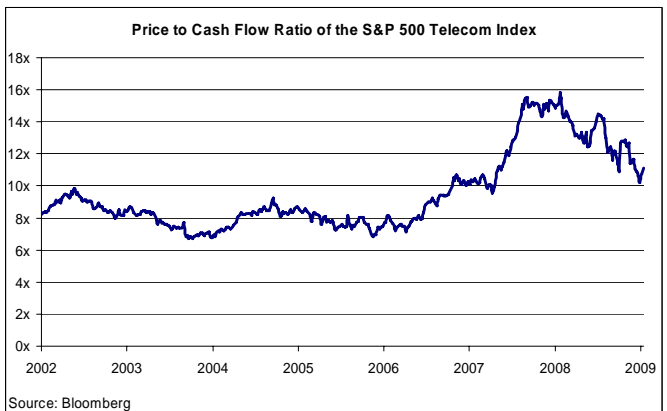
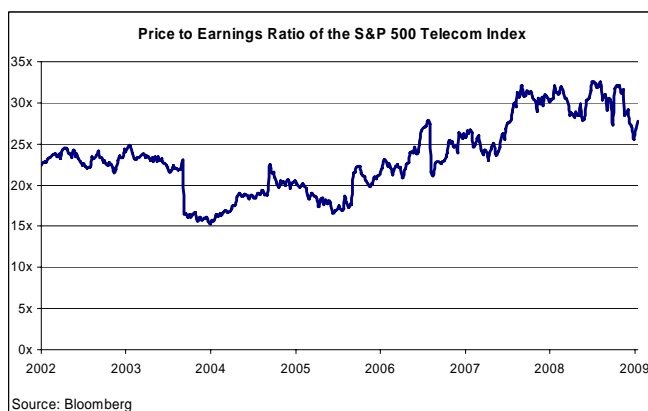
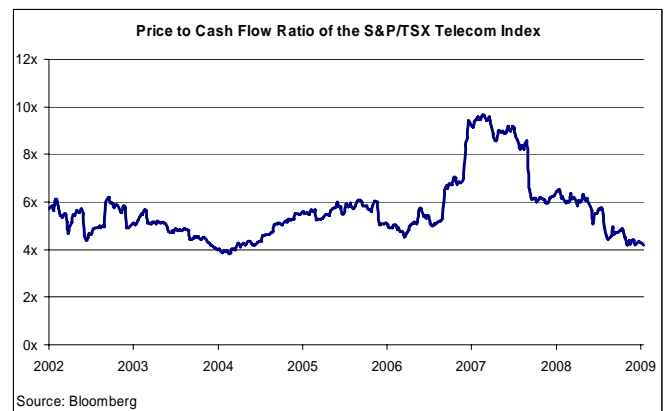
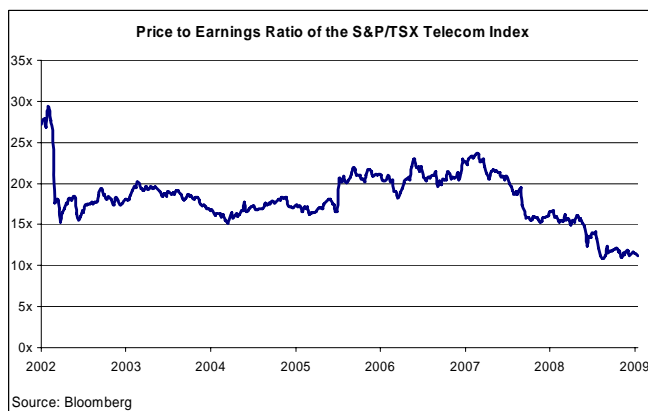
2. Dividends represent a core component of an investor's total return. With that in mind, dividend yields among Canada's major telecom companies are near their highest level in five years. The current dividend yield for both BCE and Telus, 6.2% and 5.8% respectively, are comfortably above long-term government bond yields. Rogers, offering the best growth profile in the group, offers dividend income at a rate of 3.5%. In our opinion, this provides excellent downside support for the share prices. Particularly if we enter into a period of range-bound trading activity once market volatility settles (ie. L-shaped economic recovery), it is likely that investors will seek income generating ideas to enhance returns as capital gains may be elusive.
3. As with any other business, earnings of each telecommunications firm will invariably be impacted by fluctuations in consumer and business spending. In this current environment marked by deteriorating earnings power, the general sustainability of dividends among all stocks has become quite topical. Intuitively, companies that are paying a dividend or distribution that is close to the amount of earnings or cash generated would be most vulnerable to a dividend cut if economic conditions continued to weigh on performance. Certainly the major Canadian telecom plays have not been immune to the economic slide over the past year as Rogers posted a noticeable deceleration in earnings growth in 2008 while BCE and Telus both posted year-over-year declines. That said however, the dividend payout ratios of all three companies remained between 50% and 65% in 2008. This conservative payout ratio clearly leaves sufficient flexibility to absorb downside earnings pressure, and when the state of the economy eventually recovers, provides plenty of room to grow dividends.

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Name	Current Yield	Payout ratio				Price to			
		2009 EPS	2010 EPS	2009 CFPS	2010 CFPS	2009 EPS	2010 EPS	2009 CFPS	2010 CFPS
BCE INC	6.2%	65%	64%	15%	15%	10.5x	10.5x	3.8x	3.6x
ROGERS COMMUNICATIONS -CL B	3.5%	58%	51%	7%	8%	16.2x	14.3x	6.0x	5.6x
TELUS CORP	5.8%	58%	59%	19%	19%	9.9x	10.1x	3.9x	4.0x

Source: Bloomberg, Scotia McLeod

4. Relative to historical standards, valuation across the telecommunications sector has become extremely compelling on both a cash flow and earnings basis. For such stable businesses, particularly during times of economic volatility and poor earnings visibility, it is rather surprising to see such depressed valuations and yields. In terms of price to earnings, the S&P Telecom Services Index is currently trading at 11.5x trailing results, or equivalently, offering an earnings yield of 8.7%. Even more surprisingly, the sector is trading at 4.3x trailing cash flow which implies a cash yield of over 23%. Recognizing that the Canadian landscape for wireless telecommunication services is going through a period of material change at the moment (increasing competition that will see new wireless players next year), we believe that much of the risks associated with this have now been discounted into share prices. The industry has largely operated as an oligopoly for years and the incumbent carriers are deeply entrenched in the market place. In our opinion, while not impossible, it will certainly not be easy for the new start-up carriers to thwart the well-capitalized incumbents particularly over the course of a contracting credit cycle. Additionally, the Canadian sector is also trading at a material discount to its U.S. peers, which faces a market with more competition and arguably less pricing power. In our opinion, we believe the sector currently offers extremely attractive valuation on a relative and absolute basis.



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5. The other explanation for the sector's multiple compression is evolving business profiles. The last several years have seen an explosion in the wireless market as well as increased consumer and corporate spending. This strong level of growth inevitably decelerates at some point as the market saturates. Generally, investors are willing to pay a premium for higher-growth companies and intuitively, when growth decelerates, multiple compression occurs. In our opinion, we believe that the growth trajectory for Canada's major carriers is certainly not what it once was. However, the flip side to this is that these same carriers are now more entrenched into the market place than ever before and represent attractive, stable cash generating entities.
6. We believe that there is significant potential for upward estimate revisions once the economy turns. At the moment, the street is looking for average earnings growth of 1.6% in 2009 for the three major carriers (RCI.B, BCE, T) and 4.1% in 2010. This is based on average revenue growth of 1.7% and 2.5% in 2009 and 2010. Despite concerns over wireless competition and pricing power going forward, we believe that this may prove conservative once we embark from the troughs of the recession. At the moment, Scotia Capital is forecasting Canadian real-GDP growth of 1.7% in 2010 and core inflation of 1.2%. The group is currently trading at approximately 11.3x earnings in 2010, and this valuation would look even more attractive if estimates are gradually raised once signs of a turn in the economy emerge.

Summary

Recent market activity has demonstrated tremendous appetite for cyclical and high-beta stocks. The sectors that have historically been deemed to be defensive such as utilities and healthcare have lagged the performance of the overall index as investors attempt to position their portfolios for a pending economic recovery. While the shape of the economic recovery remains open for debate, we believe the prospects and valuations in the telecommunications sector offer compelling returns under any scenario. On the defensive front, the shares offer stable cash flows that support attractive dividends with conservative payout ratios. At the same time, the low valuations of the sector position it well in terms of upside potential for capital appreciation once discretionary spending picks up. The shares at current prices offer an excellent opportunity for both short-term and long-term investors. Our order of preference is Rogers Communications (for its relatively higher growth potential, strong track record, and valuation) followed by BCE and then Telus. Rogers Communications is currently a holding within the Canadian Core Guided Portfolio, and all three incumbents are holdings within the Canadian Income Plus Guided Portfolio.

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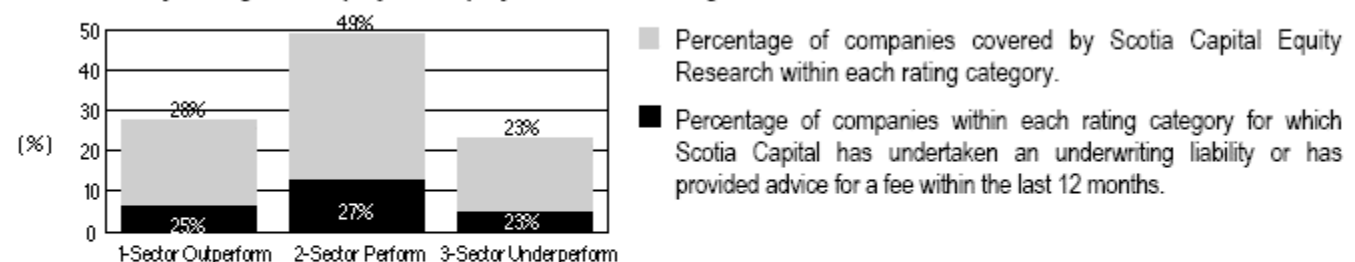
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