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## BUILDING WEALTH

### The Internet Wealth Builder

Editor and Publisher: Gordon Pape  
 Circulation Director: Kim Pape-Green  
 Customer Service: Katya Schmied, Terri Hooper  
 The Internet Wealth Builder is published weekly.  
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**By phone to (416) 693-8526 or 1-888-287-8229**

**Next issue: December 14, 2009**

**IWB publishes 44 issues a year.**

**Next issue is the final 2009 IWB.**

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## THE HOME STRETCH

*By Gordon Pape, Editor and Publisher*

Less than four weeks to go in 2009 and who would have believed the year would turn out this way? As of the close of trading on Friday, the S&P/TSX Composite Index stood at 11,510.8, up almost 30% from the 2008 close of 8,987.7. Back in the dark days of early January, no one was predicting anything like that result. In fact, the big concern was that we were on the brink of a new depression.

Of course, we are not out of the woods yet and as our political leaders keep telling us, the recovery is, to use their favourite word, "fragile". But the mood is light-years ahead of where we were at the start of the year and the latest employment numbers, released Friday, suggest that business is finally picking up steam. The banks, which almost everyone was selling in January, are reporting huge profits again. Gold has surged to record levels, Friday's sell-off notwithstanding. Oil prices have rebounded to a level where even the highest-cost energy companies can make handsome profits again. Mothballed oil sands projects are being restarted.

Add it all together and we have witnessed a turn-around that has been so rapid as to be almost mind-boggling. The question that remains is: How real is it?

In our issue of Jan. 5, we predicted that 2009 would be a rough year and warned that the TSX could experience further losses in January-February before rallying later in the year. We got that part right but we were much too conservative in our forecast, saying only that the Composite Index would be above 9,000 by Dec. 31. That call was based on our concern it would slip much lower before the turnaround began. In fact, the TSX hit its low for 2009, and the cycle, on March 6 when it closed at 7,479.96. Since then it has gained almost 54%.

That's great news for our brokerage accounts but I fear we have come too far, too fast and that the next stage will be a cooling-off period that will see a significant pull-back to below 11,000. I have expressed this concern before, only to see the Composite Index rebound to new yearly highs. But historically we need to remember that no stock market goes up in a straight line. There are always dips along the way.

Co-incidentally, as I was preparing this column I received articles from two of our contributors, Irwin Michael and Ryan Irvine. Both independently expressed the same caution (truly, there was no

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advance consultation). As you'll read elsewhere in this issue, both say that we need to be very selective when it comes to stock selection at this stage and Irwin Michael advises taking some profits to build cash.

Normally, we expect to see what has become known as a "Santa Claus Rally" in December as investors take advantage of bargains generated by tax loss selling. That would be a nice way to end the year but I am not optimistic it will happen. We may have already seen the high for 2009.

As for 2010, I'm concerned that we could end up with a repeat of 2004. I was reasonably bullish on the prospects for next year back in mid-October, but since then we have seen the market rise almost 1,000 points before pulling back recently.

In case you have forgotten, 2004 was a difficult year for both stocks and bonds. Following the end of the high-tech crash in the fall of 2002, all the major stock indexes staged huge rallies in 2003. The TSX Composite rose 24.3% that year, the Dow was up 25.3%, and the S&P 500 gained 26.4%. After the trauma of the tech bubble, everyone breathed a sigh of relief.

It turned out to be premature. As interest rates rose, bond prices dived and stocks struggled. As late as Sept. 1, 2004 the TSX Composite was trading below its opening level for the year. Only a strong autumn rally pushed it back into positive territory and it ended the year with a gain of 12.5%.

A similar pattern in 2010 would not surprise me. Stocks need time to consolidate their gains and to have them validated by rising profits. Following the correction I still expect to happen, we could be in for a few months of sideways movement before the rally resumes.

If you agree with this assessment, take profits on some of your winners now and do some tax-loss selling where appropriate to offset the gains. Then bide your time, wait for the correction, and selectively (there's that word again!) add new positions. There will be money to be made in 2010. It just won't be as easy as it has been in recent months.

Gordon Pape's new book is *The Ultimate TFSA Guide*, published by Penguin Group Canada. Order your copy now at 27% off the suggested retail price by going to <http://astore.amazon.ca/buildicaquizm-20>

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## YOUR QUESTIONS

### Impact of HST

**Q** – How will the new Harmonized Sales Tax (HST) in Ontario and B.C. affect my mutual fund and ETF holdings? I live in Alberta, but most financial investment companies are based in Ontario. Will I still pay a higher management fee? - Tyler B.

**A** – It is very possible that you will. The HST will apply to companies registered in each province. This creates a real dilemma for organizations that sell nationwide, such as mutual fund companies. The HST will be applied to their management fees and other expenses and will therefore be passed on to customers no matter where they live. There has been talk that some companies will create special fund units for Alberta residents only but so far nothing specific has been announced. - G.P.

### Capital losses and DSC fees

**Q** – If you sell mutual fund units at a loss, it creates a capital loss that you can use to offset capital gains. However, if you sold these units and there were deferred sales charges attached to the units, can you also claim these charges as part of the loss? – Brent L.

**A** – Yes. If you look at Schedule 3 of the income tax return you will see there is a space for "Outlays and Expenses" from dispositions. You would claim the DSC costs there. – G.P.

### Buy in New York or Toronto?

**Q** – I have recently taken some profits on U.S. stocks that have done very well since March and the proceeds are in a U.S. dollar account. I like the buy recommendation on RIM in the Internet Wealth Builder as a long-term position. What are your thoughts on buying the stock on the NYSE with U.S. dollars and holding them there until there is a rebound in the greenback somewhere down the road as opposed to purchasing them on the TSX with Canadian funds? – Gary H.

**A** – It makes no difference from a price perspective whether you buy a Canadian-based stock in Toronto or in New York. The price adjusts each minute to reflect movements in the currency exchange rate. The only reason to buy in U.S. dollars is if you already have American currency available to invest, which you do. So in your case, you should go ahead and buy the shares on Nasdaq to avoid having to pay an exchange rate to convert back to Canadian currency. – G.P.

## **IRWIN MICHAEL SAYS BE SELECTIVE**

**Contributing editor Irwin Michael is with us this week and while he is encouraged by the rise of world stock markets he is concerned about potential volatility ahead. Irwin is the founder and president of the ABC funds and is one of Canada's leading experts in value investing. Here is his report:**

Interestingly, despite the initial negative global financial reaction to the Dubai World debt problems, North American equity markets still exhibited impressive positive November returns. For instance, the S&P/TSX Composite recorded a gain of over 5% for the month, the Dow Jones 30 Industrials was up 6.5%, the Russell 2000 gained 3%, and the Nasdaq Composite added 4.9%.

Although it might be somewhat premature to conclude that the Dubai World issue is localized to the Persian Gulf area, the uncertainty over the stability and future direction of sovereign wealth funds will probably overshadow global economic improvement and will dog international financial markets in the short run.

Overall, it is our view that despite the sudden problematic Dubai situation, global equity markets will continue to climb the proverbial wall of worry. True, worldwide economies appear to be on an "extreme government life support" via extraordinary monetary and fiscal stimulation, however a slow but sure global economic improvement appears to be taking place.

Clearly, this is the reading that most worldwide stock market indexes appear to be emitting via the impressive returns we have seen year to date. Admittedly, this might be the result of the extreme abundance of international liquidity caused by the excessive central bank monetary easing which has reduced global short-term interest rates to virtually zero. The precipitous decline of the U.S. dollar is also a contributing factor. With commodity and gold prices surging and with few attractive investment alternatives confronting the massive trillions of dollars impatiently waiting on the sidelines to be invested, global equity markets have made a remarkable recovery from the March 2009 price lows.

Looking ahead, despite the impressive year to date stock market performance, there remains a considerable difference of investment opinion as to where the global economies, corporate earnings, U.S. commercial real estate fallout, et al will be six to twelve months in the future. This skepticism is providing for extraordinary stock market volatility and opportunity for the nimble investor.

On balance, although we remain optimistic, we are extremely selective with regard to our current equity choices. One must stay exceedingly alert during this present erratic period. Nonetheless, we expect to take advantage of the anticipated intermittent stock market swings and numerous stock-specific catalysts while still attempting to remain fully invested.

## **IRWIN MICHAEL'S UPDATES**

### **Cogeco Inc. (TSX: CGO)**

### **Cogeco Cable (TSX: CCA)**

*Originally recommended on May 4/09 (IWB #2917) at \$21.95 and \$29.53 respectively. Closed Friday at \$27.80 and \$35.10.*

After listening to Cogeco's fourth quarter conference call, it became quite clear to us that management is committed to its investment in Portugal. Although Cabovisao subscriber (or revenue generating units) losses have been stemmed, we believe that it has been at the expense of profitability. Spending on new channels, retention strategies, and marketing is expected to stabilize the customer base but could further dampen the financial results in the near term.

Ignoring Europe for the moment, we believe that the Canadian cable assets are still performing well and are attractively valued by the market. However, we are worried that Portugal, as small a portion of the company as it may be, could distract management and investors alike.

Given the illiquid nature of Cogeco Inc. and Cogeco Cable Inc., when an opportunity arose we made the unemotional investment decision to unload our ABC fund positions at an attractive premium to the market price. Admittedly, while the Canadian cable assets are undervalued, there is currently some takeover enthusiasm in the share price. To put it simply, we don't believe that any takeover is imminent.

Because of the opportunistic nature of the sale, we are still actively watching both CGO and CCA. Should the shares continue to trade at a discount to the price paid by the strategic buyer, we would consider rebuilding positions in CGO and/or CCA.

**Action now:** Long-term investors: Hold. Short-term investors: Buy CCA below \$32, Sell CCA above \$36.50. Buy CGO below \$25, Sell CGO above \$28.50.

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*Irwin Michael's Updates – continued from page 3...*

### **Equitable Group Inc. (TSX: ETC)**

*Originally recommended on Aug. 11/08 (IWB #2828) at \$21.04. Closed Friday at \$20.60.*

Equitable Group has once again released a solid earnings report on the back of net interest margin expansion and improving credit metrics. The company reported a 12% increase in net income to \$12 million in the third quarter of 2009 compared to \$10.8 million a year ago. Diluted earnings per share grew 9.5% to 81c versus 74c a year ago. Book value now totals \$20.86 per share, up 16% on a year-over-year basis.

The company's net interest margin, the key driver of profitability, improved from 1.7% a year ago and 1.9% in the second quarter of 2009 to 2.2% in the third quarter of 2009. The net interest margin is expected to continue to improve as the Bank of Canada holds the benchmark rate stable. Equitable's pricing and product mix strategies should lead to higher average interest revenue while a lower cost of financing, as relatively expensive sources of funds (raised during the credit crisis) roll over, should result in a lower average interest expense. Netting out higher average interest revenue with lower average interest expenses obviously results in a better net interest margin.

Despite rising unemployment, Equitable's credit quality actually improved in the most recently completed quarter with mortgages in arrears 90 days or more dropping to 0.88% of total principal outstanding from 1.34% in the second quarter. Excluding one mortgage that was categorized as impaired but is actually current on its payments, net impaired mortgages amounted to 0.57% of total mortgage assets, down from 0.79% at the end of the second quarter. Management suggested that they have avoided unreasonable losses due to the relative health of the company's mortgage portfolio and a general recovery in various real estate markets.

From a capital perspective, the company issued \$50 million of preferred shares and redeemed \$2.5 million of sub-debt in the third quarter. Equitable's total capital position was 17.5%, well ahead of the company's internal target of 13%, and will be used to grow the mortgage book in coming quarters. As CEO Andrew Moor stated: "We are confident in our business approach and [the] current strength of demand for mortgage financing will translate into strong performance for Equitable going forward".

Despite the solid results, Equitable currently trades just slightly below book value of \$20.86 and less than seven times 2009 expected earnings. With a nine-month trailing return on equity of 16.7%, the stock should trade at a more significant premium to book value. This discrepancy is particularly puzzling when we examine

Home Capital Group (TSX: HCG). We acknowledge that Home Capital has a larger market capitalization and a higher return on equity. However, with HCG trading at 2.6 times book value and ten times 2009 expected earnings, we believe that Equitable Group is simply a bargain in the alternative-lending sector.

**Action now:** Buy at current levels.

### **Fortress Paper Ltd. (TSX: FTP)**

*Originally recommended on Oct. 1/07 (IWB #2736) at \$7.82. Closed Friday at \$9.50.*

After reporting a relatively lackluster second quarter due to the impact of the global economic slowdown on the sale of specialty papers, Fortress Paper is now firmly back on track. In the third quarter of this year, the company reported sales of \$51 million compared to \$43.7 million in the third quarter of 2008 and \$49.6 million in the second quarter of 2009. EBITDA was \$7 million compared to \$6.2 million last year and \$5.7 million in the second quarter. Net income was \$3.5 million (34c per share) compared to \$2.3 million (22c per share) a year ago and \$1.9 million (19c per share) in the prior quarter. Given the depth of the economic downturn, it is actually pretty unusual to find a company that is demonstrating both year-over-year and sequential revenue and earnings growth.

Examining the results more closely, the Landqart mill reported sales of \$24 million compared to \$20.9 million a year ago. Operating income improved to \$1.8 million from \$1.2 million in the comparable period. The results reflect strength in the security paper segment and more banknote sales than in prior quarters.

At the Dresden mill, demand for wallpaper base has reached the highest level since the start of the economic downturn. The division's revenue increased to \$27 million compared to \$24.7 million and operating income was relatively stable at \$4.7 million compared to \$4.9 million in the third quarter of 2008. The small dip in operating income at Dresden could be explained by some product mix changes. All told, we were quite impressed by the performance of both of the operating divisions.

Finally, we would like to discuss a potential, near-term corporate development that could act as a catalyst for the shares. Once a financing package to fund the conversion of PM1 (paper machine 1) to a banknote printing machine is put into place, we believe that the market would become more willing to put a high-tech or growth multiple on the stock for two key reasons. First, banknote printing, entailing the in-house and patented development of advanced security features, is a relatively unique and high margin business. Second, management has already suggested

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**Irwin Michael's Updates – continued from page 4...**

that demand is robust. They have actually turned away some euro orders in order to accommodate other central banks. This ensures the maximum number of potential clients to fill Fortress's additional capacity once the converted banknote machine is operational.

Subsequent to the release of Fortress's solid results, the shares jumped almost 20% and currently trade at \$9.50. This represents a relatively small premium to book value of \$8.08, which is justifiable given the annualized return on average equity of 17.2% in the quarter. On an earnings basis, the shares are valued at 9.2 times 2009 consensus earnings and only 7.4 times 2010 consensus earnings. Despite the move in the stock, we believe that the shares still trade at a discount to the intrinsic value of the company.

**Action now:** Buy at current levels.

**George Weston Ltd. (TSX: WN, OTC: WNGRF)**

*Originally recommended on Dec. 8/08 (IWB #2843) at C\$58.85, US\$45.85. Closed Friday at C\$63.11, US\$60.21 (Dec. 1).*

We purchased our initial position in George Weston Limited last November during the worst market meltdown in modern times. We rationalized that, even in severe recessions, people had to eat. We believed that Weston was the best way to play the consumer staple story, for three key reasons. First, after backing out the implied value of Loblaw from each share of Weston, we were able purchase the Weston Foods operating division at 50% of its intrinsic value. Second, we expected that operating and financial results would begin to improve due to food price inflation and lower commodity input costs. Finally, buying George Weston during a period of economic turmoil reminded us of our successful investment in Canada Bread, years earlier.

Today, the world feels very different than it did a year ago. The credit and financial markets have stabilized, the stock market has staged a remarkable recovery, and investors are once again looking for investments that return more than the 25 basis points paid on cash accounts. Through the market meltdown, our investment in George Weston performed remarkably well. In fact, it was the 15<sup>th</sup> best performing stock of 2008, gaining more than 10% while the overall market fell 33%.

We stuck with the name through most of 2009, despite the high-beta rally that began in March, because of the possibility that the Weston family might privatize the company. This was based on the fact that the stock traded at such a high discount to its historic valuation and had a tremendous cash position on its balance sheet. However, we believe that this type of transaction is now actually less

likely. Over the past three months, shares of George Weston have outperformed shares of Loblaw, which makes a buyout of Weston relatively more costly.

Looking forward, Loblaw is facing some near-term headwinds. Although the company recently beat earnings expectations, management was very cautious on the quarterly conference call. They discussed slowing food price inflation and the need to "invest in lower food prices" to drive volume and market share in a very competitive environment. This scenario is good for shoppers over the holidays, but not so good for investors over the next several quarters.

Because the shares of both Loblaw and Weston have subsequently bounced off the bottom of their 2009 trading ranges, we decided to sell our entire position in George Weston Limited. It was simply time to raise the cash position in our funds in anticipation of opportunities that may present themselves in the volatile period around year-end.

**Action now:** Sell. With dividends, Canadian investors have a profit of 9.7% on this trade. U.S. readers are ahead by 34%, thanks to the appreciation in the value of the loonie over the past 12 months.

**John B. Sanfilippo & Sons (NDQ: JBSS)**

*Originally recommended on Dec. 12/05 (IWB #2544) at \$13.53. Closed Friday at \$16.54. (All figures in U.S. dollars.)*

After a wild ride over the past four years that saw the shares of John B. Sanfilippo & Sons "round-trip" from approximately \$16 per share to a 52-week low of \$4.01 and back again, we have sold our entire position for a small profit.

Over the course of our holding period, JBSS had struggled with the unfortunate fallout of the Atkins diet craze: rising nut input costs that couldn't be passed along to consumers. The company reported losses for three consecutive years but finally returned to profitability in fiscal 2009 (year ended June 25/09). Management had worked extremely hard to eliminate high-cost inventories, align nut purchasing and selling activities, consolidate facilities, and improve manufacturing efficiencies at the Elgin facility. Cash from operations recovered and capital expenditures were slashed, which allowed the company to reduce debt by 29% during fiscal 2009.

However, the losses had eroded book value from \$18.54 at the end of fiscal 2005 to \$14.92 at the end of fiscal 2008. Thankfully, with the return of profitability, book value has rebounded to \$16.04 and the shares have quadrupled off the lows. While the share price may trend higher, the stock trading is very thin and quite volatile. If we employ a target P/BV (price to book value) multiple of 1.0 times, historically where the stock tended to peak excluding the Atkins mania, we believe that the shares are fairly valued today.

**Action now:** Sell.

## **RYAN IRVINE HAS TWO NEW PICKS**

**We are pleased to be joined again this month by Ryan Irvine, president of Vancouver-based KeyStone Financial Corp., a unique research firm with a 10-year track record of successfully utilizing a GARP approach to uncover undervalued growth and value stocks. Ryan is increasingly concerned that the market is getting ahead of itself and, like Irwin Michael, he warns that we need to be very selective in our buying. But he has found two new stocks that he likes. Here is his report.**

Ryan Irvine writes:

Less than a month from my first installment for the IWB, I am back to add a couple more names to our fundamentally based "Mock Small-Cap Portfolio." Last month we kicked off the exercise with our initial buy on The Cash Store Financial Services Inc. (TSX: CSF) and saw the company's shares surge over \$2 in short order from the buy price of \$10.30 range. Remember that on a relative basis, small caps are less liquid than their larger-cap brethren and subject to higher price volatility. The shares have now traded back to close to the original buy price range, closing on Friday at \$10.20.

To counteract what can be a "chasing effect" as investors pile into a surging stock in hopes that the run may never end, this month we will provide a target buying range and advise that those interested in purchasing the stock in question stick within it – lesson learned.

Now I would be remiss if I did not state that, in our view, the timing of both today's and last month's buys are less than opportune. The S&P 500 is currently up over 62% from its March lows. Most market players are feeling quite good about themselves right now and the bullish sentiment continues to make value investors cringe just a bit.

Part of the current rallying cry has been liquidity. Be it in the form of stimulus spending or cheap capital, fundamentals should take a back seat because there is so much liquidity to be put to work and it will eventually find its way all into equities. So with all this cash parked in money market accounts just ready to pounce on the markets, they could not possibly continue to go anywhere but up. At least that's the theory.

The problem is that we heard the same liquidity talk during the peak of the bubble in late 2007. The reality is that the mountain of money is no higher or lower than it was when the market was scraping to new lows in 2008. Money market funds back then held relatively the same amount of

cash as they do today: \$3.5 trillion. Curiously, back in the autumn of 2007, roughly the same amount of "liquidity" was sitting on the sidelines. This was a time when everyone believed stocks would never fall (didn't someone write a "Dow at 30,000" book?), no investment banks had collapsed, Fannie (FNM)/Freddie (FRE) were still "privately" held, AIG still existed . . . you get the picture.

According to Gluskin Sheff's well regarded economist, David Rosenberg, on an operating basis the trailing P/E multiple on the S&P 500 has expanded a massive 10 points from the March lows to stand at 27.6x. His research suggests that, historically, when the economy is taking the turn away from contraction towards expansion, which indeed was the case in the third quarter the trailing P/E multiple is 15x or half what it is today.

What this tells us is to continue to be cautious and take profits where warranted and be very selective in our buying. We are now somewhat fearful as others get greedy.

Given the market's strong move in the face of some less than impressive raw data, our universe of small-cap GARP stocks – in this case the "G" or growth can be substituted for "great companies" at a reasonable price – is shrinking. Yes, we can find great companies, but do they continue to trade at reasonable prices? In many cases, the answer is no.

For illustration purposes, we look at one of our top Focus Buy stocks over the past two years, Alliance Grain Traders Inc. (TSX: AGT). In August of 2007, we initially recommended the company, a Saskatchewan-based processor of specialty crops (lentils, peas, chickpeas, beans, and canary seed), in the \$6.65 range. Subsequently, we issued another buy on the company earlier this year (March) in the \$8 range. Powered by solid quarterly numbers and a recent acquisition, the stock has surged and is now trading above the \$26 level.

Alliance Grain is what we would classify as a great, well-run company which displayed tremendous growth financially as well as in its stock price over the past year. But with its shares up 290% since our originally recommendation and 225% since March of this year, as revenues and earnings have tracked down in consecutive quarters, we have recommended selling half our initial positions. We continue to hold the remainder for the long term. A great company, yes, but in the near term it is no longer as cheap as it once was.

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*Ryan Irvine's Picks— continued from page 6...*

## **Western Financial Group Inc. (TSX: WES, OTC: WESPF)**

Moving to our latest additions this month, we start with Western Canadian-based Western Financial Group Inc. The financial services provider has four prongs to its business. The first, and largest by revenue (54.34% over the first nine months of 2009), is the Western Financial Group (Network) Inc., one of the largest P&C (property and casualty) insurance brokers in Canada and the largest in Western Canada. The second, is Western Life Assurance Company (27.64% of revenues for the nine-month period ending Sept. 30), which is licensed to write all classes of life, health, and loss of employment insurance in all provinces in Canada. Western Life's products are marketed through agents and independent brokers and the majority of the writings are in the provinces of Ontario and Alberta.

The third prong is the company's banking activities, which are carried out through a federally incorporated, wholly-owned subsidiary, Bank West. Bank West, which commenced operations in 2003, is a Charter 1 virtual bank that lends mortgage money and makes recreational vehicle and farm loans. It accounted for 16.92% of revenues for the first nine months of the current year. Finally, we are left with the company's 31% minority stake in Jennings Capital Inc., a Calgary-based investment dealer.

Over the past 12 years, Western Financial has become a specialist in providing financial services to customers in smaller communities, primarily in Western Canada, with similar demographics and economic drivers. Specifically, the company has focused on communities driven by agriculture, energy, and natural resources. The company has gained significant expertise and has learned to tailor its product and service offerings to these industries.

This product and community familiarity has allowed the company to target similar communities for growth via acquisition and to efficiently integrate the acquired brokers. Once it has gained a toehold in a new market, the company emphasizes its brand and marketing efforts with a strong regional and rural theme, which has been attractive to its customers and allowed it to gain market share.

This focus on strategic acquisitions in rural Western Canada has served the company well as revenues basically doubled from \$63.58 million in 2005 to \$124.86 in 2008 while the company's share price expanded three times from a low in the \$2 range in 2005 to a high of \$6.25 in late June of 2007. But after hitting this high, the company's shares have been on a steady decline. Just when it looked like they may be in for a recovery a year later they, and the entire market, were hit by the storm of

the global credit crisis. The resulting carnage, which left no financial concern unscathed, dragged Western briefly down to the \$1.35 level, its lowest price in over eight years as a public company. While the stock has staged a bit of a rally since those March 2009 lows, it remains at \$2.44, half its 2007 highs. (The shares also trade over the counter in the U.S. where the latest quote was US\$2.18.)

On Nov. 12, Western Financial announced its financial results for the third quarter and nine months ended Sept. 30. Revenues increased 25.2% to \$40.09 million from \$32.01 million for the third quarter of 2008 and 16.4% to \$112.34 million from \$96.49 million for the corresponding nine-month period a year ago. For the quarter, revenues increased 3% for the Network, 45% for Bank West, and 73% for Western Life.

So the question becomes: are we at a reasonable entry point? Fundamentally, the company currently trades a P/E in the range of 12 based on an estimate of 20.5c in earnings per share (EPS) for 2009. This is a discount to its peer group average, which is in the range of 19. Given management's target to grow earnings next year and what appears to be the shaping of a recovery or a bottom in its primary markets (helped by rebounding commodity prices), the stock appears to offer solid growth potential in its current range.

The company pays a dividend of 1.07c per quarter which translates into a yield of 1.75% based on Friday's closing price of \$2.44.

**Action now:** Buy Western Financial's shares in the \$2.30-\$2.50 range in the near term. Do not chase the stock beyond that level.

## **Sangoma Technologies Corp. (TSX-V: STC)**

The second company we will look at today is a true micro-cap situation. Markham, Ontario-based Sangoma Technologies has a market cap in the range of \$21 million but nonetheless is worthy of a look based on its solid fundamental track record and award winning technology.

Founded in 1984, the company manufactures hardware and software that enables computing devices, mainly PC servers, to communicate with high speed Wide Area Networks (WANs) and telephone networks. These products consist of hardware cards, software drivers, and utilities. Sangoma's products are in use worldwide in many industry segments such as PBX, call centres, and voice monitoring systems. As well, the company's products are used in Internet services, by governments and the military, and in such sectors as banking, retail, entertainment, medical, and manufacturing.

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**Ryan Irvine's Picks – continued from page 7...**

A private branch exchange (PBX) is a telephone exchange that serves a particular business or office, as opposed to one that a common carrier or telephone company operates for many businesses or for the general public. In other words, your typical office phone system. This market was globally estimated at \$5.5 billion in 2008, with the majority of sales being traditional PBX systems from established vendors such as Avaya, Siemens, Nortel, Cisco, and Alcatel-Lucent.

The PBX market has shifted from analog/digital systems towards IP (Internet Protocol)-based systems that are capable of handling both analog/digital and IP-based systems. IP-based PBX systems have an advantage over their older counterparts as it has become easier to integrate advanced features into the system. These advanced features are commonly known as Unified Communications (integration of e-mail, SMS, Fax, voicemail, video messaging, etc.).

At present, the PBX market is in a state of flux as software vendors are now making the PBX hardware more of a commodity. Microsoft launched its Office Communications Server 2007 in October 2007 and has since (February 2009) launched the R2 version of the server which runs solely on 64-bit platform and is more scalable.

While Sangoma's core market continues to generate strong cash flow and post decent growth, the company's management team has identified an opportunity in the software market. Sangoma's hardware and software support voice connections to the Public Switched Telephone Network, allowing PC servers to be used in Voice over IP (VoIP) gateways, PBX devices, call centre systems, and other telephony applications.

Until recently, Sangoma's voice support was confined to support for Open Source Telephony (OST) projects such as the Asterisk platform. In July, the company acquired Paraxip Technologies Inc. of Montreal which has supplied Sangoma with tools and interface programs that allow access to new markets that are not based on OST. The company's new products include hardware and software that is not dependent on traditional WAN or telephony interfaces, providing a growth path into markets based on Unified Communications and should be the true driver of growth for years to come.

While Sangoma experienced a hiccup in terms of growth in 2008 as IT departments and telcos the world over pulled back their spending, the company maintained solid profitability over this period. It appears to have already resumed a growth path as its final quarter of fiscal 2009 saw revenues at \$3.17 million, approaching the record sales levels seen prior to the global recession.

Over the company's recently reported fiscal 2010 first quarter, revenues for the period ended Sept. 30, 2009, were \$3.12 million, 20% higher than the same quarter in 2008. Although the world economic recovery has been anemic, new products, markets, and distribution channels have generated new sales, and the decline in existing business appears to have reversed. Gross margins were 76% compared to 73% last year. Net profit at \$0.56 million (1.9c per share) was 18% lower than the \$0.68 million (2.4c per share) reported in the same quarter the previous year, mostly due to a net foreign exchange effect of \$0.61 million. Without this foreign exchange effect, earnings would have shown an approximate 35% increase.

Sangoma is an exceptionally well-run company with industry-leading gross margins in the low 70% range. The company has a stellar balance sheet, completing its most recent quarter with current assets of \$11.37 million and working capital of \$8.6 million. Cash flow was positive at \$0.63 million during the quarter and the company's cash position, a figure which grows quarter-over-quarter, has ballooned to \$7.5 million or 25c per share with minimal debt.

Based on our fiscal 2010 earnings estimate of 11.5c per share, Sangoma currently trades with a P/E of 7.1, despite a resumption of growth in the range of 35%. With strong cash generation from quarter-to-quarter, cash on hand of 25c per share, a book value of around 64c a share, and a very low EV/EBITDA ratio of 2.9, the stock is fundamentally cheap. (EV stands for Enterprise Value.) In fact, the latter ratio makes it a potential takeover target.

Again, Sangoma is a true micro-cap situation with a market cap in the range of \$21 million. Only investors with patience to stick to their bids in the 65c to 80c range should invest. The outlook on Sangoma is positive and the potential for strong growth is present, but a relatively long-term horizon should be taken (1-3 years). It is a small, underfollowed, and fundamentally sound company to "invest" in, not trade in an out of, as volumes are not significant enough.

For the DIY investor, we suggest that the most effective manner to employ our research is through the creation of your own "small-cap mutual fund." Create your fund over six months to a year by purchasing between six and ten of the companies we recommend, paying particular attention to select individual stocks from a variety of sectors and geographic regions. This will prevent you from buying at an annual market top and diversify your holdings within the small-cap segment of your overall portfolio.

**Action now:** Buy between 65c and 80c. The shares closed on Friday on the Toronto Venture Exchange at 82c.

**Disclosure:** KeyStone Financial does not own any shares in the companies mentioned. Mr. Irvine owns minor positions in The Cash Store, Western Financial, and Sangoma Technologies.