

Sherritt: Best bet for bonds

Portfolio manager touts high-yield issue from a company with a sound balance sheet

DIANNE MALEY, Special to The Globe and Mail, January 26, 2009

The Source

Paul Gardner, partner and portfolio manager, Avenue Investment Management.

The Idea

Buy **Sherritt International Corp.** 7.75-per-cent bonds due Oct. 15, 2015.

These are investment-grade bonds issued by a company with a sound balance sheet, solid interest coverage and positive free cash flow, yielding 13 per cent and due in six years.

How come? Even though the bonds are investment grade, most large investment dealers and institutions won't touch them because of the United States' embargo on Cuba that forbids companies that do business in the U.S. from also doing business in the Communist country. The Cuba effect may have added as much as three or four percentage points to the yield.

National Bank Financial and some of the smaller brokers sell the bonds, Mr. Gardner said in an interview. "It's a good bond if you can get hold of it."

As well, there has been a lingering fear among some investors that the Cuban government would one day nationalize Sherritt International's assets in Cuba, which are mainly in mining, oil and gas. Its chairman, Ian Delaney, has been barred from travelling to the U.S.

All corporate bonds have been beaten down as investors fled to the safety of U.S. Treasuries over fears of rising corporate defaults. That, in turn, has boosted yields as well.

Sherritt, which is mainly in the resources business, has been hit by falling coal prices at its thermal coal operation in Saskatchewan, Mr. Gardner notes. But as he sees it, the Saskatchewan operations alone are enough to cover the liabilities on the company's balance sheet.

Sherritt's debt is only 23 per cent of total capital, its interest coverage is 20 times and its free cash flow - operating revenue less expenses, including cash for operational and maintenance capital expenditures - is positive.

In its third-quarter report, Sherritt said it was taking immediate steps to reduce its cost structure and capital spending. In November, it announced it was deferring some spending on its jointly owned Ambatovy nickel project in Madagascar.

The Payoff

A premium of 10 full percentage points over Government of Canada bonds of similar term for investors who hold the bonds to maturity in six years, which Mr. Gardner recommends doing.

The Big Risk

The risk, Mr. Gardner says, is that coal prices could drop further, eroding profitability. Another risk, more perceived than real, is that Cuba could decide to nationalize Sherritt's operations there.

While that has long been a concern, it is looking increasingly unlikely, given the shift in power to Raoul Castro in Cuba and Barack Obama in the U.S. Sherritt stands to benefit from normalized relations between the two countries.

Why listen to Paul Gardner?

Mr. Gardner has more than 20 years' experience in the investment industry, mainly in the fixed income area. Avenue Investment Management is an independent investment counsellor and portfolio manager for individuals with \$500,000 or more to invest.

This story was written for Globeinvestor.com/magazine