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THE MONEYLETTER®

STRATEGIES FOR SUCCESSFUL INVESTING

SMALL-CAP STOCKS

Strong financials make them attractive targets

M&A POTENTIAL

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MERGER AND ACQUISITION activity in Canada hit record highs in the second quarter of 2006. Crosbie & Company, which keeps a database of Canadian merger activity for both publicly listed and private companies, found $86 billion worth of transactions during the period. That's up from $34 billion in the second quarter one year earlier.

While consumers are still spending and are increasing their debt, the corporate sectors, most specifically the resource-levered mining and materials sector, have been reducing debt and building cash reserves. M&A activity in this area is approaching peak levels. Mining and materials accounted for 46%, or $40 billion, of the M&A transaction value in the quarter.

During that period, there were 389 merger deals involving companies of less than $100 million in value, up significantly from the 290 in the previous quarter and from 187 during the same period last year.

In the March 2006/First Report of *The MoneyLetter*, I noted that higher commodity prices left many companies with ample cash on hand and a reluctance to pursue in-house growth, because of the high cost of starting new mines on their own and concerns over an economic slowdown. I believe that small and mid-cap companies will continue to be takeover targets for the cash-rich corporations.

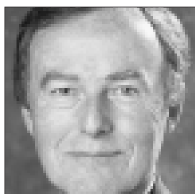
I can't predict which companies might be taken over. The focus in the **Renaissance Canadian Small Cap Fund** and the **Talvest Small Cap Canadian Equity Fund**, which my team at CIBC Global Asset Management Inc. and I manage, has always been to reduce risk. Our goal for the two funds continues to be to own companies that can still improve their return on equity even in a slowing economy. We look to low price-to-earnings and price-to-cash flow valuation measures to enhance our risk reduction and upside potential.

If a stock meets our investment criteria, it should also look attractive as a potential takeover candidate. While we have lowered our exposure to mining and energy stocks because of their cyclical nature, we would benefit if there were more takeovers because of our current holdings within the sector.

MINERS

We have two current favorites in the mining sector.

Eurozinc Mining Corp. (TSX: EZM) purchased two mines in Portugal in 2004 from **Rio Tinto PLC** and the Portuguese government. It has been producing copper from its Neves Corvo mine and has just started zinc production there as well. The company expects its second mine, Aljustrel, approximately 40 kilometres away, to produce zinc,



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lead, and gold by about the middle of 2007.

At the end of August, Eurozinc announced a merger with **Lundin Mining Corp**., which should close in October. The combined companies will produce 188,000 tonnes of zinc and 99,000 tonnes of copper and will have a market capitalization of about $3 billion, about twice Eurozinc's current size. We believe the key reason for the planned merger is to create a bigger blip on the radar screen for possible suitors.

HudBay Minerals Inc. (TSX: HBM) is an integrated copper and zinc mining company with four mines, two concentrators, a copper smelter, and a zinc plant. In 2004 it purchased the assets of Anglo American, a British mining company. HudBay's management has resolved some environmental issues, reduced costs, and resumed an exploration program that Anglo had neglected.

As of June 30, 2006, HudBay had only $70 million in debt compared with $113 million in cash. With a market capitalization of $1.9 billion and $1.0 billion in tax loss carryforwards, management says it would like to make an acquisition, but we believe it could well be a target itself.

Both Eurozinc and HudBay are trading at around six to seven times estimated earnings, and four to five times estimated cash flows. The risk in owning these companies today is mainly in commodity prices. Should copper, zinc, and other base metals' prices fall, these stocks could be vulnerable.

The downside risk in the small-cap market almost equals the upside potential today. Fears that interest rates will continue to push higher are raising concerns about an economic slowdown. There are also worries an economic slowdown could be triggered or accentuated by falling house prices which may lead to a market decline.

CONSUMERS

So from a safer perspective, we are following two consumer spending-oriented names. While both are vulnerable to an economic downturn if consumer spending decreases, their popular prices might keep their sales growth buoyant in a flat consumer market.

La Senza Corp. (TSX: LSZ) is a global vendor of women's lingerie. It has 305 stores in Canada and also sells its products to third-party licensed owners of 306 stores in 30 other countries.

La Senza has a strong market presence in Canada. It accounts for over 15% of all lingerie sales in the country, including 39% to the 15-to-29-year-old age group. The company's management envisions 500 stores in Canada and 381 outside Canada by early 2009. While the company is vulnerable to a slowdown in consumer spending, the moderate price range of its products offers a degree of stability.

La Senza trades at about 11 times estimated earnings. It also has a 2.7% dividend yield and is a strong cash-flow generator. Its balance sheet is quite strong, with $86 million in cash and investments in the second quarter ended July 29, compared with $36 million in lease obligations.

Lakeport Brewing Income Fund (TSX: TFR.UN). After being purchased out of receivership in 1999, Lakeport Brewing became an income trust in mid 2005. Current management embarked on a value beer strategy, and Lakeport is now the third leading brewer in Ontario. Two of its nine brands are now among Ontario's best-sellers. Lakeport has captured over 10% of the total beer market and about half of the value segment, which has grown to 20% of the market.

The company could also be vulnerable to weakened consumer spending, but we believe its value offering provides protection. Lakeport has increased its distribution twice in 2006, showing confidence in the outlook. The wide differential between Lakeport's prices and the prices for regular brands still offers room for the company to gain market share.

Earlier this year Lakeport began selling beer in cans and also gained entry to the LCBO, the Ontario government's liquor store chain, further enhancing the opportunity for increased market share. In our opinion, management has successfully created a "brand name" in the value beer segment. The trust currently yields 8.4% and trades at about eight times distributable cash flow, a level we find attractive.▼

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