Morgan Meighen Special Situations Newsletter

MORGAN MEIGHEN & ASSOCIATES
Investment Management

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In This Issue

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Ballard – Winning the Race to Refuel

I get it. China gets it. The Morgan Meighen Special Situations Fund gets it. The stock of **Ballard Power Systems (BLDP-TSX and NASDAQ)** is up about 50% since purchase. Ballard won the race at the pumps long ago. For the fuel cell vehicle, it can take a few minutes to fill the tank with a burst of hydrogen versus the long load time for electric batteries and it can take your wheels further along the road.

Ballard is the main company for investors buying into fuel cell transportation. There is no equivalent in electric batteries. Ballard is the entry point, which is why Chinese companies have long-term relationships with this company. The situation is more complex than that of course. Ballard started in the hydrogen game nearly 40 years ago and 15 years ago analysts soured on the name, when Ballard shares had soared like a Tilray – well at a snail pace comparatively – peaking above $210 before swooping down to single digits in one and a half years.

Long ignored, except by a few U.S. investment firms, Ballard remains almost unrecognised today even with mighty HK- and Shenzhen-listed Weichai Power weighing in with a US$163 million investment for over 19% of Ballard at a 15% premium to the market price.

Weichai gets to place two directors on a board expanded from seven to nine, is confined to a two-year share purchase standstill and has the right to make a superior proposal in the event of a third party buy-out attempt. Ballard's stock has moved up since the day that deal was announced. The deal made Weichai the new No 1. shareholder, succeeding Zhongshan Broad-Ocean Motor Co., which was entitled to hand over to Ballard $20 million at the same price to "top-up" and maintain a 9.9% ownership position. Other longer-term corporate holders are Anglo American and Nisshinbo Holdings Inc., a Japanese supplier to the fuel cell industry. These corporations now hold above 33% of the stock.

There are plenty of negatives that keep Ballard sparsely covered. Its small cap status, the scarring hangover from that suicidal price run years ago, the arduous pace of development, switching from cars to smaller products and back to vehicles, a low revenues record and still only a proximity of positive cash flow. Also, there is no Elon Musk or Tesla aura here, or the attention given to the lithium battery sector. There are positives nevertheless. There is research commitment by most motor OEMs, a long history of successful hydrogen power train usage in transport using bulk storage stations, as in bus fleets and forklift trucks. And, Ballard is the main company, attaining 75% of global fuel cell units shipped in 2017.

The lithium battery is predominant, of course. It was always the preferred development, is charged with a plug in the wall, and winning in the installation of commercial charging stations.

However, Ballard now seems to have permanency and a degree of exclusivity in its field. Its scientists are refining its Proton Exchange Membrane (PEM) fuel cells. The next generation is expected to enhance performance, power density and to take costs down considerably, perhaps by 40%. In my opinion it should continue to be worthwhile staying in the company's shares.

By the way, among other things, I have heard that the action in Tilray's shares was due mainly to covered call writing by two of those amazing hedge funds using $80 covered call strike prices when the stock they held was under restriction and could not be delivered. ◆

Down in “The Hammer” Something Stirs

Steel yourself. The new Stelco, now **Stelco Holdings Inc. (STLC-TSX)**, is a buffed-up version beckoning investors. Hamilton, Ontario, otherwise known as “The Hammer”, is receiving more attention and is in the sites of several analysts in and outside Canada.

I ignored new Stelco after an introductory meeting at BMO Capital Markets last year. Then I watched the company price 13.53 million shares at $17 at the new IPO in November 2017 move quickly to the $20 level, watched an additional 10 million shares sold by insiders in April 2018 at $21.75 and the price move to around $25 with at least six analysts on the story and forecasting a future price well up in the thirties. I guess the first buyers were familiar with Alan Kestenbaum, Executive Chairman & CEO. He seems to be North America’s uncrowned king of steel – reputed on the web to be worth $10 billion. Kestenbaum put new Stelco together as the next major project in a career of over 30 years in iron, steel trading, merging and acquiring. He is noted for combining and selling about nine North American steel enterprises, creating the bulk of his fortune. He is a major holder of the 73.51% Stelco owner, Bedrock Industries, a private entity formed by entrepreneurs – the second such group to appear since an earlier one “flipped” an earlier Stelco to U.S. Steel.

Not ideal for large investors today is a float of only 23.4 million shares, many being quite tightly held in a total of 88.8 million.

Alan Kestenbaum is already moving his wealth higher with this revival and starting to flood rooms with institutional investors, who no doubt are desperate for new major ideas in a stock market where every growth stock of importance has reflected the longest bull run of all time. At a BMO investment meeting in late August, Kestenbaum, exuding confidence, had already paid out a nice special dividend and he explained that he will bring more assets into Stelco but only when cycle bottoms bring on cheap buys, often in the form of “deserted assets”, according to one analyst.

The new Stelco is one of the few remaining integrated steel companies – that being of the old model in North America – two others being U.S. Steel and AK Steel. Specialty producers and mini mills became fashionable decades ago and use scrap rather than iron ore. The Hamilton assets were acquired from U.S. Steel, which had invested approximately $90 million, updating the old assets from 2000. A second major asset is the Lake Erie Works, North America’s newest green field integrated steel making facility, where over $600 million was invested through the same period to modernize the business. U.S. Steel had bought Stelco out of bankruptcy in 2007. Mr. Kestenbaum claims that under his management team, company and union relations have been mended after years of discord. Five-year labour contracts are now in place.

Alan Kestenbaum’s earlier corporate involvements included **Globe Specialty Metals Inc. (GSM-US)**, which he founded in 2004, took public in 2009 and combined with private company Grupo FerroAtlantica to form FerroGlobe PLC – (also GSM-US). Mr. Kestenbaum left the executive there with a $21 million severance. He is impressive and one might say important to Stelco’s success while steel lasts.

It is interesting to note Stelco’s position and no doubt that of other companies relative to the Trump inspired tariff program. Kestenbaum points out that as Canada answered the imposition with its similar tariff, a fully domestic steel market should make Stelco more attractive to Canadian buyers, including customers lost and new. Kestenbaum believes Stelco, under its present management will deal with all conditions – supply and demand swings, politics and, at the same time, will work to recapture market share lost during Stelco’s troubled times.

The company reported second quarter adjusted EPS of $1.72, well above most estimates, in a demand driven market and aided by investments in rail and barge capabilities. This resulted in a special dividend of $150 million or $1.69 a share. There is also a regular quarterly of $0.10. A weak rather than strong Canadian dollar is to the company’s advantage. The company is one of the lowest cost producers in North America and claims to be top in operating margins. An extra interest for the company is a combination of formerly leased lands totalling 3060 acres adjacent to the Hamilton and Lake Erie works. This might lead to development under hired experts.

Although Alan Kestenbaum has no need for money, one might hope he will take Stelco as far as he can. At least one distraction seems to be out of way. He is no longer a contender for the NFL’s Carolina Panthers, which was sold a few months ago by the founder. ◆

Funko and the Power of Whimsy

Queen Daenerys, Lady of Dragonstone, Protector of the Seven Kingdoms, she, who is The Unburnt, is in our midst. She is here from television's Game of Thrones to distract and captivate us in this troubled world. She is here also to make money for **Funko Inc. (FNKO-US)**, leader of creativity in pop culture and proponent of fandom. She is just one in an infinite reserve and supply of characters of fable and fact on which Funko expects to feast long into the future.

According to the doctrine of Funko, everyone collects something, especially in America. It feeds deeply into pop culture, which I am beginning to understand. While I dream of beautiful queens and princesses, I have to admit I am in the fandom world in my own way. I collect old Chinese paper money and I have a weakness for unusual cars.

A research note out of BMO Capital Markets got me into a profitable investment in Funko, but it was not until recently that Andrew Perlmutter, President, and Russell Nickel, CFO of Funko, brought Queen Daenerys into my life at a big Liolios smallcap investment conference on the West Coast. It was then that I learned that 35-year-old women are a good target market for creating a place in their lives for Daenerys – but as a whimsical creation rather than in the "real" life form.

The man behind Funko is CEO Brian Marlotti. I have not met him, but, apparently, he is the proof of the power of "Fandom", as it is known. He bought Funko in 2005 from Mike Becker, who wanted to move on. Becker had launched Funko in 1998 and created the bobbleheads – the first being Austin Powers! In his office in Everett, WA, characters of his fandom world surround Marlotti. Earlier in life he sold his Pez candy sticks collection to help fund his first house.

I note that among the famous, Jerry Seinfeld has been shy so far about becoming a bobblehead. J.P. Morgan covers the stock and sees highlights in the pipeline, as Pokémon characters and the fighters of Fortnite come to stores near you. Get your offspring to explain further. J.P. Morgan's revenue expectation for this year is $0.76 per share and $1.08 for 2019, published with the stock at $20. BMO Capital Markets who made me aware of Funko appear to have softened on the name, but purely because the analyst views the price as "ridiculously high".

Revenue growth is big, with $588 million for the half year to June 30, following $516 million for the 2017 full year. International generates about one quarter of sales and has big potential. Funko bought out Underground Toys Limited, its U.K.-based distributor for Europe and the Middle East, which came with its own range of creations associated with well-known brands and clients – no less than Game of Thrones, Marvel, and Star Trek.

For about 45% of its product, Funko uses factories in Vietnam. In every respect Funko seems to be well ahead of any businesses that could claim to be in competition or could try for a significant entry into the business.

There is a private equity firm behind this "game of thrones". ACON Investments, L.L.C., founded two years earlier than Funko in 1996, bought in 2015. ACON is described as a middle market investor and has a diversified portfolio of assets valued around $5.3 billion. It invests internationally and has a number of offices in Latin and South America.

I guess pop culture will always cross the universe, charging up the potential inventory for Funko forever. Likewise – there will always be a Prince Edward Island, perhaps always to be visited by fans of Canada's very own Anne of Green Gables. ◆

Mango the Parrot might be watching you

Cyber security and associated technologies is this parrot's business and the corporate name is the **KeyW Holding Corp. (KEYW-US)** – not an easy name until you know that the visionary founder, Len Moodispaw loved Key West. He partnered in Key West with a yellow parrot called Mango. Len, who passed on in 2015, was a nice man at the scientific end of the modern spy business, not one of those FBI types. He lives on in memory and so does Mango adopted in the graphics of KEYW.

KEYW believes it is the only commercial U.S. operation purely in cyber security, surveillance and associated work for the intelligence agencies of the U.S. government. It has a chain of offices down the east coast and a few scattered across the south, generally staffed with specialists given high-level clearance.

Hardware and software are at the heart of the company and two thousand employees span the globe and support collection, processing, analysis and the use of intelligence data and information. Simply put, KEYW finds things out. Sensor is a big word in its business –

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Morgan Meighen Special Situations Pooled Fund

(As at September 30, 2018)

Returns

YTD	1 YR	3 YR*	5 YR*
+1.2%	+14.9%	+12.5%	+10.2%

*Annualized

Top 10 Holdings

Company	% of Portfolio
Funko Inc.	4.9
Morguard Corporation	4.4
Cargojet, Inc.	4.2
Canada Goose Holdings Inc.	4.2
Spin Master Corp.	4.1
OTC Markets Group Inc.	4.1
Patriot One Technologies Inc.	3.9
NV5 Global Inc.	3.8
The Middleby Corporation	3.4
Gibraltar Industries	3.0

Stated historical returns assume the reinvestment of all distributions. Such financial information does not reflect any transaction costs or such other fees and expenses which may have been applicable, nor income taxes payable by any unitholder, which would have the effect of reducing such historical returns. Stated returns for periods greater than one year are compound average annual rates of return. As net asset values and investment returns will fluctuate, past performance is no assurance or indicator of future returns.

Mango the Parrot might be Watching You

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sensors in orbit, on the ground, in human form, in vehicles and under water – all good old James Bond stuff of hyper-speed operation, but perhaps not explosive, gadgetry in front of innocents like me at the Midwest Ideas Investor Conference run by IR firm Three Part Advisors.

New management headed by Bill Weber, President & CEO, has been working hard to grow KEYW and make it profitable. It has made acquisitions through the years. The balance sheet needs improvement. Acquisitions created debt at the $285 million level, while revenue for 2018 is going to be around the $500 million level. Though its win rate in the cyber world is at 58% higher, the company still needs to scale up and build its contract pipeline. Higher end work is needed. The company recognises that its best potential is in growing subsectors and market niches and where the company has products that are differentiated. The target government sectors are the Department of Defense – leading hugely in total cyber expenditure in the U.S., followed by intelligence units and then Homeland Security. Of help theoretically is the recent approval of an 8% increase in defence spending, the largest increase in 15 years.

Also watching are quite a few high level institutional holders owning more than half of the stock, led by FMR LLC with about 15% of the 49.9 million shares. The stock trades below the level of a series of small issues over several years but has been in a rising trend since the last quarter of 2017. Several market analysts cover the company, including RBC Capital Markets who see that a second consecutive solid quarter should lay the groundwork for an order ramp-up and the removal of a 2019 refinancing overhang. ◆

Past Articles

About the Morgan Meighen Special Situations Pooled Fund (MMSSPF)

The MMSSPF is managed within the Morgan Meighen Group of Pooled Funds. Its portfolio reflects mainly the ideas of Michael Smedley and with the support of Niall Brown. Michael Smedley is the longest serving member of MMA's staff and has market knowledge assembled in 30 years while working in Canada, the United Kingdom and Hong Kong. Holdings are mainly Canadian and U.S., event-driven and target capital appreciation. In an earlier career he was in journalism and public relations. He has lived in eight countries in total. He has responsibility for this newsletter, which is intended for clients and all others who are interested.

Morgan Meighen & Associates (MMA) is a manager of private wealth portfolios and pooled funds: Mandates include **Income, Growth, Global, Balanced** and **Special Situations**. MMA can be traced back to the 1920s when a group of Canadian and British financiers and business people including the former Prime Minister of Canada, the Right Honourable Arthur Meighen started closed-end funds. The Morgan name came into the enterprise in 1955 when MMA was established and E. Louise Morgan became Secretary to Arthur Meighen and his son Colonel Maxwell Meighen and Secretary to the corporation. Control eventually passed down through Louise Morgan to her offspring Vanessa and Jonathan Morgan who today are in charge and are also members of the investment team. Clive Robinson heads the **Private Wealth Division**, Christopher King, Alex Sulzer and Niall Brown work with him as well as Greg Eckel, who works primarily on the public quoted closed-end fund **Canadian General Investments (CGI-TSX** and **LSE)**.

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