

INCOME TRUSTS: NOT A BIG DEAL

October was a good month to be long (or in our case, mostly long) with small caps leading the way stateside (Russell 2K the big winner up 5.8%). Here in Canada, the metals made a nice comeback, regaining their status as the “hot sector”, which kept some of our “special situations” in the background (overall, the TSX posted a solid 5.0% gain in the month). We managed to stay ahead the market, posting an 8.4% gain (up 16.8% since our March launch), despite being weighed down by our 25% short positions (even the companies that missed their earnings estimates went up). We were helped largely by several takeovers, as well as a blowout quarter by the company we profiled in last month’s letter (which we are still buying and not naming). We remain optimistic heading into the back half of earnings season and look forward to several of our companies reporting quarterly results later this month.

The ruling Conservatives decision to kill the burgeoning income trust model in has dominated headlines over the past week. While we were long only one income trust (which just hit a new high today; Nov. 9), our internal targets have declined for several positions that we believed were good candidates for the trust model. Generally speaking, Canadians as well as the media were pretty emotional about the “vast” sums of money that have been lost. Frankly, we are not sure what the big deal is:

- A week after the announcement, the TSX is up marginally on the month;
- The income trust sector index has dropped 10%; put another way, investors had given back less than two years of income distributions.
- Assuming trusts continue to distribute the majority of their free cash flow (which assumes that “distributable cash” is an accurate calculation), and that the distributions of that cash was indeed reflective of an efficient capital structure (rather than just a tax dodge), then retirees should still have “high yielding” investments going forward;

Most income trust investors that have been invested in income trusts for more than twelve months will readily admit that they got more out of the model than what they gave up. In other words, people are more upset about this issue than they should be. Americans seem overly upset about a generally politically central country closing a tax loophole that the IRS would have never let happen in the first place. The Liberals seem overly upset about a broken campaign promise that was simply onside with their own policies in the first place. Given that the Bloc, NDP and Liberals (despite recent rhetoric) all support the termination of this structure, the 60%+ of the population that voted for these parties shouldn’t be too upset.

Apparently, with an increasing number of mature corporations either voluntarily converting (Telus), rumoured/thinking of converting (Encana), or being pressured by shareholders to convert (Bell), the Conservatives thought they were looking at a major drain in tax revenues. I suppose they thought that closing the tax loophole for corporations was better than potentially having to raise personal income taxes to fill the gap down the road (if they still have a “down the road”). Contrary to popular opinion, “grandfathering” existing trusts wouldn’t have worked either, as income trusts would have a perpetually unfair advantage in the acquisition market and smarter investment bankers would have found a way to structure “reverse takeover” transactions which would effectively allow larger corporations to “back into” an income trust structure by acquiring a smaller trust.

We see three groups that will likely suffer fundamental damage beyond the 20% hit from the elimination of the tax shield:

- **Consolidators:** A lot of scale has been achieved through buying companies at 5x EBITDA and getting 10x in return. The trucking trusts have been huge successful exploiters of the model. This game is pretty much over;

- **Oil & Gas:** It wasn't just about the taxes for this group. It was about spinning out new properties once they became producing. This was the exit strategy of choice for this sector. Furthermore, trusts with declining production profiles were kept alive by their ability to acquire non-trusts to extend their production lives. Investors better take a closer look at reserves, and don't get duped by 20% yields, this is a losing proposition if you only have four years of reserves.
- **Private Equity:** There has been a lot of talk of private equity players being excited at the prospect of buying these trusts on the cheap. We don't think that they are anywhere near acceptable price points for these transactions. Firstly, prices need to come down 20% (versus the current 10% decline) just to wipe out the tax effect. Furthermore, trusts in general are too efficiently operated (built to maximize cash flow) for a private equity buyer to add much value; about the only thing they would be potentially interested in are the clean balance sheets of selective trusts. You can forget about the inflation in Canadian private equity valuations seen over the past several years because a lot of that pricing was done with the income trust exit in mind. Finally, I would imagine that Canadian private equity players in general are pretty busy re-evaluating the exit strategy for many current investments now that the trust window has been shut.

We have admittedly not been big trust investors in the past. We didn't have anything against the model, its simply that we tend to focus on free cash flow rather than distributable cash (in theory these numbers should approximate each other, in practice we found that they were usually nowhere close), and we look for opportunities where we see cheap valuations with the potential for margin expansion (most quality trusts we have come across operate at near peak efficiency). Our starting point for looking at some of these trusts is a 35% decline, so in general, the sector is not yet popping up on our screens. Maybe after tax-loss selling season is over...

With regard to the current state of the Founders Fund, we will admit to some satisfaction in passing our high watermark and thus putting all of our unitholders comfortably in the black. We are starting to get a little more aggressive in the management of the fund and are currently consolidating into fewer positions with larger weightings. Technology stocks are starting to show signs of life again, although we are admittedly having a difficult time finding high quality, reasonably priced stocks in Canada, and thus the NASDAQ remains our primary source for technology ideas. In Canada, we continue to underweight resource stocks, although we did start building some positions in the Uranium sector early last month. We have recently upped our short position weight to 40%, reflecting an investment in the results of our tax-loss target screen.

Thank-you for your continued support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.