The VIEW *from* BURGUNDY

NOVEMBER 1997

SELLING THE DOWNSIDE

We returned to the subject of income trusts in this issue of The View from Burgundy, *paying special attention to governance issues that were troubling us. Managers of trustable assets were forming income trusts where the mind and management of the trusts was in a separate company that had control of the assets and managed them for fees. The fees were of course excessive and unitholders had no control over them whatsoever. We took an example of this type of fund, the Legacy Hotels Real Estate Income Trust, to show how this ugly structure benefited management at the unitholders' expense. Subsequently, managements forced the unitholders to purchase management contracts for outrageous prices, usually in the form of units in their own funds.*

This article was probably instrumental in helping to force these conversions, and as the rate of income trust issuance burgeoned, these unfair structures were abandoned. So, ironically, we may have extended the longevity and attractiveness of the income trust sector by forcing it to clean up its governance act.

Richard Rooney, 2007

A Modest Proposal

IT IS WELCOME NEWS THAT THE CANADIAN GOVERNMENT has almost eliminated its deficit, but now we must deal with the very high debts that have been built up over the past 30 years. We feel the solution to the problem is obvious once a little "out of the box" thinking is applied to our fiscal situation. The Canadian government has a proud history of picking up the management fads of every era, after they have failed in the private sector, and applying them with comparable success in government. An outstanding opportunity to take a brilliant new product from the private sector and apply it with stunning effect is now available to the authorities at Finance. Mr. Martin and his cohorts could make history if they have the vision and boldness to use this new product imaginatively. We refer, of course, to the income trust.

The Revenue Canada Income Trust

The Canadian Federal Government has one of the world's finest streams of income on which to base an income trust. Virtually unencumbered by nondiscretionary costs, the stream of income tax receipts amounts to $80 billion annually. Increasing this stream of income has been a task at which Canadian politicians of all political parties have proven to be conspicuously successful – in fact, it is the only task at which they have been conspicuously successful.

Now, Bay Street knows a thing or two about unencumbered income. The new income trust vehicles they have been launching are based on it. With cap rates in the 8% range on fully taxed income trust products, the potential value of the income tax revenue stream is $1 trillion, or 125% of Canadian GDP. We believe that the yield-starved public would look with favour on an income vehicle based on the public's own tax payments. At Burgundy, we advocate investment in certainties, and after all, what is more certain than taxation?

The $1 trillion income fund would provide sufficient money to retire all of Canada's burdensome national debt, as well as that of the provinces. Think we could keep Quebec in Confederation by bribing it? Now we can afford to! Wait until Lucien Bouchard is offered, free and clear, a way out of his fiscal straitjacket in return for a simple business deal. Not only that, now we can bribe all the provinces to stay in Confederation. All provinces will be treated equally, just as the Reform Party wants!

Repaying our debt would immediately free up $45 billion in interest payments, those outmoded financing payments that are actually a legal obligation. The government could finance its remaining activities, if any, through the GST (unless they wanted to set up the GST Income Trust, which Bay Street – as a patriotic duty if Canada called – would design and sell for the normal 3-5%) and from its tax collections on the income trust payments themselves! Just try and avoid paying this tax! It'll be deducted at source: no muss, no fuss – $30 billion in revenues.

The provinces too can issue income trusts based on their taxation powers, in return for enormous amounts of money right now. What an opportunity for responsible public stewards of the nation's wealth.

We believe that the whole country, and especially Bay Street, is at the cusp of a Golden Age if our ideas are acted upon. Freed of debts, the country could march into the radiant future, confident that Laurier's prediction that the 20th century would belong to Canada had been fulfilled, for the last three years of the century anyway. (In the investment business, three years is known as "the very long term.") And if pressing national interests made the payment on the income trust units too burdensome, what the hell, we don't really have to make the payments. If it works for the private sector income trusts, why should the government be held to the primitive idea of mandatory payments?

Burgundy seeks no commercial gain from this proposal; we are motivated by patriotism and the desire to share with a broader public the potential of that incredible piece of financial alchemy, the income trust.

Burning the Furniture

As you may have guessed from our opening feature, the prices being paid for some assets via income and royalty trusts have exceeded our wildest expectations, but have exhausted neither the imaginations of the corporate financiers of Bay Street, nor the credulity of the Canadian public. It has truly been a situation where, as Buffett says, those who don't know are buying from those who don't care. How have these price levels been reached?

Let's consider a hypothetical example. Company A has a good, low growth, cash-generating business that requires little reinvestment in most years. The company has $1.00 per share in depreciation, and $2.00 per share in pretax earnings. It is currently valued in the market at $18, or 15 times earnings, the highest multiple it has achieved since its business matured. The corporate income statement looks like this:

COMPANY A INCOME STATEMENT	
Operating Income	$3.00
Minus: Depreciation	$1.00
Equals: Pretax Earnings	$2.00
Minus: Tax @ 40%	$0.80
Equals: Net Earnings	$1.20

So let's say that Company A decides to turn itself into an income trust. The first thing that an income trust structure does is to eliminate the corporate tax from the income statement. The distributions are now taxed at individual rates in the hands of the unitholders. And since individual tax rates are usually higher than corporate tax rates, the government is happy to have it so.

The second critical change between income trust and corporate accounting is that income trusts always seem to assume that some portion of their depreciation expense is excessive, and can therefore be distributed as income. Let's assume that Company A specifies that only 40% of its depreciation expense is a "real expense."

The trust income statement looks like this:

COMPANY A INCOME TRUST	
Operating Earnings	$2.00
Plus: Depreciation	$1.00
Minus: Capital Expenditure Reserve	$0.40
Equals: Distributable Income	$2.60

Assuming a yield of 9.0% on the units, the price of the units would be $2.60/0.09 = $28.89, a whopping 60% premium over what the stock market was willing to pay for the same assets in corporate form. At that equivalent price, the stock would have been trading at $28.89/$1.20 = 24 times earnings. For a mature, low growth business, such a multiple is out of the question even in the irrationally exuberant 1990s.

Observe one more thing. There is a tremendous temptation at the time of a new issue to maximize the expected payout by underestimating how much ongoing capital spending the company must make to sustain its business, let alone grow it. And like Oscar Wilde, managements and corporate financiers can resist anything but temptation. If, for example, Company A actually needs $1.00 per share in ongoing capital expenditures, as the full depreciation expense suggests, the price of the units would be only $2.00/0.09 = $22.22, still a premium to the share price, but not a very large one.

For our part, we wonder how the accounting profession can be so wrong about how it accounts for depreciation. There is no doubt that, in some cases, depreciation does not reflect economic reality. In fact, it is one of Burgundy's techniques to find such anomalies and, where appropriate, invest in them. But, they are not all that common – usually the depreciation levels are appropriate over long periods of time. Remember, in the inflationary 1970s, everyone believed that depreciation was far below economic levels, and multiples of earnings were exceptionally low to compensate. The 1970s were a historic buying opportunity for common stocks. The enormous volume of asset sales into royalty and income trusts would indicate to us that managements view the late-1990s as an equally historic selling opportunity.

A business that genuinely needs very little ongoing capital expenditure is a rare bird indeed. Oil and gas development companies, mattress companies, coal mines, hotel chains and sugar companies do not qualify, though they have all been offered into the market as income trusts this year. If they pay out their income as though historic depreciation is not a real cost, they are self-liquidating entities, not going concerns. In other words, you may be keeping the fire alight, but you're burning the furniture.

Heartbreak Hotels

We said in a previous issue of *The View* that royalty and income trusts have some of the characteristics of an insider sale. But it is an insider sale of a peculiar type: they are only selling the downside. What we are seeing in many cases are sellers realizing insane prices for assets, and also keeping control of those assets under conditions that can ensure that for management, though emphatically not for unitholders, the crop will never fail. Sell your business and entrench management? It's a dream come true!

How does it work? Well, we decided to dissect a recent income trust issue to illustrate our concerns. We chose the Legacy Hotels Real Estate Income Trust, not because it is among the worst of the new breed of income vehicles (except for its prospectus disclosure, which is, in our opinion, disgraceful), but rather because it is one of the best. Canadian Pacific Limited (CP) is bundling together its business hotels like the Royal York in Toronto, the Palliser in Calgary and the Chateau Laurier in Ottawa, and selling a REIT based on the cash flow from these hotels.

These are very good assets. They are well maintained and well managed. Many of them are familiar landmarks in Canadian city centres. While not irreplaceable, they are very well positioned in their markets. CP spent almost $31 million per year upgrading these hotels in the last decade, and it shows. But the hotel business is cyclical, though you would have to read the prospectus carefully (no easy task, since it runs to 86 pages) in order to find out. Someone in corporate finance has discovered the linguistic miracle by which a double negative gives the meaning of a fudged positive. For example: "There can be no assurance that regulatory compliance or downturns or prolonged adverse conditions in the hotel industry or real estate or capital markets or national or local economies will not have a material adverse effect on the Trust's results of operations."†

Translation: "Regulatory compliance or downturns or prolonged adverse conditions in the hotel industry or real estate or capital markets or national or local economies (all of which have an unfortunate tendency to occur at the same time) will have a material adverse effect on the Trust's results of operations." Is that clear? We're always glad to help.

From the prospectus, it would be very difficult to find any evidence of the last time these malign planets came into alignment. CP has provided data back to 1994, which was hardly Armageddon in the hotel business. From CP's annual report, we get the following progression of operating earnings for CP Hotels, of which the hotels in the Legacy Trust represent 45% of the revenues, and less of the profits:

ROOMS AT THE TOP
CP Hotels' Operating Income 1987 - 96

1987	25.3
1988	53.0
1989	53.9
1990	58.2
1991	24.5
1992	50.0
1993	57.1
1994	72.7
1995	96.9
1996	115.8

Source: IPO prospectus

Now why start in 1994, we wonder? Perhaps because that was the first year which could have supported a payout on the REIT units?

The Straw Man

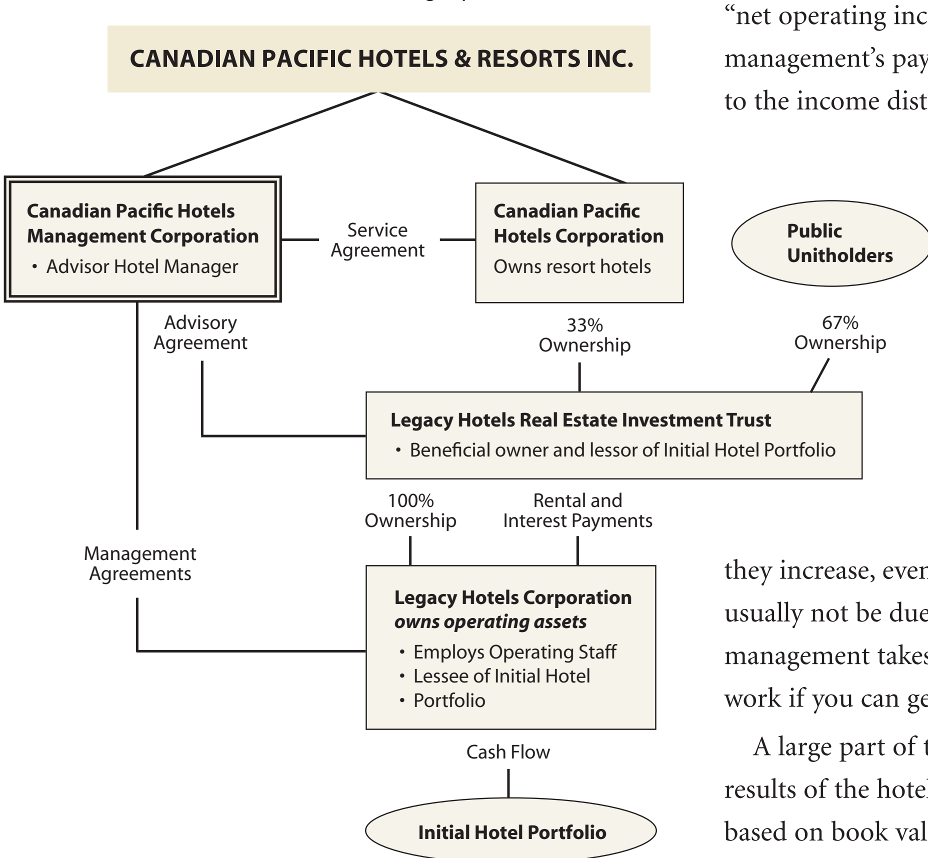
Several people have made the point that investors such as Burgundy who like to invest in companies that generate free cash flow to shareholders should really like royalty and income trusts, which do just that. But there is a crucial difference to our way of thinking. The relationship of a trust unitholder to management is entirely different from that of a shareholder in a public corporation, especially in the way most income trust deals are now being structured in Canada.

Corporate structure is straightforward – shareholders elect directors, who then appoint management to run the firm on the shareholders' behalf. However distant most Canadian companies may be from this ideal, that is the basic theory of the business corporation that has revolutionized the world over the past 300 years.

And as we have said many times before, management is the critical variable in assessing a business. A genuinely excellent management group, with its own culture and network of relationships, and its detailed knowledge of markets and operations, is the most valuable thing a shareholder owns. The dialogue between management and informed shareholders is the crux of capitalism, in our opinion, and is essential to the success of both.

It just doesn't work that way with income trusts. Managements of the assets in the income trusts are going out of their way to design structures where they do not work for the unitholders, and where their incentives are radically different from those which would benefit unitholders.

Look at the structure of the Legacy Hotels REIT.



Source: Burgundy Investment Team Research

To simplify a rather complex structure, we have highlighted the most important entity on the organizational chart, which is not, unfortunately, the Income Trust. Mind and management of the Legacy Hotels REIT reside outside the Trust, in the CP Hotels Management Corporation.

The way in which CP Hotels Management Corporation makes its money is very illuminating. It charges a 3% fee on the revenues of the hotels as a "Hotel Management Fee." It charges the Trust an advisory fee based on the undepreciated book value of the assets in the Trust. It receives a fee based on the transaction size for any purchase of new hotels and for the sale of existing assets from the Trust. And finally, it receives an "Incentive Fee" based on any increase in "adjusted net operating income," which could, under ideal circumstances, equal 30% of the upside in such "net operating income." So the only part of management's pay that is more or less directly related to the income distribution (the only thing the unitholder cares about) is the "incentive." In a cyclical industry, the extent to which management controls increases in operating profitability is questionable, as is, therefore, their right to any "incentive" so calculated. If distributions remain flat or decrease, management will not suffer. If they increase, even though the major increases will usually not be due to management's actions, management takes up to 30% of the increase. Nice work if you can get it.

A large part of the fees will be independent of the results of the hotels. Fees for transactions and fees based on book value of fixed assets will not vary with the business cycle as distributions will. And while the revenues on which the Hotel Management Fee is based will vary with the economy, it will vary a lot less than, say, distributable income. The vast majority of the cyclical downside will be borne by the unitholders. We feel that this is a rather asymmetrical arrangement: sell the downside, cream off the upside. If CP ever wants to take its CP Hotels Management Corporation public, it would find willing buyers. It is the really good business in this setup.

So what if you buy the units and become disenchanted with the arrangement? Can you change it? Well, no, you can't. CP effectively controls the nomination of the trustees through its holding of one-third of the units (which it is able to buy at a special price), and through a too-clever Nominating Committee structure. The governance of this Trust appears to us to be devoted to maintaining CP control over the assets, while realizing a monumental price for the hotels, and creaming off a good portion of the upside, if any, in the business. The unitholders are a straw man, with no management team working for them, no control over their destiny and no power to change anything important. That is the difference between a unitholder and a fully enfranchised shareholder.

It is interesting that in the U.S., this kind of arrangement is comparatively rare. It was common at one time, during the 1970s and 1980s, but the predictable and inevitable conflicts of interest that occurred forced the reorganization of the U.S. income trust industry. Virtually all U.S. income trusts now have management residing in the trust itself. U.S. investors shun arrangements like the Legacy Hotels REIT, due to bitter experience. And now it appears that Canadians will have to learn the same lesson – the hard way.

A Prophecy

We will now venture a prediction for the future of the income trust industry. First, given their structure of rewarding management for transactions, they will engage in numerous acquisitions, financing them with the sale of more units. Eventually, low commodity prices, a slow economy or business-specific reasons will reduce distributable income from the business. The trusts will be able to borrow to maintain their distributions for a time, hoping for a rebound. Finally, the management companies running the trusts will announce, with great sadness, that they will be reducing the distributions to unitholders. This will result in an unholy mess in the public markets for income trusts. Some of the lowest quality ones will go out of business entirely, while a large number of mediocre ones will reconvert to corporate form. A lot of naïve people's savings will be lost. Bay Street's name will be mud, particularly those firms that were most aggressive in selling these creations. Not just underwriters either – the companies who participated will have blotted their reputations as well.

We hope they feel that selling the downside was worth the consequences.

Endnotes

†. Wyndham Hotel Corporation. Prospectus Summary. Registration Statement. 1996.

BURGUNDY™
ASSET MANAGEMENT LTD.

Bay Wellington Tower, Brookfield Place
181 Bay Street, Suite 4510, PO Box 778
Toronto, ON M5J 2T3
Main: (416) 869-3222
Toll Free: 1 (888) 480-1790
Fax: (416) 869-1700

1501 McGill College Avenue
Suite 2090, Montreal, QC H3A 3M8
Main: (514) 844-8091
Toll Free: 1 (877) 844-8091
Fax: (514) 844-7797

info@burgundyasset.com
www.burgundyasset.com