The VIEW *from* BURGUNDY

DECEMBER 1996

THE CRYING GAME

During 1996, a new kind of investment product had appeared on the Canadian scene. The royalty trust or income trust started in the resource area and spread to virtually all other sectors of the Canadian market over the succeeding decade. Our first quixotic attack on aspects of this new type of security was in this issue. We were particularly concerned with oil and gas royalty trusts. However, careful reading of this article, and of all succeeding Burgundy articles about income trusts, shows that Burgundy never opposed them root and branch. We felt that for a certain kind of business they were a great idea, and still do. But as usual on Bay Street, a good idea was taken to ridiculous lengths and the government had to shut them down.

We must point out, however, that by and large these assets performed very well for most of the 1996 to 2006 period, due to an unusual combination of strong commodity prices and declining interest rates, so our forecasts of extreme disarray in the income trust markets were never borne out.

Richard Rooney, 2007

READERS OF *THE VIEW FROM BURGUNDY* ARE AWARE that capital allocation is one of the issues we constantly refer back to in our analysis of companies. The one thing above all others that is guaranteed to infuriate us is a company that possesses or generates substantial cash in excess of its normal operating requirements, lacks high return investment opportunities, and refuses to pay out this money to shareholders. We have mentioned several examples of this "hoarding instinct" among the managements of Canadian businesses, such as Imasco, Canadian Marconi and Moore Corporation. In the last year, a new product has appeared on the Canadian investment scene that involves the complete payout of cash flows in excess of operating requirements from assets in a wide variety of Canadian industries. That product is called the royalty trust.

It would be logical to expect us to like royalty trusts, since by definition they prevent managements from squirreling away cash that rightfully belongs to the shareholders. And, in theory, we do. In the case of a no-growth business that generates a reliable stream of free cash flow over a very long time, we think that they are a brilliant idea. Unfortunately, in the overheated investment atmosphere of 1996, brilliant financial ideas are often extended into realms where angels fear to tread. With staid and sober Canadian fixed-income investors starving for yield, they have embraced royalty trusts with great fervor and a complete lack of discrimination. Indiscriminate embraces often lead to unpleasant after effects! We suspect that this is as true in investing as in life, and will in time bring pain to investors in some of the royalty trusts we see being issued today.

The problem is that royalty trusts have been seized upon by the most capital-hungry business in Canada as an avenue for cheap financings. We refer, of course, to the oil and gas industry.

A Cautionary Example

An oil or gas well might on first sight be considered to be an ideal prospect for a royalty trust, since it is an asset that produces cash flow year in and year out for a long time.

Boone Pickens, the flamboyant corporate raider of the 1980s, thought so when he turned Mesa Petroleum into a type of royalty trust called a Master Limited Partnership (MLP) in 1985. The idea was exactly the same as that of our Canadian royalty trusts, with some differences in the legal structure of the final product. All cash flows beyond the operating expenses of the company were to be paid out, and the company was to acquire new long-life reserves as it went along. The market, which considered Mr. Pickens a genius at that time, applauded loudly, sending the price of the MLP units to $100 the same year. Large distributions were made in each of 1986, 1987, 1988 and 1989. The Master Limited Partnership made several large acquisitions and the balance sheet became rather leveraged. The 1990 distribution was only $1.875 per share, which did not support a unit price that by that time had fallen to $30. In 1991, the MLP units were reconverted to corporate form at $10 and no distribution was made; after several refinancings, all grossly dilutive to the original shareholders and unitholders, they trade today at $5.

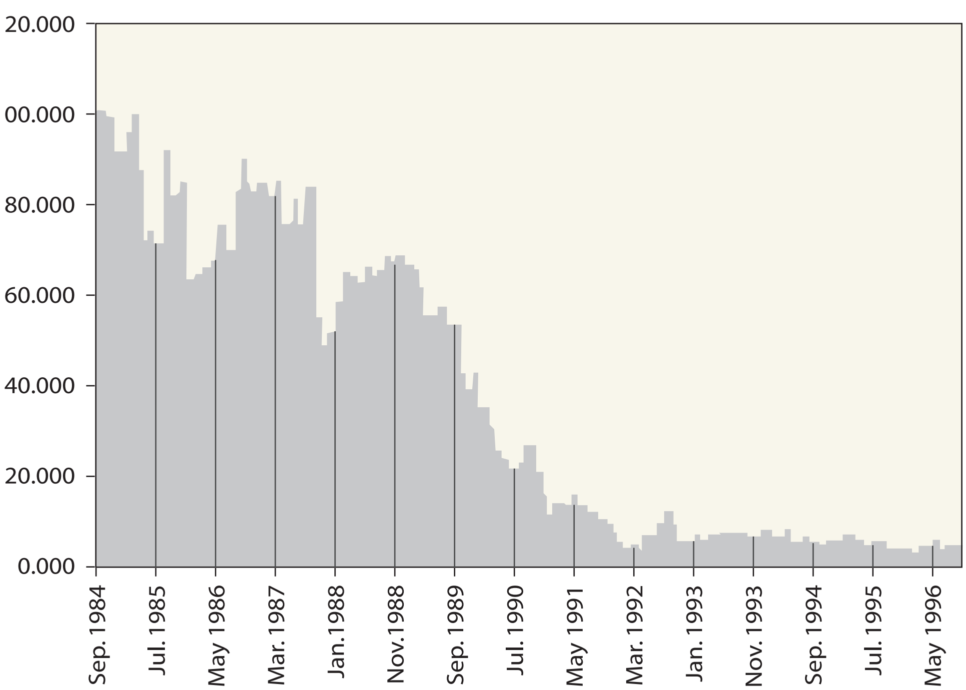
Even after giving credit for distributions amounting to $39 over the period 1985-1989, the Mesa MLP units must be considered a failure as an investment, since only those who paid $49 or less even received their money back on a simple payback basis at the time of the reorganization; the price paid would have had to be far lower for investors to have earned a reasonable rate of return over that period. We append the stock price chart of Mesa from late 1984 to the present day. The six years from 1985 to 1991 were the period during which it resembled a royalty trust.

A Roulette Mortgage

Those who paid $100 in 1985 for a notional "yield" of 7.75% on their Mesa MLP units were obviously gravely disappointed. This yield illusion is the driving folly behind the great royalty trust bubble of 1996. Much is made of the fact that distributions from the royalty trusts are "tax advantaged," since Revenue Canada treats most of the distribution as a return of capital. Now there are two ways to look at this information. First, Revenue Canada is totally wrong about the tax treatment and is missing out on a great opportunity to tax a type of income to Canadians. In this case, given its past form, Revenue Canada will act with dispatch to remove this advantage and tax the income as dividends or as interest, whichever it deems appropriate. In other words, if Revenue Canada is wrong, the holder of royalty trust units is one tax ruling away from taxable status.

The second possibility is that Revenue Canada is right in its economic assessment of royalty

MESA INC.



Source: Burgundy Investment Team Research trusts and that a huge portion of the distribution received is return of capital, or if you like, repayment of principal. In this case, what you have is a "roulette mortgage" on which you know neither the term nor the interest rate. Would you lend your hard-earned dollars in this form? We doubt it. What might be the result of buying a royalty trust if Revenue Canada is correct? Fortunately, someone has done the numbers.

The royalty trusts have been a bonanza to the corporate finance industry. One highly respected securities firm in Calgary has been particularly cautious about the "gold rush" because it believes that many of the royalty trusts will turn out badly. That firm, Peters and Co. Limited, has turned its back on a lot of quick cash in the interests of the investing public, which is not normal behaviour in the financial industry during a bull market. We cannot speak highly enough about this firm and its decision to sacrifice very attractive short-term returns to maintain its long-term reputation. The firm's president, Michael Tims, gave a provocative and interesting speech to the Canadian Energy Research Institute in September 1996, in which he examined the royalty trust phenomenon. Let's look at what he had to say.

Mr. Tims looked to the U.S. experience in Master Limited Partnerships to see where they had gone wrong. He found six main factors that made these products a disaster. These were:

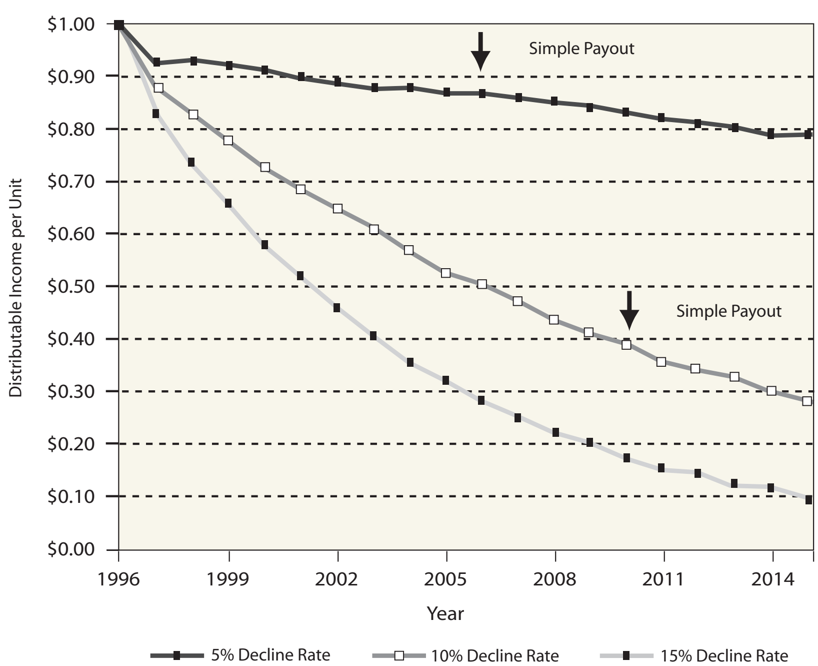
1. Overpaying for assets
2. Unanticipated commodity price declines
3. Excessive fees paid to investment bankers, management companies, resource companies, consultants, etc.
4. Poor reinvestment of cash flows into existing assets or new assets
5. Excessive leverage, which became critical as the revenue stream declined
6. Income tax law changes

While Mr. Tims believes that we have learned something from the MLP boondoggle, he presents a list of potential problems that give us pause. The three points that we would like to examine concern the decline rate on distributions from royalty trusts, the impact of commodity price assumptions on returns, and the impact of taxes on returns. (As an aside, Mr. Tims had a list of no less than 11 factors to watch in buying royalty trusts, which indicates to us the complexity and potential for misunderstanding inherent in this product.)

First, we look at the impact of declining distributable income resulting from simple production declines, a permanent and inevitable feature of oil and gas properties where declines begin from the day production starts. Our example assumes that the cash distributions decline in line with production from the underlying wells. The chart assumes three decline rates: 5%, 10% and 15% annually. The chart also assumes steadily rising prices for the commodity

*** DECLINING DISTRIBUTABLE INCOME OVER TIME**

Example based on escalating price forecast, before income taxes

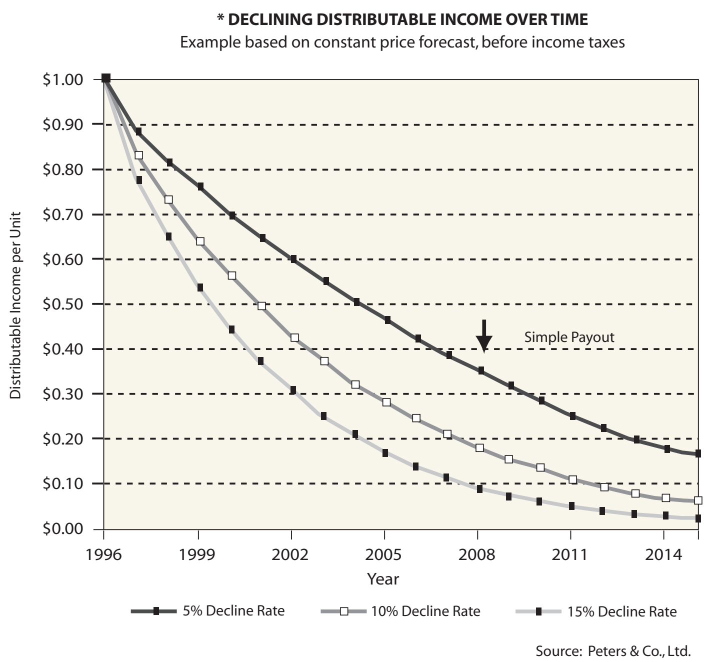


Source: Peters & Co., Ltd.

underlying the trust, usually at a rate of 2-3% annually. No taxes are assumed to be paid.

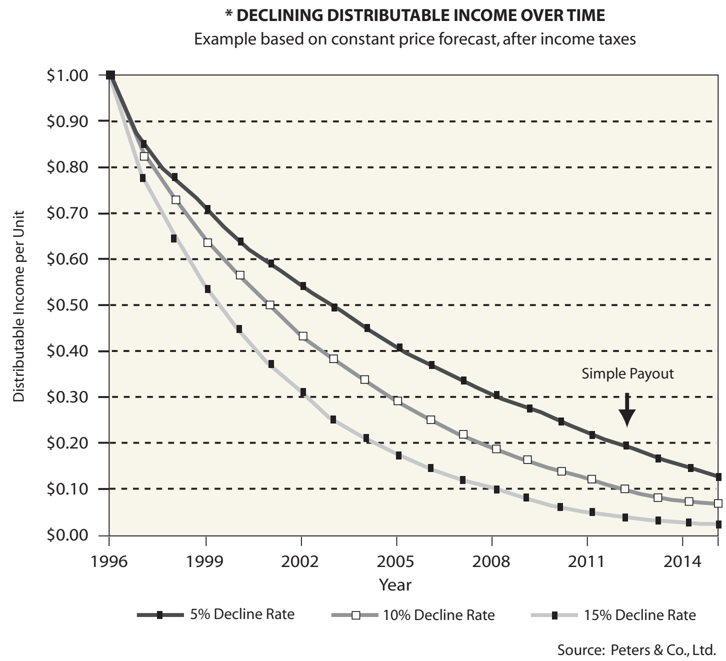
As you can see, at a 5% rate of decline, the investor receives his money back, undiscounted, in 10 years, or 2006. At a 10% rate, the payback year is 2010, while a 15% annual decline will not payback until after 2015.

But we all know that commodity prices do not rise at nice steady rates. The oil price has in fact been pretty flat for the past 10 years, and is now at the high end of the trading range over that period. If we use a flat price forecast to examine the returns, we get the following chart:



With constant commodity pricing, simple payout occurs in 2008 for a trust with a 5% annual decline rate in distributions. Neither the 10% nor the 15% decline rates payout before 2015; that is to say, there is nothing earned on investment for at least 19 years.

And since these products are very much being sold on their tax advantaged status, we must of course incorporate the effects of income taxes. Then, if we make some taxation assumptions on our constant price model, we get the following chart:



At a 5% rate of decline for distributions, after-tax payout occurs in 2012, while neither the 10% nor the 15% decline rates payout before 2015. We are long-term investors at Burgundy, but these time frames are a little too long for us. We would like to get our returns in the future, not the hereafter.

So are all royalty trusts bad? Of course not. At our firm, we have bought shares in one of them, the Athabasca Oil Sands Trust. The Trust in question owns 11% of Syncrude, the huge project near Fort McMurray, Alberta. The oil sands are the definition of long-life reserves, since there is about as much oil there as in the whole Middle East. Cash flows are very reliable (though in the event of high capital expenditures and low oil prices, the payout on the trust units could be interrupted at any time) and production costs have shown a downward trend over time. It seems reasonable to assume that the oil sands will be a good source of cash flow for a very long time, and that the eventual return on investment may be 10%, given conservative assumptions.

Westar

In fact, there are probably a lot of assets in Canada, many of them non-resource assets, which could be better investments if they were placed in a royalty trust. A striking recent example was provided by Westar, a stock in which Burgundy holds a large position.

The Westar example shows why it is such a good idea to invest in good businesses run by good people. Westar is the remains of the old BC Resources Investment Corporation, or BCRIC. This relic of the 1970s interventionist government in British Columbia was living proof that if you wanted to find something worse to invest in than an ordinary conglomerate, have a government construct a conglomerate for you. Built up with resource assets purchased at the peak of the inflationary boom, BCRIC lost almost a billion dollars and sold off assets at fire-sale prices through the 1980s until, by 1993, it had no assets left but huge loss carry-forwards for tax purposes, almost $200 million in capital losses for tax purposes, and the Roberts Bank Coal Terminal in Tsawassen, south of Vancouver. The company had huge debt levels and was, for all intents and purposes, bankrupt.

At that point, one of Canada's best businessmen appeared on the scene. Jim Pattison is legendary in British Columbia, but less well known outside it. He has built a very large (and very private) empire embracing car dealerships, food retailers, packaging companies and a variety of service firms on the Lower Mainland of B.C. Very little happens in that part of the world without Mr. Pattison being aware of it. And at a time when Westar was a joke or a swear word to most people who knew anything about it at all, Jim Pattison and his right-hand man, Nick Geer, saw an opportunity.

Consider the Roberts Bank facility. It is an unsightly thing, jutting miles out from shore off one of the world's most beautiful coasts. It takes almost all the coal from the rich Southeast B.C. coal mines, which then must be exported to Asia. Huge volumes of coal – at least 15 million tonnes – pass through the facility every year. And on each and every tonne, the Westar terminal collects $5.50. It is quite unlikely that anything like another Roberts Bank coal terminal will ever be built on the west coast of North America, given the environmental sensitivities in that part of the world. We hasten to add that the negative environmental effects of the coal terminal are purely aesthetic; coal is a very inert substance, so there is little pollution of air or water associated with the terminal.

At Burgundy, we like to invest in businesses that we understand, and which produce reliable cash flows for shareholders. We think that Westar is one of those businesses. It is a toll booth, and owning a toll booth is a very attractive proposition, especially when no one else can set up another one nearby.

Mr. Pattison thought so too. In a masterly series of transactions, he gained economic control of Westar, and cleaned up its balance sheet. In the last week of October, he announced that he was considering spinning the Roberts Bank terminal into a royalty trust. At the time of the announcement, Westar had a market capitalization of $250 million. With $50 million in annual cash flow, capitalized at 10%, the assets would potentially be worth $500 million in a royalty trust. We might argue that given the virtually perpetual nature of the cash flows through the terminal, a lower capitalization rate might be appropriate, and therefore a higher price. But you get the idea – with one announcement, Mr. Pattison doubled the potential value of his (and our) Westar investment. (We hasten to add that we have not yet seen a prospectus for the proposed trust and our numbers are estimates only.)

This is not to say that the Westar royalty trust will be without risk. There will be two main risks: the risk that volumes of coal through Roberts Bank will fall (a certainty since coal demand is cyclical and is currently very strong); and the risk that the price per tonne of coal that Roberts Bank can charge the industry will be reduced from the current $5.50 per tonne. Either of these events could cut the cash flow from Roberts Bank in half in any given year. A combination of the two could make the royalty trust eliminate its distribution entirely. And we are obliged to note that the smarts here are definitely possessed by Messrs. Pattison and Geer, and they are selling, not buying, royalty trust units. The same could be said of most royalty trusts: they have some of the characteristics of an insider sale.

Conclusion

Clearly, royalty trusts can have a useful role in Canadian finance, and some of them can provide high quality yield on an after-tax basis. Westar may prove to be a good example. But royalty trusts, based upon wasting assets and declining revenue streams from commodities with volatile prices, could prove to be a recipe for disaster. Not only that, the clientele being attracted into the royalty trusts tends to be retired savers who are trying to increase yield in an era of very low nominal interest rates. Many have never invested in anything but fixed-income guaranteed products. This mismatch of client and product bodes ill for the future. We think that many of the royalty trusts that Canada's underwriting firms are launching and placing in client accounts will prove disappointing, and some will end in tears. In the invariable custom of the capital markets, it will not e the underwriters who are weeping.

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