



Al Rosen
Between the Lines

Bad eggs

When it comes to investing in income trusts, don't count your chickens before they hatch

Nowhere might you be more puzzled than perusing the analyst price targets for Aeroplan Income Fund (TSX: AER.UN). The possibilities range from \$14 to \$29.50 a share. With a recent market price of nearly \$22, investors might be looking at anywhere between a 35% loss and a 35% gain.

Poking into the various analyst reports reveals the discrepancy comes not just from differences of opinion on business prospects, but also matters much more fundamental to valuation. One report notes that the reason for the bullish price target (in direct relation to other brokers) is the analyst's decision to credit Aeroplan for money that the company hasn't earned yet.

Aeroplan receives cash when its partners (like Air Canada) give points to customers. Aeroplan holds on to the money, but can't call it revenue until it pays out the costs of the rewards eventually redeemed by customers. The average delay between distribution and redemption is 30 months. A lot can happen to costs during that time, so the ultimate profit margin for Aeroplan is far from set in stone.

It's also questionable whether Aeroplan will continue to grow at its current rate. Essentially, counting cash before it's earned is the valuation equivalent of counting chickens before they hatch. Ergo, the large difference of opinions on the company's value.

The pitfalls of this valuation approach are illustrated by the Brick Group Income Fund (TSX: BRK.UN). The Brick receives cash up front for extended warranties that it sells on appliances, electronics and furniture, but doesn't record the income until later. In the interim, the estimated costs can change—and did, for that matter. In Q4 2006, increases to the company's unpaid claims reserve negatively impacted EBITDA when it became clear that the chickens weren't laying eggs so much as...well, bricks.

The use of two income trust examples to illustrate the point here is no coincidence. When investors became overly focused on cash distributions, they started not to care where a company's

cash came from, even if it was the result of selling more units. The logic of basing a value on earned cash flows was conveniently forgotten by the underwriters, and companies that had ongoing sources of unearned cash suddenly found themselves with premium market prices.

This brings us to Home Equity Income Trust (TSX: HEQ.UN), a provider of reverse mortgages, which are loans given seniors secured by the equity in their homes. They require no repayments until homeowners die or move, but cost a significant amount in interest charges.

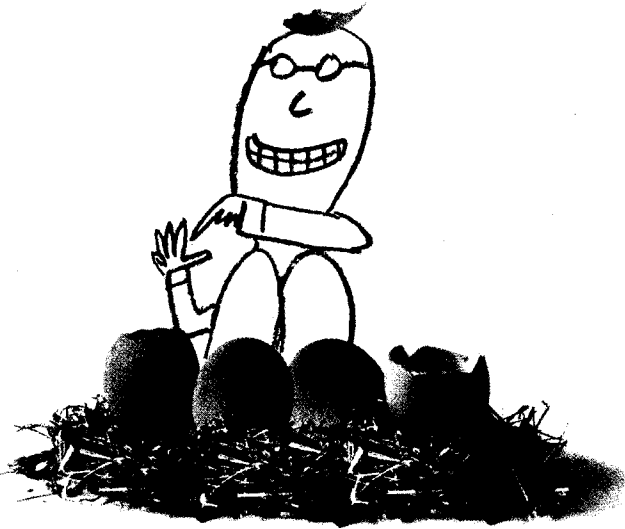
For example, a couple aged 70 with \$500,000 in home equity could borrow roughly 35% of their home's value. At about 8.5% interest and 2% long-term historical appreciation, they would deplete the equity in their home by age 87. If they die in arrears, Home Equity can sell the house and get its 65% cut of the original half million.

Even though Home Equity doesn't get any cash until the couple moves on, so to speak, it still needs to pay distributions to its unitholders. In fiscal 2006, the trust reported income of \$7.3 million and cash from operations of negative \$4.5 million. Almost \$23 million of interest revenue was non-cash, or

accrued. Yet, cash distributions to unitholders were more than \$14.5 million. The solution: sell more units, incurring greater cash obligations, and try to stay ahead of the increasing commitments.

So far, Home Equity hasn't had a problem obtaining financing. But, what happens if housing prices have peaked too high, seniors don't die fast enough, or interest rates start climbing again? Home Equity has the reverse problem of Aeroplan and the Brick, which had more cash than income. But, the proviso is similar. Don't misjudge the risks inherent when cash flows don't match up with income gains.

The income trust structure has a way of appeasing investors with high cash distribution yields, but also has a way of blinding people to fundamental mismatches that can hide deep in the company's financial statements. Whether it's unearned cash or non-cash income, investors should stay on the lookout for potential bad eggs.



Income trusts have a way of blinding people to fundamental mismatches

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