

Outlook for the Energy Income Trust Conversion Wave

by Kevin Dehod,

Vice President and Portfolio Manager

The energy income trust sector has come a long way since that frightening Halloween on October 31st, 2006, when the financial community learned that Energy and Business trusts were going to become taxable. Today, the energy income trust sector is on average 45% higher than the lows reached that October, and the sector is up about 128% from the market lows reached in March 2009. In fact, for the one year period ending October 31st 2010, energy income trusts have performed very well with a one year return of 18.0% vs. 15.45% for the TSX 60 Index, and a 4.50% return for non-trust energy equities. With the majority of energy trusts converting to corporations as of January 2011, what is the outlook for this sector and should investors be concerned with distribution cuts as the players try to adapt to a different business model and growth focus?

There have been a number of dynamics unfolding in this sector since the tax changes were announced in 2006. First, payout ratios (the percentage of annual cash flow paid out to shareholders in the form of distributions or dividends) have adjusted by falling from 70% in 2006 to a forecasted level of 46% for 2011. So at first glance the dividend payouts appear

more sustainable. Incorporating an \$80US WTI oil price and \$4 Cdn natural gas price, and US\$/C\$ exchange of .99, 'all in payout ratios' for 2011 should be in the 125% range for the sector on average. All in payout ratio simply combines dividend payments with capital expenditures divided by total cash flow. Ideally, investors should look for corporations with all in payout ratios of around 100-110% depending on commodity price assumptions, corporate debt levels, individual asset quality and corporate net backs. One factor that can really help a trust maintain cash dividends once they convert to a corporation is a high level of participation in the companies Dividend Re-Investment Program (DRIP). This enables the company to conserve cash flow and issue shares for a portion of the dividend each month. The catch, however, is that you had better be delivering production and/or Net Asset Value (NAV) growth per share as you increase the share float each month and dilute current shareholders.

Second, development cap-ex budgets (excluding corporate acquisitions) have moved from around \$800 million in 2006 to around \$1.3 billion as trusts transition to corporations and focus on a Yield + Growth business model. Technology has had a huge impact in helping trusts transition to the growth model as horizontal drilling and multi-stage fracturing techniques has unlocked hidden value on a large number of the trusts' legacy land positions. Year to date, energy trusts have accounted for approximately 50% of the horizontal drilling in the

WCSB. Also up until recently, most of the mid-cap and junior producers were focused on natural gas drilling and development. When the huge disparity began to develop about a year ago between oil and natural gas prices, most trusts were in a better position to exploit oil opportunities within their existing asset base and hence protect cash flow and maintain healthy netbacks in a very depressed natural gas environment.

Industry Comparable Valuation Metrics

	Price to CF	
	2011E	EV to EBITDA
Royalty Trusts	7.7x	9.1x
Intermediate E&Ps	5.2x	7.0x
Junior E&Ps	7.3x	8.1x
Senior E&Ps	6.1x	6.0x

Source: BMO Capital Markets, Bloomberg

As we look ahead to 2011, energy income trusts at today's price levels appear to be fully valued unless commodity prices continue to move higher from current levels. At current commodity price levels dividend payments look stable and secure, however share price appreciation appears much harder to come by given current valuations and the uncertainty of results as trusts transition to the growth model. The Chart above shows industry comparable valuations as the income trust sector has reached valuation levels not seen since 2006. It is interesting to note that the high valuations within the sector are not being driven by growth expectations as only 3 out of 16 trusts show any production per share growth from 2009 to

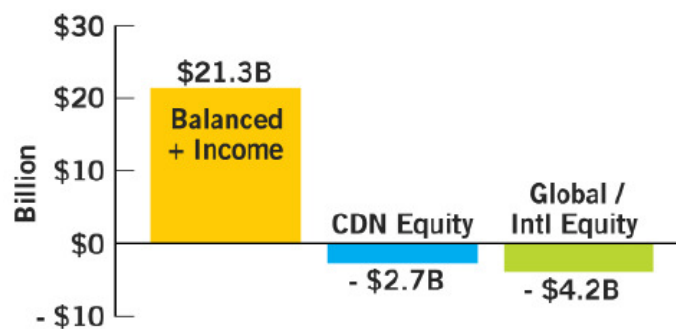
forecasted 2011 levels. Even with increased drilling budgets and new drilling technology, production per unit is still hard to deliver on as trusts convert to corporations.

So what is driving this valuation dynamic within the sector as trusts convert to corporations? Very simply, investors are starving for yield. A perfect storm of low interest rates, favourable tax treatment on dividend income, a range bound stock market, supportive demographics, an oil price that is trending higher, and strong fund flows are pushing up the valuations of the majority of yield products and equity instruments that pay dividends in Canada.

The Chart below shows net sales numbers for the Canadian Mutual Fund Industry over the last 12 months and it is very clear that there is a strong appetite for income orientated funds. Of the income trusts that have converted to corporations so far in 2010, on average institutional holdings and demand has increased by 32% as dividend paying energy companies qualify for a much larger opportunity set of investment mandates than energy income trusts.

Fund Flows Drive Appetite for Yield

(Mutual fund net sales, 12 months ending October 31, 2010)



Source: IFIC

The main observation with the yield trade that has been so rewarding over the last 12 months is that the party is not over. However investors need to closely monitor the factors that are driving this trade and they should be prepared for less capital appreciation going forward. Even though the yield on a particular equity may be secure, if the capital is overvalued, some profits should be taken on the capital value and reallocated to other companies within the same sector at a lower valuation or to other asset classes with stronger risk/reward characteristics.

With lower payout ratios and more reliable dividend streams from energy companies that move to the Yield + Growth model, Canadian income tax rates on dividend income dramatically increase the attractiveness of energy companies that pay dividends. The following Chart shows the levels of after-tax income from an energy company with a 6% dividend yield, relative to corporate bonds or GIC's. While GIC's have very little capital risk (except for inflation, of course) when compared to dividend paying energy companies, the fact that investors are receiving 313% more in after-tax income is driving fund flows into the sector. Positive investor sentiment around oil prices and drilling technology that can economically exploit and develop various resource plays in the WCSB are also factors that are very supportive for dividend paying energy equities.

Income Options

	Converted Trusts	Corporate Bonds	GIC
Yield	6.00%	3.45%	2.00%
After Tax Yield	5.04%	2.10%	1.22%

Source: Bloomberg

In 2011, Canada will have a market tier of mid-cap energy companies that pay dividends and have a total market capitalization of approximately \$70 billion. Going forward the energy companies that can demonstrate per share production growth while generating a competitive netback with a stable dividend yield should trade at a valuation premium to the sector. Enhanced drilling technology combined with healthy oil prices and strong demand from investors has helped Canadian energy trusts transition to corporations and regain their cost of capital advantages. In general, current valuations reflect an optimistic outlook and do not provide much of a margin of safety if future fundamentals deviate from current expectations.

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