

MARCH 3, 2011



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Energy trusts still a good bet

New corporations blend high yield, growth prospects

Investors looking for high-yield equity exposure should consider some of the recently converted exploration and production energy trusts (E&Ps). With a current average annual cash yield of 5.6%, investors can achieve income targets while gaining exposure to a sector that is expected to perform well in 2011.

January 2011 marked the end of the income trust era. Income trusts were required to convert to corporations and join the S&P/TSX Equity Index. According to Canaccord Genuity analysts, the newly formed corporations are now pursuing a business model geared towards growth and yield; with most stating a total return objective of 10% or higher.

The trust conversion also brought about a change in the type of income stream earned from these investments. The Canadian source portion of the cash distribution is now taxed as a dividend, making it eligible for the dividend tax credit. All else being equal, the favorable tax treatment of dividends should enable non-registered investors to realize an estimated 30% gain in after-tax income.

When choosing a suitable investment from the E&P group, it's important to assess performance and analyze outlook. As a group, E&Ps provided a total return of approximately 25% in 2010. Expectations for 2011 point to continued support,

and the E&P group should benefit from the positive outlook for oil.

The E&P group is well positioned to deliver results. Most E&P companies have increased their capital budgets for 2011, with a primary focus on oil or natural gas projects. Those with key strategic plans should be better able to hit production growth targets.

Income-oriented investors will want to analyze the E&P group to determine the sustainability of the dividend. Payout ratios should be assessed to determine whether growth is possible within the existing business model. If companies are able to fund their growth initiatives internally, they are less likely to cut dividends.

The strength of the balance sheet is a key ingredient. A company may be unable to deal with a cash shortfall or take advantage of a strategic acquisition if it is already facing high levels of debt.

Another important consideration is the amount of tax shelter the company has on the books. Under the trust structure, companies were not required to write off capital expenditures. As a result, many have built up large tax pools to shelter future cash taxes. The greater the tax shelter, the more efficient the financial structure of the company.

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Continued from Page 1

Canaccord Genuity analysts' top pick in the high-yield E&P group is Daylight Energy Ltd (TSX: DAY). They believe the stock is currently undervalued relative to its peers and now offers good potential reward on a risk-adjusted basis. The analysts also prefer Baytex Energy Corp (TSX: BTE) as a part of a long-term buy-and-hold strategy. For above-average sustainable yield, the analysts recommend Crescent Point Energy Corp. (TSX: CPG).

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