PRT Forest Regeneration Income Fund
(PRT.UN : $4.74)
Outperform
Target Price: $6.00
(reduced from $8.00)

March 5, 2008

PRT surprised the market on February 28 with its report for 2007 and three disclosures: a gloomy forecast for 2008-2009; a cut in the monthly distribution from $0.046 to $0.02; and a goodwill impairment charge of $13.2 million. Believing that this year's results will not be as bad as the distribution cut implies, we continue to recommend purchase of the units, though with a target price reduced from $8.00 to $6.00. There is large pent-up demand for forest renewal, but it is unclear how soon Ottawa and Victoria will act upon it. In the meantime, PRT's rather low 5.1% yield at the new distribution rate introduces a speculative element of unit price vulnerability.

The distribution cut. The unit price has fallen 24% on balance since the report. The most important reason for the steep decline is probably the reduced distribution. This is the third cut in twelve months: the monthly distribution was $0.075 at this time last year, then dropped to $0.07 in May, $0.046 in December, and now $0.02.

With 9.6 million units outstanding, the $0.02 distribution rate requires $2.3 million annually. Last year's operating cash flow was $9.2 million before working capital change and $10.3 million after it. The Fund's definition of cash available for distribution was lower at $7.5 million, but both available cash and operating cash flow were penalized last year by almost $1 million in non-recurring cash charges relating to proxy solicitation and a strategic review. Is the outlook so bad that the Fund must allow for a possible 70% or 80% reduction in operating cash flow? We doubt it. More probably, PRT is making up for a series of too-small cuts by making one that is overly conservative. Unfortunately, the strategy punishes the unit price yet again, serving the private equity hawk better than the long-term investor.

The outlook. So just how bad is the outlook? The place to look for an answer is PRT's home province, British Columbia. The province takes about half of PRT's total seedling volume, and PRT supplies 40% of BC's seedling needs. We believe about a third of PRT's sales in BC go to the province itself, while two-thirds go mainly to forest companies. In Table 1 we estimate the absolute numbers of sales and plantings, in millions of seedlings.

David W. Bodenberg, CFA - Consulting Analyst - 250-388-0248
david.bodenberg@citadelsecurities.ca

Table 1. Estimated Seedling Sales and Plantings (millions)			
		PRT sales	
Year	BC plantings	To BC	Total
2006		112	225
2007	276	102	205
2008	250	82	165
2009	200		

Compared with British Columbia's 276 million plantings in 2007, indications are that plantings will be 250 million in 2008 and possibly no better than 200 million in 2009. The range is very wide: the 276 million in 2007 were the second-largest planting in history, while 200 million in 2009 would set a 20-year low.

Plantings are generally one year later than PRT's sowings and sales. That is, the 112 million that PRT sowed and sold to BC in 2006 were among the 276 million planted in 2007. Between 2007 and 2009 plantings are slated to fall by almost 30%, from 276 million to 200 million. This year we expect PRT's sales volume to drop just 20%. The other 10% of the two-year decline was absorbed last year.

If volumes drop 20% this year, it seems unlikely that cash flow will fall by 70% or 80%. We can believe 35% or 40%, but not more. Fixed costs are comparatively low in this business; variable costs, mainly labor, predominate. The Fund has pointed out that price-cutting may occur, causing revenue to fall more sharply than volume. However, price-cutting is not usually a major hazard when costs are mostly variable.

Preliminary expectations are that seedling production will pick up again next year for increased plantings in 2010. The Fund might wish to keep extra sales force and nursery administration personnel on hand, judging that to be a more sensible strategy than firing and promptly rehiring. If temporary excess employment puts an additional burden on cash flow, we trust the implication of a more positive outlook will balance it.

It is quite incredible that British Columbia should be looking at 20-year lows in seedling planting next year. With almost 2 million acres classed as NSR ("not sufficiently replanted" or "not satisfactorily restocked") and 20 million acres in the interior lost to the mountain pine beetle, we calculate a pent-up demand for 10 billion seedlings. If PRT got half the business and devoted half its capacity to it, the Fund would need half a century to complete the work.

The feeling is widespread among British Columbians that the provincial government has been lax in its own replanting and too lenient in enforcing forest companies' obligations. The best hope for long-term investors in the Fund is a groundswell in public opinion demanding that the government reforest, restrict raw log exports, halt the removal of private lands from tree farm licence areas, and reduce the area of forest tenures whenever mills are closed or control of forest companies changes hands. Large tenures have been acquired by out-of-province companies that have abundant financial resources, were not themselves hurt by the softwood lumber dispute, and acquired troubled local companies just in time to collect refunds of those companies' antidumping cash deposits.

Goodwill impairment. To recognize that the near-term business outlook is in decline, the Fund not only reduced the distribution but wrote down goodwill by $13.2 million. They stated that their goodwill impairment test is "referenced to the Fund's unit trading price." We take this to mean that if the market price falls below book value per unit, the intangible component of book value may be written down against income.

At last year end, after the $13.2 million writedown, goodwill still on the books was $19 million, and total equity was $60 million. The unit price decline since last week has reduced market value to $45 million, just 76% of book value. The Fund's annual impairment test is made in August. If today's conditions prevail then, virtually all the goodwill that remains may be written down. Barring another cut in distributions, we doubt that such a writedown, being non-cash, would have a meaningful effect on the unit price.

Conclusion. At the new $0.24 annual distribution rate, the yield at the current price is just 5.1%. The average yield for all business trusts is above 8%. Although we think there is little risk that the distribution will have to be cut further, there is clearly a risk that the market may take the unit price down to establish a higher yield basis. Militating against this risk is the fact that the forward payout ratio must be very low – on the order of 35% or 40% - even on pessimistic business assumptions.

An investment in PRT has two strong positive attributes. First, the price-to-book ratio is a low 76%. It is true that the intangible asset goodwill makes up 30% of book equity. On the other hand, goodwill was a higher 40% of book equity at end-2006, and so the quality of equity can be said to have improved.

Second, notwithstanding its modest market capitalization, PRT has a dominant position in its industry: it supplies 40% of the forest seedling market in British Columbia and about a quarter of the market across all Canada. The industry is as green as can be, and it has a connection to the timberlands sector that has become popular among infrastructure investors. Taken together with the low price-to-book ratio, these circumstances are conducive to a bidding war if the Fund should be put on the block.

The speculative attraction of PRT lies in the chance that the plight of the Canadian forest industry will become such a hot political issue that reforms simply have to be undertaken. One of the reforms should be, and probably will be, a commitment to speed up the replanting of logged and blighted forests. A broad issue at stake here may be nothing less than the continued public control of Crown lands. Controversy would implicate the federal Tories as well as the BC provincial Liberals. Ottawa's softwood lumber "settlement" of 2006 entailed the imposition of export charges and volume restraints if US softwood lumber prices should fall below certain levels. How can the "settlement" be regarded as anything but a capitulation when it punishes Canadian producers for a US housing collapse that was in no way their fault?

Recommendation. The present price of $4.74 is only 76% of the $6.25 book value per unit. It is a reasonable speculation that forest policy reforms may lift the price to the book value, or by 32%, over our 12-month target period. We assign a two-thirds probability to that outcome, giving the appreciation potential a probabilistic value of 21%. That value and the current distribution yield of 5% sum to 26%. Accordingly, we are setting a target price of $6.00, some 26% above the current price. The new target price is below the previous one of $8.00. We maintain the Outperform rating but caution that the below-average yield injects a speculative risk. Although the actual distribution yield of 5.1% is below the business trust average, we think the market will accept our hypothesis that operating cash flow could support a distribution as high as $0.35-0.40, consistent with an 8% average yield.

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