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Exchange Income investors stand to lose far more than the dividend

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It's easy to see the appeal of Exchange Income Corp. The Winnipeg-based concern buys cash-generating industrial businesses and passes along the profits to its shareholders in the form of robust dividends.

There are some problems with the model, however. Exchange Income's portfolio, concentrated in the aviation and telecommunications-tower industries, doesn't actually generate enough cash to cover capital expenditures, the cost of new acquisitions, and that attractive dividend. (At 14 cents a month, it's currently a 9-per-cent yield.) Instead, the company has issued hundreds of millions of dollars in debt to keep the proposition going.

This would be fine were this a temporary lull in the businesses, soon to be forgotten as Exchange Income's companies spew a growing gusher of cash. And most of the Bay Street analysts who cover Exchange Income believe this to be so.

The dissenter, however, is **Veritas Investment Research**, a firm that positions itself as taking a deeper dive into companies' financials. The **Veritas** analysts think there are troubles at Exchange Income's marquee business, a cellphone-tower construction company called WesTower. And if WesTower falters, the remainder of Exchange Income's businesses can't help the company meet analyst expectations for earnings, **Veritas** says.

When the **Veritas** analysts issued their report on July 9, Exchange Income traded at \$21.48 per share; it quickly fell below \$20 and, at its \$17.16 low on July 31, had shed 20 per cent of its value. It's recovered slightly, but investors have either dismissed, or are not aware of, the **Veritas** argument.

Veritas believes the fair value of Exchange Income stock is \$8.50 – and could conceivably go to zero if it can't handle its debt burden.

Exchange Income declined to provide input to **Veritas** before or after the report, **Veritas** says. An Exchange Income spokesman said the company had no comment for this column, and that management would discuss only second-quarter earnings after they are released Aug. 12.

Its results seem poised to continue the cash burn of the past several years. As **Veritas** notes, Exchange Income has posted a total of \$32-million in cash flow from operations since the beginning of 2011. Over that period, it has paid \$105-million in dividends, made \$200-million in capital expenditures and purchased \$165-million worth of businesses. To pull this off, **Veritas** notes, the company has tapped its line of credit and floated five issues in the public debt markets. Its net debt of about \$440-million is more than five times its EBITDA, or earnings before interest, depreciation and amortization.

This will not be as much of a problem if Exchange Income grows EBITDA to \$130-million in 2015, as a number of analysts forecast. But **Veritas** notes much of the growth is to come from a profit expansion at WesTower, which gets 63 per cent of its revenue from AT&T Inc.

MasTec Inc., a WesTower competitor, recently said cutbacks in AT&T's wireless project spending meant it expected a significant decline in revenue that started in the second calendar quarter and should continue into 2015. The **Veritas** analysts believe that WesTower will not only not be immune, but is likely to feel a greater negative impact because it has no guaranteed minimum amount of business in the contract, and it can't count on the decades-long, stable relationship with AT&T that MasTec has.

The **Veritas** analysts also express concern that even as Exchange Income discloses "project inefficiencies" at WesTower's U.S. operations, the company has been reporting higher profit margins in the segment.

WesTower uses an accounting method called "percentage of completion," where the company estimates, and then records, revenue and profit as a project continues but before the bill is sent to the customer. **Veritas's** examination of Exchange Income's disclosures, which includes the balance of work done for customers but not yet billed, suggests the company hasn't billed, much less collected on, some of its most profitable work done over a year ago. This raises the question, **Veritas** says, of whether the company will ever get paid. Company disclosures that say WesTower "continues to dialogue with its customers" regarding "claims" support this, **Veritas** argues.

To arrive at its \$8.50 price, **Veritas** forecasts \$95-million, not \$130-million, in 2015 EBITDA, assuming WesTower winds down its U.S. operations. More bullish analysts see any recent AT&T slowdown as a blip in a long-term trend of greater wireless capital spending.

Veritas's worst-case scenario assumes the company's aviation businesses, which include a number of small airlines pressured by competition, require more capital expenditures – and that, ultimately, the company's cash flow can't cover its debt load.

They are both pessimistic scenarios, to be sure. But Exchange Income, it seems, has little margin for error. And so do the shareholders who expect the company to be a long-term provider of income.