The poster child for income trusts comes with a warning label

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For the legions of Bay Street dwellers who've made a killing on the income trust boom, there's one company to love above all others. **Energy Savings Income Fund** has been a godsend to them because its performance has provided a rebuttal to every serious argument against business trusts.

You think trusts are a collection of dead companies with no growth prospects? Look at Energy Savings' 3,000-per-cent sales growth over five years (1999 to 2004). You think trusts are paying dividends they can't afford? Here's one with 18 distribution increases in four years. From the initial public offering in April, 2001, Energy Savings unitholders have earned a total return of more than 770 per cent, which tends to shut up the naysayers pretty quickly.

There's no doubt Energy Savings is in a good business. The company provides fixed-price natural gas and electricity contracts to homeowners in Canada and the United States, an easy sell during an era of fear about energy costs. The company buys gas and electricity at a wholesale rate, resells it at retail prices and collects the difference.

The trouble is that investors have largely priced its unbelievable growth rate into the unit price. Its current yield is 4.8 per cent, a shade higher than 10-year Canadian government bonds and low by the standards of the blue-rinse ladies who put their money into trusts for the monthly distribution cheque.

Suffice to say that if Energy Savings' rapid expansion continues, everything's fine, but if doesn't, the market will reprice this trust to a more normal yield and bring a world of pain to anyone buying at these levels.

Given the stellar track record, it takes a brave analyst to sling an arrow at this one. But we're suckers for a contrarian, so we couldn't help but notice the lone bearish voice in **Anthony Scilipoti** of **Veritas Investment Research**.

Mr. Scilipoti's argument is that the years of easy growth are over, and that Energy Savings has reached a point where it's going to find it harder to keep its fat margins -- and customers.

The bullish view is that, even if this is true, it doesn't matter because Energy Savings has a low payout ratio, which gives it room for error. **Mr. Scilipoti** believes the margin isn't as big as people might think because the trust excludes capital expenditures in its calculation of distributable cash.

Since it's largely a service business, its capital expenditure is modest but not insignificant. It was $4-million last year. When you deduct it from the operating cash flow, **Mr. Scilipoti** says, last year's payout ratio was 93 per cent, not the 88 per cent the trust claimed.

As the growth slows down, this could become a more critical issue. Energy Savings will generate $77.1-million in operating cash flow in fiscal 2005, **Mr. Scilipoti** estimates. When you subtract $6.3-million in capital expenditure, the company is left with $70.8-million in cash from which to make distributions of nearly $79-million.

This doesn't mean there's a huge risk of a cut to the payout. An $8-million gap is not that big for a trust of Energy Savings' size.

Besides, many trusts pay out more cash than they're taking in, sometimes for a few years in a row, in the hope that they will grow into their distribution. Very often it works.

The point is that it's imprudent for investors to expect the same kind of upward leaps in the distribution now, when Energy Savings is paying out most or all of its cash, than we saw a couple of years ago, when the payout ratio was about 70 per cent.

"Energy Savings is at a turning point in its life cycle," **Mr. Scilipoti** writes. It's facing the prospect of finding more growth outside of Ontario while protecting its customer base (and margins) from competitors within the province.

In other words, it's a maturing company, which is not to say it's a bad business or poorly managed. It's just that it isn't trading like a maturing company. With a $1.6-billion enterprise value, Energy Savings is worth 23 times its past four quarters of EBITDA (earnings before interest, taxes, depreciation and amortization).

What do you think a normal valuation might be for a trust like this if it shows a decent growth rate, but not an astronomical one? Ten or 11 times EBITDA? A yield of 8 per cent, perhaps? **Mr. Scilipoti** notes that insiders, including CEO Rebecca MacDonald, have been selling units recently. Perhaps they know that in the market, even sacred cows sometimes get slaughtered.