To trust or not to trust?

That's the question now. Medisys converts, but the debate continues

By Anne Papmehl

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Here's an interesting development. On Dec. 20, 2004, Medisys Health Group announced that its shareholders had approved a plan of arrangement to convert Medisys into **Medisys Health Group Income Trust** (MHG.UN-TSX, $11.90, 800-499-2772, *www.medisys.ca*).

The plan met with regulatory approval and since early January Medisys has been trading on the Toronto Stock Exchange under the ticker MGH.UN.

It's not uncommon for health-care service companies to convert to income trusts once they achieve critical mass and liquid cash flow. CML Healthcare, provider of laboratory testing and medical imaging, did so in February 2004.

Once a company achieves decent earnings and stable cash flows, it makes sense to pay out the bulk of it to unitholders. The alternative is to pay dividends, but there's a problem with that: dividends get taxed twice, making them less tax-efficient.

Medisys is one of the smallest income trusts on record. Was it wise to have converted so early? Shameze Rampertab, senior health-care and biotech analyst with Jennings Capital, has some reservations.

"They made the decision in September 2004 to convert because they felt they had consistent and sustainable cash flow, but I disagree" says Mr. Rampertab. "They stumbled back in 2003 and they've only had three quarters of decent results."

Moreover, growth stories do not make income trusts. "Income trusts are mature companies in mature business sectors that are fairly predictable and I don't think Medisys is there yet."

Another thing about income trusts — size matters. "CML had $263 million in revenue and 149 medical imaging centres across Canada, while Medisys has trailing 12-month revenues of $65 million and has only three centres, plus eight more acquired in October 2004," explains Mr. Rampertab.

But Bob Leshchyshen of Northern Securities views the income trust timing a little more optimistically.

"I thought back in November that it wasn't a good idea, but I guess I've been proven wrong because the units have gone up ever since, hitting a high of $12.35," he says.

In his Nov. 15 research note, Mr. Leshchyshen downgraded the company from a "buy" to a "hold"" with a target price of $4.75. On Jan. 21, 2005, he put the stock back at a "buy" recommendation with a target of $13 per share. While income trusts are traditionally the domain of mature companies, Mr. Leshchyshen sees a big push for investors to continue buying equities that pay some kind of return.

Was it wise to have converted so early on?

"I think income trusts that are growing by way of acquisition and increasing their payouts are probably going to be a better bet than the more mature ones that are affected by interest rates, which will probably increase over this year."

Mr. Rampertab, on the other hand, has a "sell" recommendation and a $10 target price, subsequent to the 2.5-for-one share-to-unit consolidation. If Medisys were still an equity company, he would be a lot more bullish.

"We wouldn't have seen the share price run up as quickly. I still think it's a great growth story, and we're going to see some phenomenal growth in revenue, but there will be volatility in the earnings and cash flow."

And that's not good in an income trust, particularly if the company misses a monthly distribution or has to borrow money to make its distributions.

Mr. Rampertab is also concerned about the complexity of the company's corporate structure. "When I see complexity, it scares me, because companies create complex structures to achieve certain accounting goals or certain objectives in the eyes of the shareholders.

"I've seen other companies with complex structures that were very difficult to analyse. So you rely more heavily on management's interpretation of that structure and how it will affect your investment in that company and that's very risky."

That stated, Mr. Rampertab admits there's a lot to like about the company.

"I really like their corporate health-services business, and they have some nice clients in it like Canada Post and CN Rail."

Both Messieurs Rampertab and Leshchyshen agree the executive health-care arm is a high-profile and high-profit business. The company's insurance health-services business is stable and solid, though with less return potential.

But the biggest growth area is the medical imaging business. "That can be a licence to print money if managed properly," says Mr. Rampertab, "and it looks like Medisys is managing it well."

Mr. Leshchyshen agrees, pointing out that the company will be making more acquisitions in this area. He also sees good growth opportunities in the executive health business.

"They have about 12,000 executives that will come to see them this year, fuelled by the trend of baby boomers to take charge of their own health through prevention and wellness programs."

The two analysts are less bullish on the company's occupational software business, its fourth arm.

"I suspect at some point they'll dispose of it so it won't be part of the trust," says Mr. Leshchyshen.

Mr. Rampertab warns that despite the high quality of the software, the revenue and earnings from it are going to be volatile. "They make their biggest revenue kill by selling licences to new customers, as opposed to renewals, and that's a lumpy business."

Volatile earnings

Both analysts agree that Medisys is a retail play and caution institutional investors to tread carefully. It's probably better suited for the investor seeking income with some growth, as opposed to pure growth.

"I think the growth has already occurred," says Mr. Leshchyshen, "so it's not a stock that's going to double next year." That's not to say it won't double again. "It has more potential to double than some of the other income trusts," he continues, and uses the BFI Income Fund as a comparable.

"That's been in a range of prices, from as low as $15.65 to a high of $28.98. They're making acquisitions and recently announced an increase in monthly payouts."

Medisys' first monthly distribution of $0.067 is to be paid out Feb. 21. Whether the company will increase its monthly payouts and by how much is something analysts are divided on. Figures range from one penny to a dollar. Much will probably depend on how well the company executes its acquisitions strategy.

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