

An Introduction to Flow-Through LPs: 2012 Edition

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The attractive tax benefits of flow-through limited partnerships (LPs) along with the prospects of hitting it big on a concentrated pool of junior resource names have made these issues appealing offerings to many investors. We are barely into 2012, but we've already seen a number of LPs hit the market. And more are sure to come as we move through the year.

The purpose of this piece is to outline the basic dynamics of flow through LPs and to provide insight into how they can be beneficial to investors. Additionally, an overview of the products that are available to DundeeWealth advisors at the time of publishing is provided.

Table I: Industry Wide Flow-Through LP Assets Raised Historically

Year	Total Flow-Through LP Assets Raised
2005	\$1.2 billion
2006	\$1.7 billion
2007	\$2.0 billion
2008	\$1.0 billion
2009	\$0.5 billion
2010	\$0.9 billion
2011	\$1.1 billion

Source: FPInformat

The Basics

Flow-through shares are common shares issued by Canadian mining, oil and gas or certain types of renewable energy companies, the purpose of which is to finance exploration activities. Although companies of any size can issue flow-through shares, it is typically only the junior ones that do so. After issuing shares and receiving the capital from investors, these companies renounce certain exploration expenses to investors, and these expenses are generally fully deductible against all income sources. Apart from the flow-through share agreement and associated tax benefits, flow-through shares are identical to non-flow-through shares of the same class.

While investors may purchase individual flow-through securities themselves, perhaps the best way to access these issues and to get the accompanying tax benefits is through a limited partnership. Flow-through LPs allow experienced money managers to build portfolios of flow-through shares without giving up any tax write-offs.

There are two primary advantages to using an LP to access the flow-through space. First, the money is managed by professionals who are specialists in the areas in which the LP invests. Second, the pool of securities that underlies the LP is diversified. Granted, sector risk still exists, but in the event that a single security goes to zero, all is not lost for the LP as plenty of other names are left to pick up the slack. In addition, the seemingly simple task of building a diversified basket of individual flow-through securities may be more difficult than it seems for retail investors.

It is worth noting that flow-through shares do not achieve their tax benefits through the exploitation of loopholes, rather, specific provisions within the Income Tax Act make these tax benefits possible. These are not tax shelters where there is a risk that the CRA will come down and rescind all tax benefits on a retroactive basis if something is not up to snuff.

History

Flow-through shares have existed in one form or another since 1954. They came into being in order to help certain resource companies finance Canadian exploration projects. Resource firms could transfer certain exploration expenses to investors, who in turn could deduct these expenses against their own resource income. The federal budget of 1983 enhanced the program by allowing the deduction of exploration expenses against any income. This immediately increased the relevance flow-through securities had for retail investors. Flow-through LPs were pioneered by CMP in 1984.

Nuts and Bolts

Flow-through LPs generally come to market via a syndicated deal involving multiple investment dealers. These are "blind pool" offerings, meaning the actual companies the money manager plans to pursue are not specified (although they must be flow-through securities, of course). Once the deal has closed, the general partner (manager) uses the net proceeds of the deal to purchase the flow-through shares of a number of resource companies. All money raised has to be put to work by December 31 of the year in which it was raised, and most flow-through LPs are offered early in the year in order to give the portfolio manager enough time to ensure that the money raised is deployed by the end of the year. Even after the all the money has been placed, it is not uncommon for a flow-through LP to hold fewer than ten names.

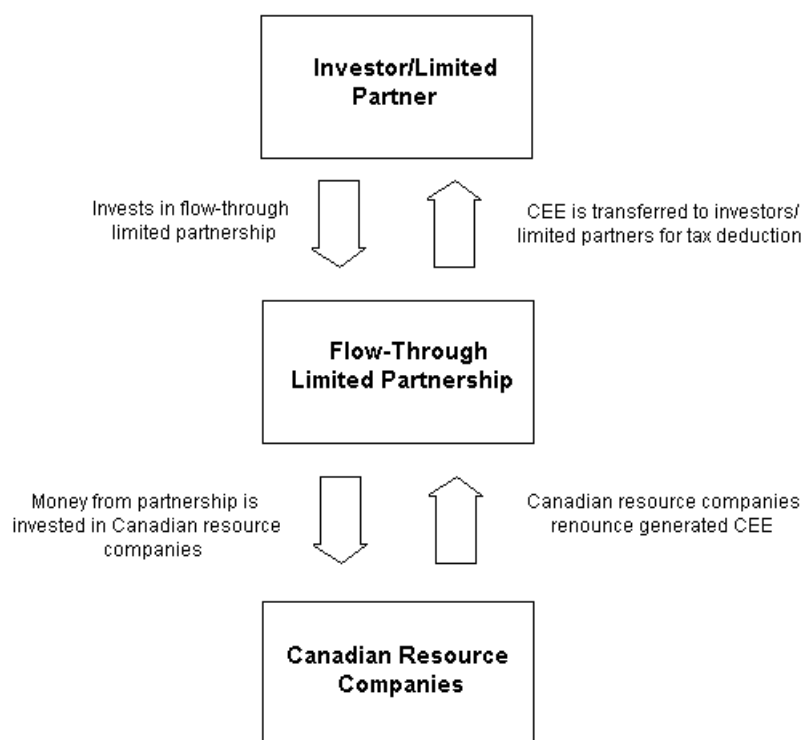
When the general partner decides it is ready to make a flow-through investment in a company, it is typically required to pay a premium to the prevailing market price of the company's shares. This is so because the flow-through arrangement means the company is potentially giving up some tax benefits of its own, for which it has to be compensated. Flow-through shares of mining companies generally move at a 10% to 20% premium, while shares of energy companies, which often are cash flow positive or even profitable, go for a premium in the 20% to 25% range.

The tax savings for investors come after the resource companies renounce their Canadian Exploration Expenses (CEE) to the LP. The CEEs are then passed on to investors in the LP. Canadian Exploration Expenses, which are fully tax deductible when in investors' hands, are broadly defined and encompass most exploration and development expenses incurred by firms exploring and developing mineral or oil and gas assets in Canada. The total amount of expenses incurred by a company under a flow-through share agreement must not exceed the dollars received by the firm for the particular flow-through shares.

Investors receive a substantial amount of their original investment back in the form of tax savings. Depending on the investor's marginal tax rate, these tax savings could come in at close to half the original investment. It is also important to note that as a result of the tax deductions, the adjusted cost base for the LP is zero or very close to zero.

Once the tax deductions have been claimed, investors will retain their stake in the LP and the general partner will continue to run the LP until it has been dissolved. The total holding period for the LP is generally 18 to 20 months, after which point the assets will be rolled into a mutual fund where liquidity is available. **Prior to rollover, no liquidity is available for LP investors.**

For its services, the typical compensation for the general partner is a 2% annual management fee plus a performance fee of 20% of any increase in value over a specific threshold. For instance, if LP units are issued at \$25, a prospectus might say that a performance fee is payable on the amount by which the NAV per unit exceeds \$28. The performance bonus is typically calculated just before the assets are rolled over.

Figure I: Flow-Through LP Basics

Source: Sentry Investments

The Tax Benefits

The tax advantages available via a flow-through LP are reasonably easy to understand and they are fully disclosed and described in the prospectuses of the products themselves. Table II provides a sample scenario that is based on the prospectus for the Qwest Energy 2012 Flow-through LP.

Table II: Sample Flow-Through LP Tax Savings Scenario

	2012	2013 and Beyond	Total
Assumed Marginal Tax Rate	45%	45%	
Investment	\$5,000	\$ -	\$5,000
Tax savings from deductions	(\$2,358)	(\$126)	(\$2,484)
Capital gains tax	\$ -	\$87	\$87
Total income tax expense (savings)	(\$2,358)	(\$39)	(\$2,397)
Money at risk			\$2,603
Break-even level			\$3,359
Downside protection			33%

Source: Qwest Investment Management

The column furthest to the right in Table II is the most important. The assumption is that the investor moves \$5,000 into the LP. Using that figure, the total tax savings for the investor comes in at \$2,484.

The initial investment minus the tax savings equals the investor's money at risk. Perhaps more important to the investor is the break-even level. This is calculated by taking the money at risk figure and dividing it by one minus the product of the marginal tax rate of 45% multiplied by the capital gains tax rate in the year of disposition, which is assumed to be 50%. The adjusted cost base of the portfolio is assumed to be zero, and therefore all proceeds at disposition are taxed as capital gains. The aforementioned calculation essentially grosses up the money at risk. The calculation will therefore look like this:

$$\$2,603 / (1 - (0.45 \times 0.5))$$

$$=\$3,359$$

What that number means is that the value of the initial investment can drop from \$5,000 to \$3,359 before the investor loses a penny on an after-tax basis. This implies an embedded level of downside protection of 33%.

The Rollover Process

Under normal circumstances, an investor in a flow-through LP is locked in (i.e., has no liquidity whatsoever) until the expected date of rollover into a mutual fund. The lock-up period is typically 18 to 20 months. Assets are then rolled into a mutual fund, which is typically resource oriented, and investors receive fund units one to two months following the rollover. This one to two month window exists to ensure the manager has sufficient time to make any changes to the portfolio where needed without being forced to trade or sell any securities too quickly in the market, thereby putting unnecessary downward pressure on the fund's NAV. This rollover takes place on a tax-deferred basis, but once the mutual fund units are redeemed, a capital gain equal to the redemption amount is incurred. Again, this is because the ACB of the units is zero.

While most flow-through LPs are rolled into a resource oriented fund where switching options are non-existent, Dynamic has set up a unique structure whereby rollover assets can be reallocated to a number of non-resource corporate class funds.

Assets that get rolled into funds usually don't stay there for long. A common practice of many investors is to recycle assets that get rolled over into a fund into a flow-through LP that is available for the current year.

Primary Risks

Volatility

A key consideration before any flow-through investment is made should be the fact that the level of volatility associated with such securities can be extreme. The volatility consideration is two pronged. First, individual flow-through securities tend to be small cap in nature. To compound that, these companies play in sectors that are driven very much by commodity prices, which themselves can be very volatile. Accessing the space through a limited partnership will certainly reduce unsystematic individual security risk, however, the structure does nothing to address the fact that we are dealing with micro/small cap resource companies.

Liquidity

Liquidity affects flow-through LPs in two ways. As mentioned earlier, an investor is required to hold an LP until the partnership is dissolved. Again, this does not typically occur for 18 to 20 months after the time of purchase. In addition, the companies that underlie the LP may be highly illiquid themselves, meaning the manager may have difficulty moving into or out of positions in a timely manner. Poor portfolio liquidity is never advantageous to investors.

Using Flow-Through LPs in a Portfolio

The implications of adding exposure to a basket of junior resource companies to a portfolio should be considered equally, if not more seriously, than the tax implications of an investment in a flow-through LP, especially if the investment in the LP is significant. The ability and willingness of an investor to add a high volatility product to his or her portfolio must not be overlooked. Adding a flow-through LP to an already resource-heavy portfolio simply to take advantage of the tax benefits of such a strategy is an approach we suggest investors take with extreme caution.

Flow-through LPs are also most suitable for investors whose incomes are subject to the highest marginal tax rate. This could be on the corporate or individual level, and it could include recipients of large one-time lump sums payments. In addition, individuals who wish to reduce the cost of charitable donations, or who wish to donate more without increasing their costs may benefit from the use of flow-throughs, and there are benefits for individuals who have significant capital loss carry forwards. Tax experts should always be consulted when more complex scenarios are being considered.

Other Considerations

Tax Forms

Investors receive T5013 tax receipts indicating their investment in a flow-through LP. It is important to note that these forms are generally available around the end of March each year, which is later than when most other tax receipts are issued.

MFDA Advisors and Flow-Through LPs

MFDA advisors cannot sell flow-through shares that are offered for sale by way of a prospectus (although clients of MFDA advisors can access them if a referral arrangement with a securities licensed advisor is set up). A small number of offering memorandum-issued flow-through products have come to market over the past few years and these can be accessed by MFDA advisors, depending on jurisdiction. Proficiency requirements are in place for MFDA advisors wishing to sell OM-issued flow through products.

Table III: Flow-Through LPs Available Today to DundeeWealth Advisors

Issue	Mgt Fee *	Performance Bonus **	Issue Size	Issue Price	BNS %
AlphaNorth2012 FT LP	2%	20% over 12%	\$25M	\$10	8%
Canoe 2012 FT LP CDE Units	2%	20% over 12%	\$100M	\$25	9%
Canoe 2012 FT LP CEE Units	2%	20% over 12%	\$25M	\$25	9%
CMP 2012 Resource LP	2%	20% over 12%	\$100M	\$1,000	14%
Front Street 2012-1 FT LP National CI	2%	20% over 12%	\$120M	\$25	5%
Front Street 2012-1 FT LP Quebec Class	2%	20% over 12%	\$30M	\$25	5%
MRF 2012 Resource LP	2%	20% over 12%	\$100M	\$25	10%
NCE Diversified FT (12) LP	2%	20% over 12%	\$100M	\$25	5%
Sprott 2012 FT LP	2%	20% over 12%	\$100M	\$25	4%
Stone 2012 FT LP	2%	20% over 12%	\$50M	\$25	11%
Qwest 2012 Oil & Gas FT LP	2%	20% over 12%	\$20M	\$25	24%

* Excludes service fee

** Performance bonus shown as percentage received by manager over hurdle return (where applicable)

Source: Scotia Capital

The Bottom Line

The flow-through LP space is one of the few areas of the Canadian investment universe that offers individuals a real tax break. These professionally managed pools spread risk across a number of individual flow-through shares, and although volatility can be high and liquidity is typically non-existent for 18 months to close to two years following an investment, the tax benefits of these products are tangible. And because these benefits are part of the Income Tax Act currently, legislation would have to change before they could disappear.

The suitability of these products, given their nature, should be the primary consideration for potential investors. Investors should also understand that the performance of these LPs will be driven by the sector composition of the portfolio and the corresponding performance of those sectors. The tax benefits of flow-through LPs are powerful, especially for investors in the highest tax bracket, but we strongly recommend that individuals consult with a tax expert before moving money into these products.

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