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From Niche to Mainstream – A Primer on Income Trusts



Navdeep Malik, MBA – (416) 863-7499

Chris Blake – (416) 863-7067

Tony Courtright, MBA, CA – (416) 945-4536

Brian Ector, CFA – (403) 213-7332

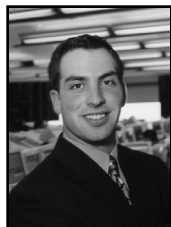
Grant Hofer, CFA – (403) 213-7345

Himalaya Jain, MBA, CFA – (416) 863-7218

Turan Quettawala, MBA, CFA – (416) 863-7065

Income Units Research

Business Trusts



Chris Blake
(416) 863-7067
chris_blake@scotiacapital.com



Navdeep Malik, MBA
(416) 863-7499
navdeep_malik@scotiacapital.com



Turan Quettawala, MBA, CFA
(416) 863-7065
turan_quettawala@scotiacapital.com

Associate:
Maggie Fanari, CA
(416) 863-7423
maggie_fanari@scotiacapital.com

REITs



Himalaya Jain, MBA, CFA
(416) 863-7218
himalaya_jain@scotiacapital.com

Associate:
Mario Saric, CA, CFA
(416) 863-7824
mario_saric@scotiacapital.com

Oil and Gas
Royalty Trusts



Brian Ector, CFA
(403) 213-7332
brian_ector@scotiacapital.com



Grant Hofer, CFA
(403) 213-7345
grant_hofer@scotiacapital.com

Associates:
Kristian Schneck, MBA
(403) 213-7759
kristian_schneck@scotiacapital.com

Karma Roste-Hagen, CA
(403) 213-7750
karma_rostehagen@scotiacapital.com

Power and Energy
Utility Trusts



Tony Courtright, MBA, CA
(416) 945-4536
tony_courtright@scotiacapital.com

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Pricing as at April 22, 2005, unless otherwise stated.

For Reg AC Certification and important disclosures see Appendix A of this report.

Introduction


We are pleased to introduce *From Niche to Mainstream – A Primer on Income Trusts*, a broad review of the evolution and current state of this income-oriented equity instrument. While we think this report may be of use to all investors, we believe it may be of particular interest to those investors wanting a general introduction to income trusts and a high-level discussion of the major sub-sectors, namely energy, real estate, power/infrastructure, and consumer/industrial business trusts. In-depth research on these sub-sectors and individual trusts is available through *SC Online*, or by contacting members of Scotia Capital's income trust research team. This report is divided into the following segments:

- Introduction to income trusts
 - Structural aspects of trusts
 - Benefits and risks of investing in trusts
 - Evolution of the income trust market
 - Role of interest rates and funds flow on valuation
 - Recent developments in regulation, indexation, and governance
- Unique characteristics of each major sub-sector, including key performance drivers, valuation, risks, and our outlook and top picks
- Our current coverage list, including ratings, target prices, cash flow estimates, and valuation metrics

Over the past few years, income trusts have been the fastest growing segment of the Canadian capital markets. Both the size and number of listed trusts has grown significantly. The types of businesses that now exist as income trusts and the variety of investor styles that consider trusts for portfolio inclusion have also widened significantly. Whereas trusts were historically dominated by oil and gas, real estate, and utility assets, the field has grown to include various consumer and industrial businesses, where underlying operations are relatively mature and stable. While growth may not be the primary motivation for investing in trusts, we believe many trusts are capable of delivering modest levels of growth.

The growth in the market has been driven by increasing demand for higher-yielding investment alternatives, as low interest rates have made fixed income investments less attractive. In addition, volatile common equity markets and a shift toward income-oriented investing have resulted in record levels of funds flowing toward income trusts and trust related products. Returns generated by the sector have also garnered a great deal of attention (see Exhibit 1); 2004 was the fifth consecutive year that income trusts outperformed the broader equity market on a total return basis. Although we do not expect the performance of the past five years to be repeated, we think the emphasis on distributions should result in attractive total returns over the long term. As suggested in Exhibit 2, we think income trusts become increasingly rewarding the longer they are held.

Exhibit 1 – Compelling Historical Returns

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 YTD*	CAGR
Scotia Capital Income Trust Index (Total return)	35%	3%	-19%	9%	28%	23%	14%	38%	28%	5%	16%
S&P/TSX Capped Composite Index (Total Return)	28%	15%	-2%	30%	19%	-8%	-12%	27%	14%	2%	11%
	 = Outperformed										

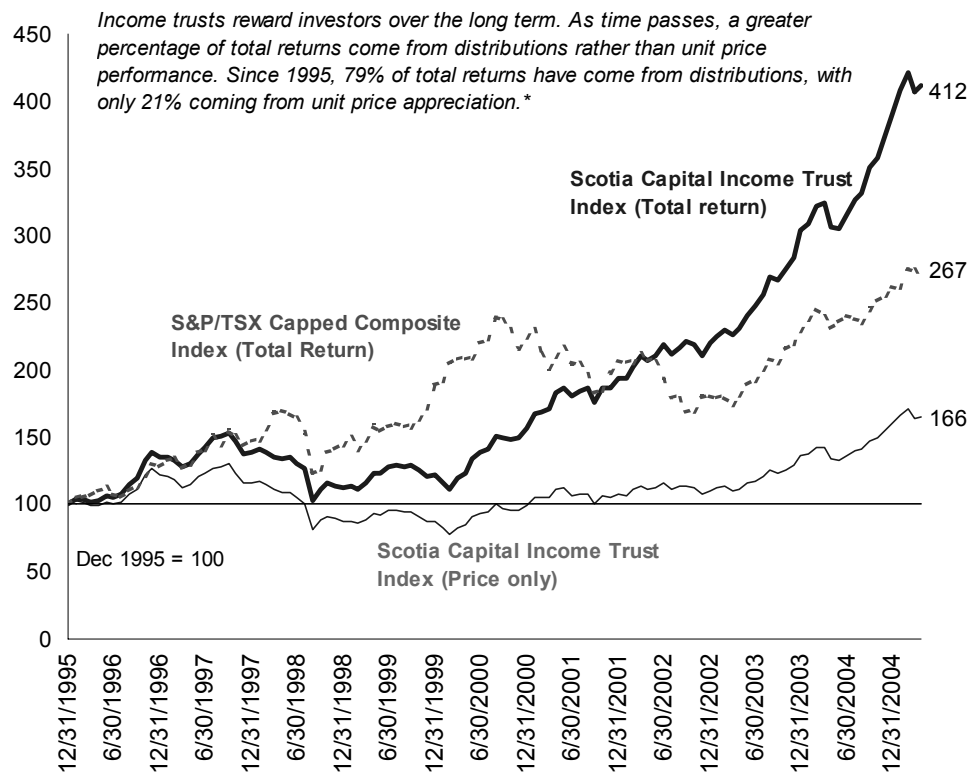
* Up to April 22, 2005

Source: Scotia Capital; Bloomberg.

In our view, the income trust market continues to evolve. A number of key developments took place in 2004 and early 2005 that we believe will shape the market in the years to come. Most notable were Standard & Poor’s decision to include trusts in the benchmark Canadian composite index as well as the passage of limited liability legislation in Ontario and Alberta. In addition, the Canadian Securities Administrators (CSA) finalized and adopted a regulatory instrument that focuses directly on the trust structure. Our report examines these developments and their potential impact in greater detail. Eventually, we think income trusts will become an integral component of the Canadian capital market, with individual trusts classified into the existing S&P Global Industry Classification Standard (GICS) definitions.

As with other financial instruments, both underlying cash flow and valuation of income trusts are sensitive to changes in interest rates. However, we assert that the ebb and flow of economic activity and interest rates impacts each trust differently. The degree of interest rate sensitivity, therefore, varies across the income trust universe. Due largely to the potentially damping effect of a higher Canadian dollar (relative to the U.S. dollar), Scotia Economics forecasts longer-term interest rates to remain relatively unchanged for the next 18 months. Notwithstanding this interest rate view, we think there is sufficient diversity in the income trust sector (181 trusts, \$120 billion aggregate market capitalization) to accommodate other interest rate scenarios.

Exhibit 2 – The Tortoise and the Hare



* To April 22, 2005
 Source: Scotia Capital; Bloomberg.

Scotia Capital currently provides research coverage of 76 trusts, with coverage of each of the major trust sub-sectors. On a market capitalization basis, our current coverage list represents approximately 75% of the aggregate income trust universe (listed in Appendix 1). Exhibit 3 presents a summary of our 1-Sector Outperform rated trusts.

Exhibit 3 – Summary of 1-Sector Outperform Rated Trusts

	Ticker	Unit Price	Distribution 2005E	Yield	One-Year Target Price	One-Year Total Return	Risk	Comment	Analyst
Acclaim Energy Trust	AE.UN	\$15.10	\$1.95	12.9%	\$14.75	10.6%	H	Low payout ratio, strong balance sheet	Hofer
Allied Properties REIT	AP.UN	\$13.97	\$1.17	8.4%	\$14.60	12.9%	H	Dominant owner in a highly defined niche; above-average growth	Jain
Boardwalk REIT	BEI.UN	\$19.50	\$1.26	6.5%	\$18.60	1.8%	M	Canada's largest portfolio of apartments; disciplined management team	Jain
Bonavista Energy Trust	BNP.UN	\$31.30	\$3.30	10.5%	\$30.00	6.4%	H	Low payout ratio, stable production	Ector
Consumers' Waterheater Income Fund	CWI.UN	\$15.75	\$1.11	7.0%	\$15.50	5.5%	L	Captive pricing power; re-entering commercial market	Courtright
Fording Canadian Coal Trust	FDG.UN	\$116.85	\$15.20	13.0%	\$145.00	37.1%	H	Exposure to continued strong met coal prices	Kodatsky
Fort Chicago Energy Partners LP	FCE.UN	\$11.85	\$0.93	7.8%	\$12.00	9.1%	M	Base of long-term contracts; NGL fractionation upside	Courtright
Hardwoods Distribution Income Fund	HWD.UN	\$12.60	\$1.14	9.0%	\$13.50	16.2%	M	Good relative valuation, subordination feature provides downside protection	Blake
Home Equity Income Trust	HEQ.UN	\$13.89	\$1.08	7.8%	\$15.00	15.8%	M	Stable distributions, with attractive growth potential	Malik
Keyera Facilities Income Fund	KEY.UN	\$15.15	\$1.25	8.3%	\$15.25	8.9%	M	Stable operations, growing distributions	Hofer
Legacy Hotels REIT	LGY.UN	\$7.13	\$0.55	7.7%	\$7.85	17.8%	H	Recovery underway in lodging sector; opportunity for margin expansion	Jain
O&Y REIT	OYR.UN	\$15.32	\$1.12	7.3%	\$16.80	17.0%	H	Portfolio is in the process of being monetized	Jain
PrimeWest Energy Trust	PWL.UN	\$30.11	\$3.60	12.0%	\$28.50	6.6%	H	Conservative payout ratio, attractive cash yield	Ector
RioCan REIT	REL.UN	\$18.89	\$1.29	6.8%	\$19.20	8.5%	L	Highly stable occupancy rate; excellent track record; experienced management	Jain
Vermilion Energy Trust	VET.UN	\$20.99	\$2.04	9.7%	\$22.75	18.1%	H	International exposure, low payout ratio	Hofer
Yellow Pages Income Fund	YLO.UN	\$13.51	\$1.02	7.5%	\$16.00	26.0%	L	Increasing distribution, extraordinarily profitable oligopoly	Mitchell

Note: Prices as at April 25, 2005.

Source: Scotia Capital estimates.

Income Trust Basics

We view income trusts as high-yield equity investments that provide investors with regular distribution payments based on the cash flow generated by an underlying operating business. Since the majority of cash flow is paid to unitholders, ideal income trust candidates are stable, relatively mature businesses with predictable capital expenditure requirements. The sector has matured to include trusts in a range of industries that may not fit the ideal profile exactly. This does not necessarily mean that these trusts are poor investments, as some have been very successful to date and have allowed unitholders to participate in the cash flows of a wide range of businesses. However, investors should be aware of the risks associated with the specific underlying business when assessing an individual trust.

Broadly speaking, trusts can be classified into four general categories: energy, real estate, power and utilities, and diversified businesses. Energy trusts emerged in the late-1980s as a vehicle to provide investors with cash flow from mature, producing oil and gas assets. Commodity prices (i.e., crude oil and natural gas) are a key driver of distributable cash, while other factors such as production volumes, operating costs, and capital expenditure requirements are also important. Canadian real estate investment trusts (REITs) emerged in the early 1990s and provide investors with exposure to a variety of residential, commercial, and industrial real estate markets. Over the past decade, REITs have become the dominant publicly traded vehicle for real estate in Canada. In the late 1990s, income trusts emerged based on power-generating and infrastructure assets, generally ones characterized by long-term supply arrangements and sales contracts. Most recently, the demand for income-oriented securities has prompted a wide variety of other companies to adopt an income trust structure. These include businesses in industries such as telecommunications, food services, casinos, waste management, cheque printing, retailing, transportation, and logistics.

The Structure

While the exact structure of an income trust depends on a variety of factors, the basic objective of all income trusts is the same: to provide a more tax-efficient manner in which to distribute cash flow to investors. The current Canadian tax system does not fully integrate taxes paid at the corporate and personal levels on income generated by an operating business. That is, dividends are paid to investors of a share of net corporate profits after taxes have been deducted; however, investors are still subject to tax on these dividends. Even taking into account the dividend tax credit, a certain level of double taxation exists. Income trusts are essentially structured to minimize or eliminate corporate taxes payable, thereby distributing cash flow generated by an underlying business on a pre-tax basis. While investors are subject to tax on the distributions received, the layer of corporate taxation has largely been removed. This improved tax efficiency enables investors to receive a higher after-tax share of corporate profits, as illustrated in Exhibit 4.

As a result of this tax efficiency and the resolution of reinvestment risk for excess free cash, the income trust structure has proved appealing for a variety of prospective issuers. In addition to the healthy income trust IPO market over the past few years, the market has also witnessed the conversion of publicly traded corporations from traditional common equity ownership to an income trust.

In order to accommodate the growth of the sector, a variety of income trust structures have been developed through which cash flow generated by an underlying business is flowed through to investors on a pre-tax basis. The exact structure is determined after considering a number of factors including, but not limited to: the type of business and nature of assets to be held by the income fund, the location of assets (Canada, United States, or elsewhere), the retained interest to be held by existing equityholders, the income projections of the business, and the fund's future growth and acquisition strategy. Appendix 2 provides a more detailed description of the specific trust structures in existence today.

Exhibit 4 – Comparative After-Tax Returns for Income Trusts versus Equities

	<u>Income Trust</u>	<u>Common Equity (100% payout)</u>
Earnings before taxes	100	100
Corporate tax (assume 35% of EBT)	0	35
Earnings	100	65
Distributions paid to unitholders	100	
Dividends to shareholders		65
Amount received by individual investor	100	65
Personal tax on distributions (46.4% tax rate*)	46	
Personal tax on dividends (31.3% tax rate**)		20
After-tax return to investor	54	45
Total tax paid	46	55

*Assuming no favourable tax treatment on distributions.

** Takes into account the dividend tax credit.

Source: Scotia Capital.

Why Invest in Income Trusts?

Income Orientation

One of the primary benefits of investing in income trusts is their ability to fulfill income objectives. Trusts are generally based on mature businesses that have a proven ability to generate sustainable cash flow. While there may be a tendency to compare trusts with fixed income securities, they are in fact equities, with the generally higher yields meant to compensate investors for higher risks. Like equities, income trusts are perpetual instruments, whereas fixed income products promise full repayment of capital at maturity.

Moderate Growth Prospects

Income trusts can offer modest growth prospects through inflationary increases in their revenues and organic growth, providing there is no requirement for expansive capital. Funding necessary for acquisitions and major expansions is generally raised through some combination of senior bank debt, convertible debentures, or additional unit equity issuance. Income trusts that own long-lived tangible assets (e.g., real estate, pipelines, long-reserve-life depleting resources) often incur debt at attractive interest rates relative to their cash yields in order to leverage returns to unitholders. As always, debt increases financial risk, and the appropriateness of debt levels to underlying cash flows and tangible asset values must be carefully considered. Most acquisitions and expansions require additional equity, if for no other reason than to maintain borrowing capacity with lenders, as income trusts cannot retain taxable earnings without defeating the efficiency of their flow-through structure.

Major non-expansive factors affecting capital appreciation of income trusts are the generally inverse relation of unit values to interest rates, similar to the typical behaviour of bonds, and appreciation of underlying asset values (e.g., real estate or resources sensitive to commodity prices).

Discipline of Cash-on-Cash Investment Returns

The focus on sustainable cash distributions imposes a rigid investment discipline on income trust managers. Acquisition transactions must be justified on the basis of immediate cash flow contribution. Income trust investors, who generally prioritize tangible cash distributions, do not reward growth without a corresponding immediate or imminent cash distribution benefit to unitholders. Acquisitions that merely match existing yields (in terms of cash distributions per unit) do not tangibly benefit unitholders. While such actions may be tolerated temporarily, investors will ultimately shift to those income trusts with a track record of rewarding unitholders. Similarly, any event or transaction that permanently diminishes or dilutes sustainable cash distributions per unit is almost invariably perceived negatively and typically results in a sudden and sharp unit price correction.

Because cash is straightforward to measure and clearly reported in financial statements, there are very few methods, beyond an obvious increase in debt leverage, to disguise cash distributions in excess of distributable cash generated. All involve some unsustainable return of capital, either by recirculating funds raised in new issues of capital or by cannibalizing the future earning potential of an income trust through distributions of asset sale proceeds, principal repayments on financial assets, or capital recovered through depreciation and amortization. Unlike the sometimes widely different measures of reporting net income for common equities, due to the exercise of management judgment in adoption of esoteric and complex accounting policies, the simplistic focus in income trusts on the ratio of sustainable cash generated to cash distributed can be exceedingly revealing.

Enhanced Return Opportunities

The potential for enhanced total returns is well illustrated over the arguably short history of the Scotia Capital Income Trust Index (SCITI), its Energy and REIT sub-indices (since January 1995) and the even shorter history of the Power, Utilities and Infrastructure, Resource, Industrial, and Consumer sub-indices (since May 1999). These historical returns span wide fluctuations in oil and gas commodity prices and encompass the recent effect of many new and additional issuances as well as the general decline in interest rates to at least 40-year record lows.

The relative total return calculation assumes that all distributions (interest from bond coupons, cash distributions from income trusts, and dividends from corporate equities) are reinvested at then-prevailing prices in their respective index baskets. This assumption favours income trusts because of their relatively higher total yield and compounds the benefit over time. Nevertheless, we believe that a risk-adjusted combination total return, with risk measured by standard deviation (variability around the mean total return) is a more meaningful standard of comparison when assessing different investments, particularly those across such disparate objectives as security, income, and growth. We attribute the apparent outperformance of income trusts over equities (see Exhibit 2, page 5) to their discipline of distributing much of their cash flow.

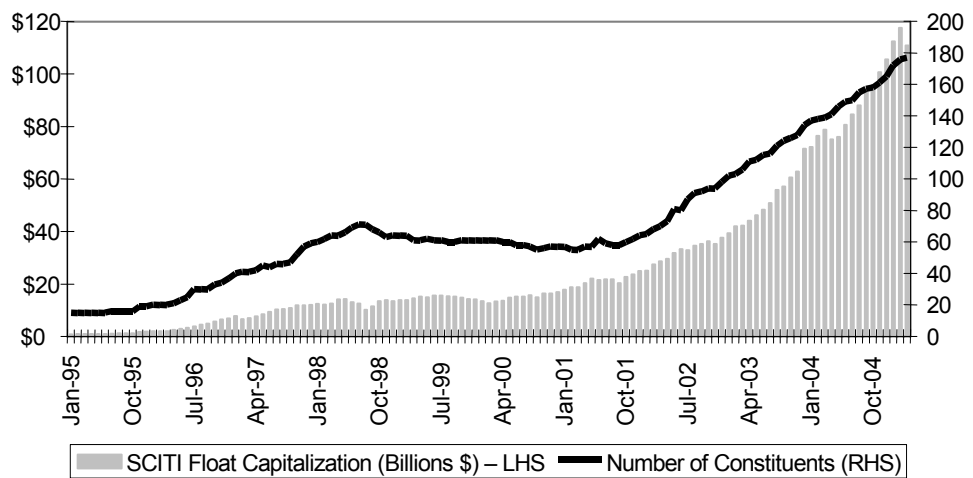
Diversification

By adopting a blend of security, income, and growth objectives for different components of a portfolio, investors may potentially achieve better diversification than by focusing on simply one or two objectives. Income trusts now cover the gamut of many different general industrial classifications, which largely form the classification basis of SCITI's sub-indices. Accordingly, it is now possible to achieve reasonable diversification within income trusts among sub-categories, as it is among the other standard investments of bonds and common equities.

The Evolution of the Income Trust Market

Over the past few years, the low interest rate environment, volatile common equity markets, and investors' desire for income have resulted in increased demand for higher yielding securities. In such an environment, the combination offered by most trusts of stable distributions along with prospects for moderate growth has proved attractive for investors. As a result, the income trust market has developed substantially, as both the size and number of listed trusts has grown significantly. The types of companies that now exist as income trusts and the variety of investors (and investing styles) that consider trusts for portfolio inclusion has also materially widened. At the end of 1995, there were 18 trusts in the Scotia Capital Income Trust Index, which primarily consisted of REITs and oil and gas royalty trusts. Today, there are 181 income trusts in existence, operating in industries including consumer staples, consumer discretionary, and industrials. The total float capitalization has grown from \$1.8 billion in December 1995 to approximately \$120 billion at present, a 58% CAGR over the time period (Exhibit 5). Exhibit 6 shows the current sectoral breakdown of income trusts.

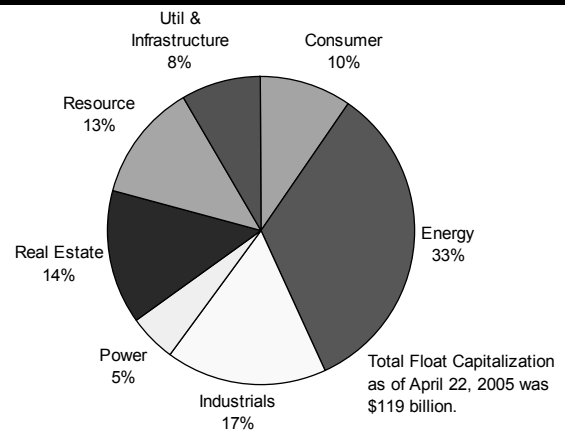
Exhibit 5 – Growth in Income Trusts



Source: Global Insight, Inc., Scotia Capital.

Exhibit 7 shows the size of new issues, and the sectors of the market in which they operate. It is interesting to see the gradual diversification of sectors that housed income trusts toward the end of the 1990s and the ballooning expansion in 2002 and afterward. Annual income trust new issue activity increased from \$1.2 billion in 2000 to \$14.5 billion in 2004 and is expected to remain strong through 2005.

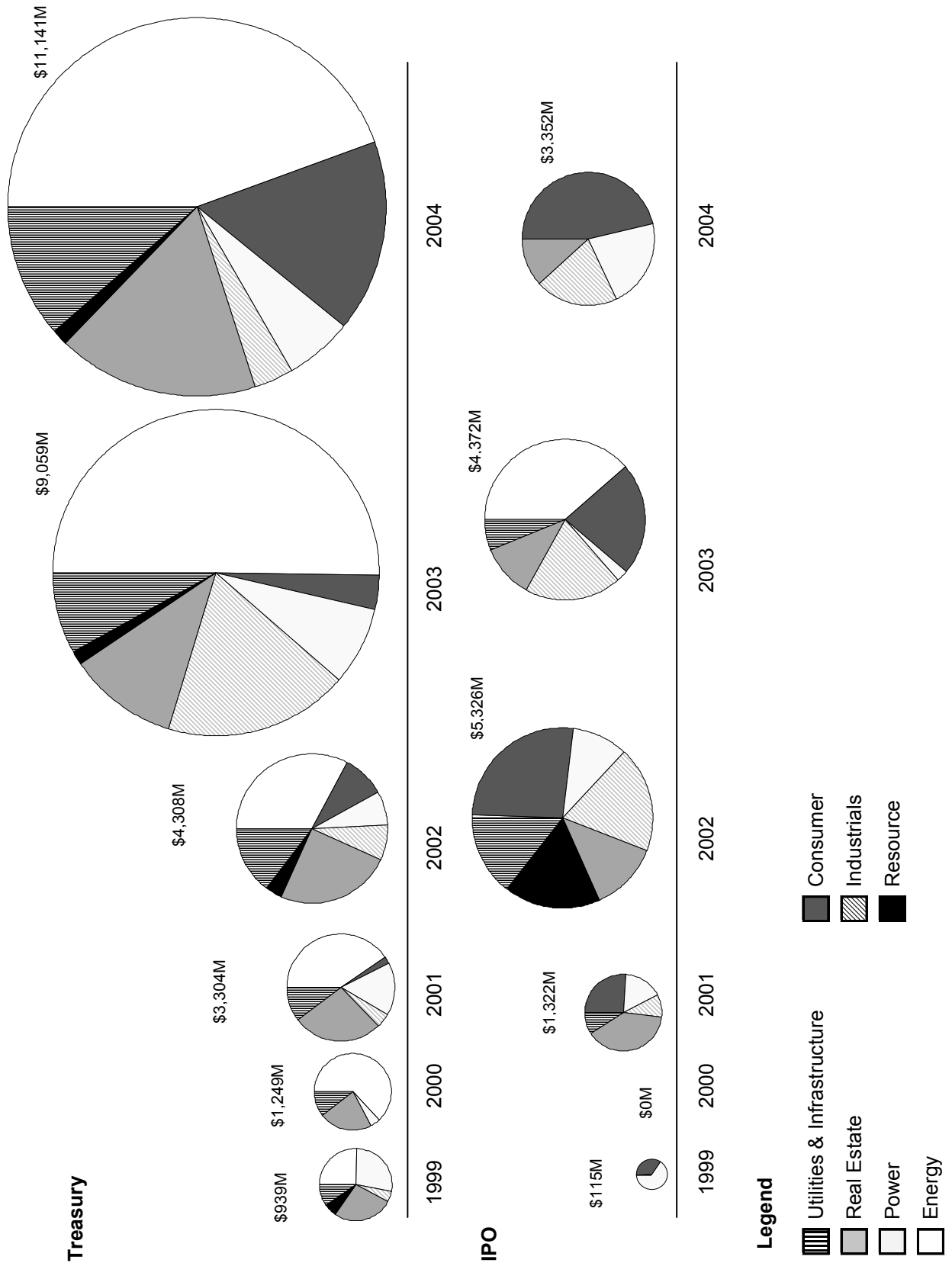
Exhibit 6 – Sectoral Breakdown of Income Trusts



Note: Based on float capitalization data from the Scotia Capital Income Trust Index.

Source: Global Insight, Inc., Scotia Capital.

Exhibit 7 – Income Trust Annual Cash Calls by Sector



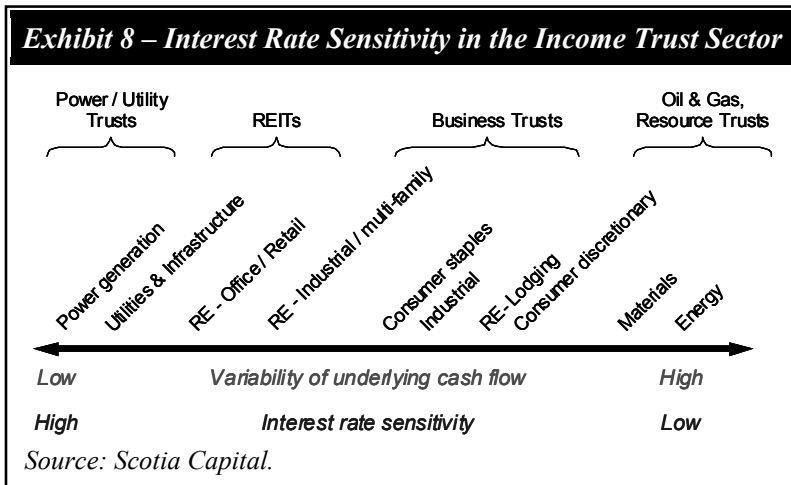
Source: Scotia Capital.

Key Issues and Trends

Interest Rate Sensitivity

As with other financial instruments, both the underlying cash flow and valuation of income trusts are sensitive to changes in interest rates. With yield the primary focus for many investors, we cannot deny the temptation to categorize income trusts as “bond proxies.” The reality, however, is that income trusts are equity instruments whose distributions are not

fixed but driven by the cash flow of an underlying business. We assert that the ebb and flow of economic activity and interest rates impact each trust in a different manner. The degree of interest rate sensitivity therefore varies across the income trust universe.



The degree of interest rate sensitivity depends on the variability of the underlying cash flow of each trust. Valuation of trusts with low variability of cash flow tends to be more sensitive to interest rate fluctuations. Underlying cash flow that is contractual in nature or subject to regulation tends to vary less than does cash flow dependent upon broad economic activity. Income trusts involved in

utilities (power generation, pipelines, basic telephony, etc.) and certain sectors of real estate (retail and office) exhibit these characteristics (Exhibit 8). Similarly, valuation of trusts whose underlying cash flow varies with broad economic activity tends to be less sensitive to interest rates. Cash flow and valuation of energy and resource trusts, for example, tends to vary with commodity prices.

Power/Utility Trusts Highly Sensitive to Interest Rates; REITs Moderately Sensitive

Since periods of declining interest rates are typically associated with lower inflation and slower economic activity, trusts with low variability of cash flow typically outperform. Through long-term supply contracts or leases, cash flow of these trusts remains relatively unchanged even as broader economic activity slows. Conversely, as economic activity improves and interest rates rise, these trusts are often unable to “reprice” their products in the short term. Ultimately, as contracts or leases expire, these businesses should be able to mark-to-market their products at prevailing rates. In the case of real estate, a portfolio with little vacancy and a long average lease term is desirable as the economy cools; a portfolio with a shorter average lease term and some vacancy should outperform as economic activity heats up.

Higher usage of debt by REITs and infrastructure trusts compounds the impact of interest rate fluctuations. Declining interest rates not only boost valuation but also reduce the cost of borrowing, thereby improving cash flow. The reverse occurs as interest rates rise. Most of these trusts attempt to mitigate the impact of fluctuating interest rates by staggering mortgage and debt expiries.

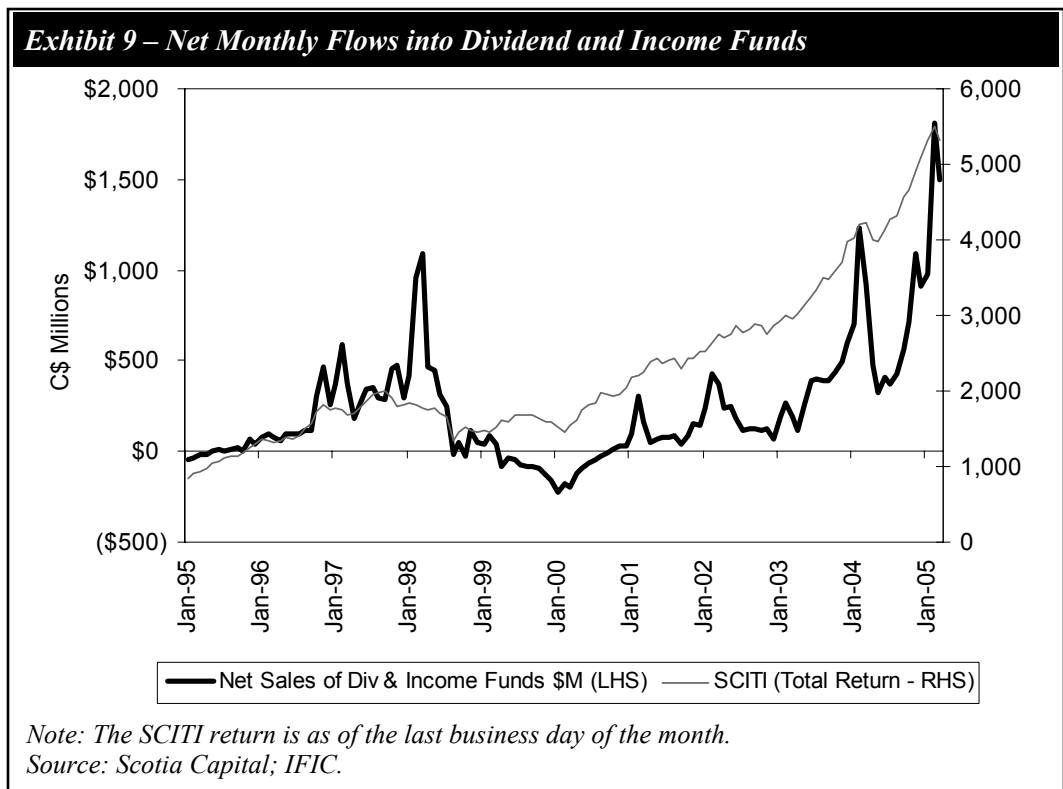
Business Trusts Generally Less Interest Rate Sensitive

The fundamentals of many business trusts are typically linked to the economic cycle. During periods of economic expansion and rising interest rates, an improvement in underlying cash flow can partially offset the detrimental impact of higher interest rates on valuation. We caution, however, that the degree of cash flow variability varies significantly among business trusts, with some businesses exhibiting more elasticity than others. For example, trusts selling consumer staples (e.g., Rogers Income Fund, Arctic Glacier Income Fund) may be less economically sensitive than consumer discretionary trusts (e.g., Cineplex Galaxy Income Fund, Boston Pizza Royalties Income Fund).

Flow of Funds

We expect further growth in the income trust market, although the pace may be tempered if interest rates rise. Most of the growth in income trusts over the last few years has been “demand pull” as investors (mainly retail) have been drawn toward income-oriented investment vehicles. We expect this pull to continue, based on continued flow of funds into dividend and income funds.

Flow of funds to dividend and income funds (see Exhibit 9) in general and to income trusts in particular has been phenomenally strong in the last few years. The overriding reason for the burgeoning flow of funds to the income trust market has been the dearth of investment alternatives. Since 2000, investors have faced difficult fixed income and equity markets. Declining interest rates have meant that fixed income prices have performed well but also that attractive reinvestment opportunities are few and far between. At the same time, equity market aversion rose in the first half of this decade because of the volatile corporate profit picture generated by the uneven North American economic environment, and a variety of corporate governance issues. Within the equity markets, there is a lack of high-quality, high dividend-paying stocks. Of the 226 companies included in the S&P/TSX Composite Index, only nine (representing a float capitalization of approximately \$58 billion) offer dividend yields over 4%. We believe that an aging population with relatively higher present income needs is also an important factor driving demand for income-oriented investment vehicles.



Recent Developments

Changes in Liability and Other Legislation

Until recently, most income trust unitholders were subject to the theoretical risk that they could be held liable for obligations exceeding the value of an income trust's assets (for example, in the event of a catastrophic environmental liability). The exceptions were trusts established in Quebec, which have been afforded limited liability protection under the province's Civil Code since 1994. Although the theoretical risk of unlimited liability was never tested by jurisprudence and was widely viewed as extremely remote, it still precluded some institutional investors (particularly pension funds) from investing in income trusts.

Over the last year, both Alberta and Ontario (the two provinces where the vast majority of trusts are established) passed legislation explicitly providing limited liability protection to income trust unitholders similar to that provided to shareholders of a corporation. The B.C. government is also expected to amend its legislation, although no time frame has been established. The province of Manitoba announced in its 2005 budget (released March 8) that it too will soon introduce legislation limiting the liability of income trust unitholders. Accordingly, we expect institutional investors, including pension funds, to take an increasingly active role in the income trust market going forward.

In December 2004, the federal government chose not to implement measures (proposed in the March 2004 budget) that would have restricted foreign ownership levels within the trust sector to below 50%. Earlier in 2004, the government suspended measures that would have limited pension funds to holding a maximum of 1% of their assets in business trusts; however, language in the 2005 federal budget suggests that this subject may be revisited this year. We believe that limiting pension fund investment in this sector may have a negative impact on trust valuations. The pension fund industry has lobbied against such changes, as trusts are a suitable investment vehicle for these funds, especially considering their rising income needs.

Inclusion in the Composite Index

On January 26, 2005, Standard & Poor's formally announced its intention to add income trusts to the S&P/TSX Composite Index. We believe that this decision represents a significant milestone for the sector. Inclusion in the Composite Index is expected to attract additional institutional investors to income trusts, which were once thought of as primarily a retail-oriented product. As a result of a broader investor base, liquidity and demand for trust units will likely increase.

Trusts are expected to be added to the index before the end of 2005; however, neither a formal implementation strategy nor a final timetable has been set. The "classic" benchmark (which excludes trusts) will continue to be maintained and calculated on a real-time basis and supported indefinitely by S&P. We expect the "classic" benchmark to be phased out over time if investors embrace the new Composite Index. S&P is not initially planning on adding income trusts to the S&P/TSX 60 Index.

We estimate that most index funds will transition to the new benchmark, resulting in over \$3.0 billion of income trust demand. This demand may be eclipsed by additional demand from active Canadian equity funds, which manage their funds around the overall index sector weightings. The energy and industrial sectors should see net inflows of investor capital as equity funds seek to approximate the overall sector weightings.

Exhibit 10 – Possible Candidates for Index Inclusion

Symbol	Float	Est % Weight	Est Demand	Sector
COS.UN	91,146,394	0.80%	4,100,000	Energy
FDG.UN	48,970,558	0.59%	2,200,000	Materials
YLO.UN	344,201,268	0.50%	15,490,000	Consumer Discretionary
ERF.UN	103,899,757	0.49%	4,680,000	Energy
REI.UN	183,466,824	0.36%	8,260,000	Financials
AET.UN	177,806,497	0.33%	8,000,000	Energy
SPF.UN	73,482,039	0.23%	3,310,000	Industrials
PEY.UN	45,725,272	0.23%	2,060,000	Energy
PWI.UN	69,332,504	0.22%	3,120,000	Energy
HR.UN	95,584,079	0.19%	4,300,000	Financials
PTF.UN	99,413,286	0.19%	4,470,000	Energy
PVE.UN	141,521,031	0.18%	6,370,000	Energy
BNP.UN	56,600,027	0.18%	2,550,000	Energy
AE.UN	103,227,535	0.16%	4,650,000	Energy
PIF.UN	102,249,358	0.15%	4,600,000	Energy
SIF.UN	89,002,436	0.15%	4,010,000	Utilities
VET.UN	60,553,206	0.13%	2,720,000	Energy
ALA.UN	49,575,562	0.12%	2,230,000	Energy
TWF.UN	76,886,870	0.12%	3,460,000	Materials
PMT.UN	65,115,694	0.12%	2,930,000	Energy
SHN.UN	54,080,918	0.12%	2,430,000	Energy
SMU.UN	55,527,668	0.11%	2,500,000	Financials
CLC.UN	79,633,216	0.11%	3,580,000	Health Care
PGF.B	59,749,755	0.11%	2,690,000	Energy
REF.UN	55,394,002	0.11%	2,490,000	Financials
HTE.UN	40,775,304	0.10%	1,830,000	Energy
BEI.UN	48,598,774	0.10%	2,190,000	Financials
OYR.UN	58,775,223	0.10%	2,640,000	Energy
GLH.UN	48,276,476	0.10%	2,170,000	Utilities
BTE.UN	62,910,216	0.09%	2,830,000	Energy
TIF.UN	55,208,488	0.09%	2,480,000	Industrials
RRR.UN	91,425,826	0.09%	4,110,000	Financials
DHF.UN	37,920,792	0.09%	1,710,000	Financials
PGX.UN	66,484,498	0.09%	2,990,000	Energy
WTE.UN	70,381,111	0.09%	3,170,000	Industrials
VKR.UN	109,907,027	0.08%	4,950,000	Energy
AVN.UN	39,952,095	0.08%	1,800,000	Energy
NAE.UN	52,960,039	0.08%	2,380,000	Energy
LIF.UN	32,000,000	0.08%	1,440,000	Industrials
AY.UN	58,876,087	0.08%	2,650,000	Energy
CAR.UN	50,850,398	0.08%	2,290,000	Financials
FET.UN	35,854,447	0.08%	1,610,000	Energy
CBF.UN	37,903,166	0.07%	1,710,000	Consumer Staple
BFC.UN	26,500,000	0.07%	1,190,000	Industrials
APF.UN	69,446,795	0.07%	3,130,000	Utilities
KEY.UN	43,434,100	0.07%	1,950,000	Energy
NPI.UN	47,915,943	0.07%	2,160,000	Utilities
LGY.UN	89,360,094	0.07%	4,020,000	Financials
CF.UN	61,742,288	0.07%	2,780,000	Utilities
NAL.UN	27,253,996	0.06%	1,230,000	Industrials
CWT.UN	32,655,918	0.06%	1,470,000	Financials
BRK.UN	43,724,016	0.06%	1,970,000	Consumer Discretionary
CWI.UN	39,668,798	0.06%	1,790,000	Industrials
CUF.UN	31,633,120	0.06%	1,420,000	Financials
UWH.UN	41,513,000	0.06%	1,870,000	Industrials
CCR.UN	19,878,092	0.06%	890,000	Energy
GCI.UN	26,417,687	0.06%	1,190,000	Consumer Discretionary
BNQ.UN	32,605,000	0.06%	1,470,000	Telecommunication Services
INN.UN	45,761,981	0.06%	2,060,000	Financials
CPG.UN	28,726,401	0.05%	1,290,000	Energy
BPT.UN	45,300,002	0.05%	2,040,000	Utilities

Source: Scotia Capital.

Timetable

S&P is conducting discussions with members of the Index Advisory Panel to discuss possible transition alternatives and timetables. S&P will need to change the existing rules for inclusion in the Composite Index to remove the exclusion for income trusts. Further changes will be identified and confirmed in the coming months. No changes are anticipated to existing methodology concerning the one-year seasoning or size/liquidity thresholds.

We expect income trusts to be added to the S&P/TSX Composite Index in September. S&P will either stagger the additions over several quarterly rebalances or add all of the trusts at only one-third or one-half of their total expected weighting, increasing the weights over several quarterly rebalances. When S&P transformed the S&P/TSX Composite Index from a fixed number of 300 companies to the current “floating” number, the deletions were staggered over three quarterly rebalances. The other main option for S&P to consider is the “big bang” approach of adding all the trusts at once. In our opinion, however, the impact of buying \$3.0 billion of income trusts and selling a similar amount of the current Composite Index might stretch the market’s ability to operate in an orderly fashion.

Concurrent with the transition, we expect S&P to offer a provisional index to allow index funds to transition to the new benchmark at any time during the implementation phase. This provisional index will allow index funds to somewhat disguise their actual transition dates.

There remains some uncertainty as to whether limited partnerships will be included in the index. LPs are considered foreign property and therefore may not qualify for index inclusion. The federal government proposed the elimination of foreign property restrictions in the 2005 budget. However, budget legislation has not yet been passed.

Implications

We believe this announcement will have several positive ramifications for the income trust market. Inclusion in the equity composite confirms our view that income trusts are to be viewed as higher-yielding securities that offer alternative equity exposure to the various classes in the Global Investment Classification Standard (GICS). We expect that, combined with the passage of limited liability legislation, index inclusion will result in a broader investing audience for trusts, leading to increased trading liquidity and a more efficient market. Institutional and individual investors who have not previously considered income trusts for portfolios will now, in our view, be increasingly expected to do so in order to obtain full exposure to the Canadian equity market.

The inclusion of income trusts in the various GICS classes of the S&P/TSX will allow traditional equity investors to choose among a larger number of securities in each sector. Income trusts are higher-yielding equity investments that pay regular cash distributions to holders; thus income will constitute a higher proportion of an investor’s total returns than would be expected from the dividends of common stocks. We also expect index inclusion to lead to increased liquidity for income trusts in general.

Governance

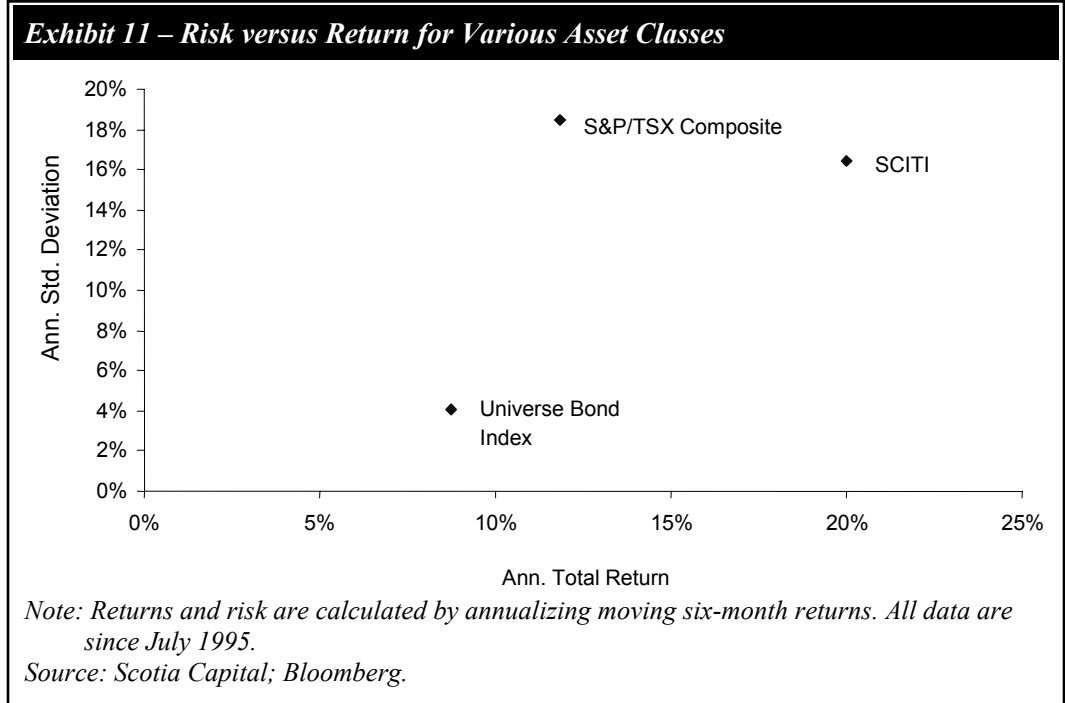
Just as corporations are governed by statute (such as the Canadian Business Corporations Act (CBCA)), income trusts are governed by the declaration of trust (DOT) under which they are established. We note that declarations of trust are flexible and while they generally include provisions similar to those found in corporate statutes, they are not obligated to do so. Although DOTs are flexible, publicly traded income trusts are still subject to similar securities regulations and legislation as other public issuers. These rules include certification by management of financial reports, quality of internal controls, and the independence and qualifications of board committee members.

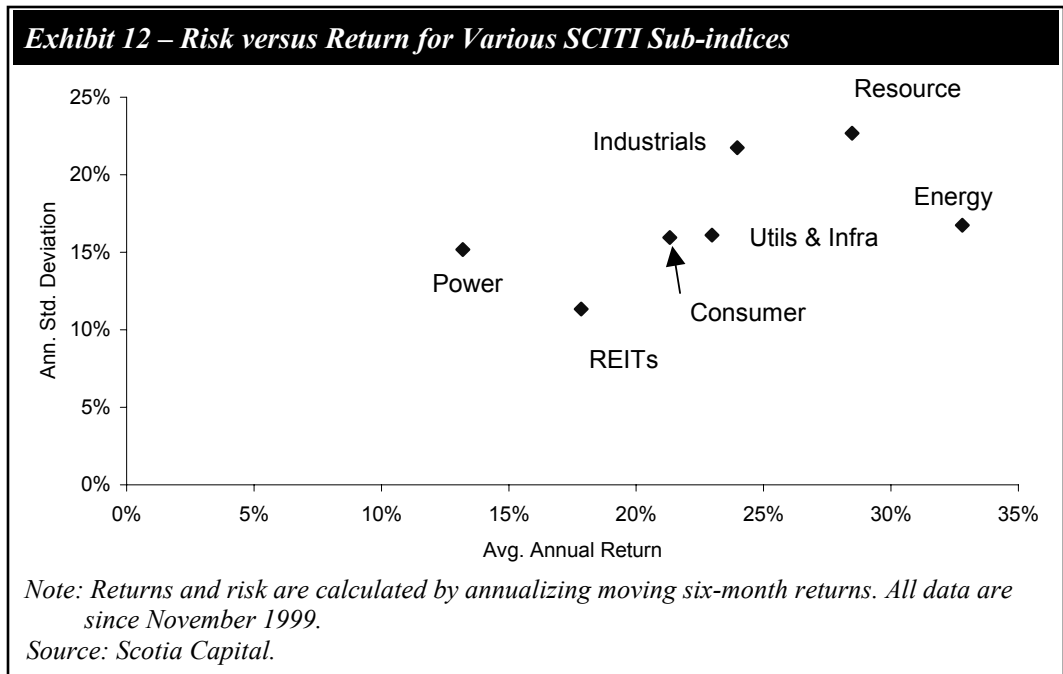
In order to provide guidance to market participants about income trusts specifically, the Canadian Securities Administrators (CSA) adopted National Policy 41-201 (“Income Trusts and Other Indirect Offerings”) in December 2004. According to the CSA, the policy is in response to the large number of income trust offerings over the past few years, and addresses issues relating to prospectus disclosure, continuous disclosure, vendor liability, sales and marketing materials used in income fund offerings, and corporate governance. The CSA policy provides recommendations about how income trusts fit within the existing regulatory framework, rather than actually establishing a new regulatory framework. Full details of the policy can be found on the Ontario Securities Commission Web site (www.osc.gov.on.ca).

We view the policy as a positive development, as it is the first regulatory guideline that provides clarification on income trusts directly. Most income trusts already comply with many of the recommendations outlined. However, we believe a national policy reduces inconsistency between trusts and provides additional credibility for the overall income trust market.

Comparing Income Trust Risks and Returns Against Other Asset Classes

As shown in Exhibit 11, trusts in general have provided a significant return pickup over equities and bonds, with a standard deviation (variability around the mean total return) comparable to that of equities but higher than that of bonds. Exhibit 11 shows the risk-adjusted comparison of average total returns from the S&P/TSX Composite Index, the Universe Bond Index, and the Scotia Capital Income Trust Index. The SCITI has provided the best returns of the three, despite the equity bull market that has been underway for the past three years.

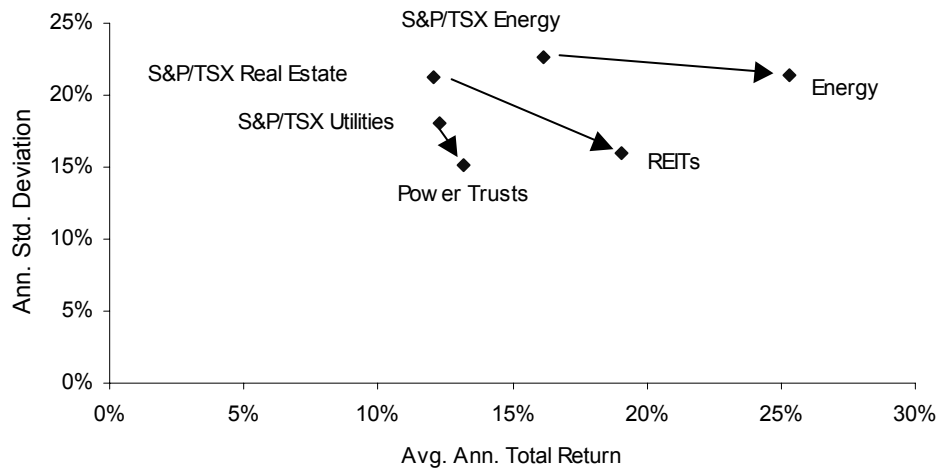




Energy and resource trusts have generally provided higher returns, but also have higher standard deviation on this return. Exhibit 12 shows a sectoral risk-return matrix for all the sub-indices of Scotia Capital’s Income Trust Index. One of the reasons behind this solid return performance by energy and resource trusts is the current commodity bull market. Industrials, utilities, consumer, and REITs provide comparable returns, although industrials are generally riskier (as measured by standard deviation of unit price returns). We believe that returns from economically sensitive consumer and industrials trusts are likely to be higher than more interest-sensitive utilities trusts and REITs when interest rates start to back up. The power trusts stand out at the bottom of the return profile with slightly higher standard deviation than REITs. The power trusts are possibly the most interest-sensitive income trusts.

The energy, REIT, and power trust sub-indices have also provided better returns than comparable S&P/TSX sector indices with relatively lower standard deviations (Exhibit 13). The return pickup for power trusts is relatively marginal at a comparable risk profile, which suggests that on a risk-adjusted basis, the returns of both power trusts and utilities equities have been comparable. This data suggest that a portfolio of select income trusts is a suitable alpha-enhancement tool with relatively low risk characteristics.

Exhibit 13 – Risk versus Return for Income Trust and Equity Indices



*Note: Returns and risk are calculated by annualizing moving six-month returns.
Data are since July 1995, with the exception of Utilities and Power, which are since November 1999.
Source: Scotia Capital; Bloomberg.*

Performance of Income Trusts Against Equities and Bonds

We believe that on a risk analysis and structural basis, income trusts are closer to equities than to bonds. Income trusts, other than those with depleting resource bases, are generally quoted on a cash yield basis, which can easily be expressed as a yield spread over “risk-free” sovereign government bonds. This is changing as the income trust investor base seasons. Institutional investors generally apply more sophisticated analysis tools and compare income trusts to other conventional equity investments held in the portfolio. Looking at only yield spreads implies that income trusts are more akin to bonds than to equities, but income trusts are closer to equities than to bonds on a risk and structural basis. Unlike the interests of creditors, the interests of unitholders are subordinate to any prior claims (senior debt, convertible debentures) and similar, in theory, to those of shareholders. Most unitholders can earn an indefinite stream of cash flows from the underlying business or activity of the income trust. Furthermore, unlike fixed income instruments, limited organic and acquisition growth opportunities do exist for most income trusts.

As shown in Exhibit 14, we have calculated the correlation coefficient of the Scotia Capital Income Trust Index (total return) versus various equity and bond indices over various time periods. We would caution investors that the short historical data series available for income trusts allows us to reach only preliminary conclusions. Our three main conclusions are:

- **On a total return basis, income trusts are more correlated to equities (S&P/TSX Composite and S&P 500) than to bonds.** This correlation between equities and income trusts has increased in the past three years. Before then, however, the performance of bonds and income trusts was more highly correlated, as suggested by data going back to July 1995. In our opinion, this could be due to initial mispricing of income trusts as fixed income instruments, which was later corrected with seasoning. We also note that the relatively low correlation among income trusts, bonds, and equities suggests that income trusts can be used to diversify a portfolio.

- **On a risk-adjusted basis, income trusts seem to have superior returns to equities and bonds.** We have used the Sharpe measure ((Average return of index – Average return of risk-free)/Standard deviation of index) to compare risk-adjusted returns for the various indices. We have used the SC-Government of Canada Bond Index as a proxy for risk-free. The Sharpe measure for the Scotia Capital Income Trust Index, at 0.71, is the highest among all indices. This suggests that on a risk-adjusted basis, income trusts have provided superior returns as compared to bonds and equities.
- **The coefficient of variation (standard deviation of returns/average return) for the income trust index, at 0.82, is almost twice that of the bond indices and half that of the equity index.** This suggests that income trusts are almost twice as volatile (per unit of return) as compared to bonds and exhibit about half the volatility (per unit of return) of equities.

Exhibit 14 – Return Correlations with Income Trusts over Various Time Periods

	Canadian Equity (S&P/TSX Composite)	Income Trust (SCITI)	Bonds (SC Universe Bond Index)	Risk-Free Bonds (SC Govt. of Canada Bond Index)
1-Year	0.76	1.00	0.89	0.88
2-Year	0.70	1.00	0.64	0.62
3-Year	0.72	1.00	0.25	0.14
4-Year	0.49	1.00	0.02	-0.07
5-Year	0.28	1.00	0.09	0.03
6-Year	0.05	1.00	0.38	0.36
7-Year	0.23	1.00	0.27	0.21
Since Jul-95	0.26	1.00	0.39	0.36
Mean Daily Return (annualized)	11.86%	20.00%	8.75%	8.36%
Std. Dev. (annualized)	18.48%	16.45%	4.05%	3.98%
Sharpe Measure	0.19	0.71	0.09	n.a.
Coef. of Variation	1.56	0.82	0.46	0.48

Note: All numbers are based on six-month moving total returns.

All data are since July 2005.

Sharpe measure defined as: (avg. return of index – Avg. return of risk-free)/St. dev. of index.

Coefficient of variation defined as: St. dev. of index/Avg. return of index.

Source: Scotia Capital; Bloomberg.

The results of our correlation calculations, although preliminary due to the brevity of historical data, suggest that income trusts behave more like equities than like bonds. As detailed below, however, income trusts and high-yield equities have several structural differences. This suggests to us that income trusts may provide superior risk-adjusted returns to both bonds and equities and have investment merits for income-oriented investors.

- **The yield of income trusts is significantly higher than the yield of equities.** The average yield for the Scotia Capital Income Trust Index is approximately 8.5%, whereas less than 5% of stocks (by market capitalization) in the S&P/TSX Composite Index have a yield of more than 4%.
- **Income trusts pay out close to 90%–100% of cash flows** after interest, management expenses, and maintenance expenditures. Even in the case of high-yielding equity stocks, management generally retains a portion of cash to invest in growth.

We also note that income trusts are less likely than equities to be a yield trap (a high yield due to declining profitability, which would signal future stock price depreciation), as their structure values stability of distributable cash. In particular, acquisitions are justified on the basis of either immediate or imminent accretion to distributable cash. This does not, however, prevent the cash distributions of particular income trusts from being reduced or suspended should business conditions deteriorate.

Risks

As we have noted, income trusts are equity investments. Unitholders are therefore subject to the operational risks of a trust's underlying business and face the same financial risk of complete loss of capital.

Strength of Business Model

The appropriateness and suitability of the business model adopted by an income trust dominates all other risks. Generally, income trusts are well suited to stable, predictable, and mature businesses. Historically, these businesses have included real estate and long-term contracted and quasi-monopoly activities such as power generation and pipelines. In addition, by reason of royalty tax provisions allowing for flow-through of such payments to investors, oil and gas royalty trusts have been successful despite inherent stability and sustainability concerns relating to commodity prices and depleting reserves. The relatively recent proliferation of trusts in various other industries requires a careful examination of the suitability of their underlying business models.

Sustainability of Distributions

An income trust's current indicated rate of cash distribution is neither fixed nor guaranteed. Cash distributions are thus not equivalent to the fixed interest rate or yield of a bond. Many operational and financial factors specific to each underlying business can affect the stability and sustainability of cash distributions. Examples include cost increases, competitive pricing pressure, loss of market share, depletion of resources, expiry of contracts or leases, equipment damage, obsolescence, higher-than-anticipated capital expenditures, regulatory changes, export or import restrictions, inability to refinance maturing debt, foreign exchange fluctuations, and increases in interest rates. Because income trusts are often valued on the basis of their risk-adjusted yield based on current and forecast cash distributions, the inability to sustain these distributions can have a direct and material impact on unit price. This is especially true of those income trusts that have few or no underlying net tangible assets to support an alternative liquidation value.

Unit Price Volatility

Despite the efficient market hypothesis, there can sometimes be wide fluctuations in the market value of income trust units that are independent of their underlying stability or the sustainability of cash distributions. Income trusts trade on an exchange (just like common equities) and the value of income trusts is determined daily in the market. Market psychology and asset allocation play large roles in shaping the price of almost all traded securities at the margin. An oversupply of new issues by income trusts with similar characteristics, or an issuer-specific overhang due to apprehension of treasury or secondary unit offerings, could put downward price pressure on unit values. The more limited upside potential of income trusts, due to their generally mature nature and lower growth potential, typically results in less dramatic upside price volatility. The relative illiquidity of some smaller income trusts can also add to price volatility.

Interest Rates

A major influence on the unit prices of most income trusts is the general level of interest rates. This is because of the fundamental tendency of liquid markets to constantly reassess comparative risk and rewards. As the risk-free rate of interest or yield on government bonds goes up, the corresponding risk-adjusted yields on other income-oriented securities generally follow suit, which leads to corresponding reductions in unit prices of income trusts, all other things being equal. The reverse is generally true as well, with lower overall interest rates leading to higher unit prices.

The degree of interest rate sensitivity depends on the variability of the underlying cash flow of each trust. We believe valuation of trusts with low variability of cash flow (such as power generation and pipeline trusts and certain REITs) tends to be more sensitive to interest rate fluctuations. However, valuation of trusts whose underlying cash flow varies with broad economic activity tends to be less sensitive to interest rates. In addition, cash flow and valuation of energy and resource trusts tends to vary more with commodity prices rather than interest rates.

Apart from their effect on overall sector valuation, higher interest rates can also affect the amount of distributable cash of those income trusts with more economically sensitive business prospects and floating rate debt exposure. These income trusts are likely to be more sensitive to increases in short-term rates. Conversely, increases in longer-term interest rates are likely to affect the overall income trust sector, including those income trusts that are otherwise economically insensitive due to long-term revenue contracts and fixed operating and financial costs.

Commodity Prices

Income trusts in the energy and resource sectors are more sensitive to commodity prices than they are to interest rates. Commodity prices can have a direct impact on their top-line revenue and corresponding cash flow. These income trusts appeal to investors seeking ways to participate in the commodity play while earning a yield or return in the process. Many energy income trusts manage part of their commodity price exposure by adopting hedges that provide a greater measure of short- and medium-term stability to their cash distributions. Hedging can be of significant value for income trusts with short reserve lives, as the potential economic value of their resources (and correspondingly their unit values) might otherwise be more quickly depleted were commodity prices to drop suddenly.

Changes to Tax Policy

The 2004 federal budget contained proposals to limit investment by pension funds in business income trusts. However, after concerns were raised by several pension funds and provincial governments, the Department of Finance decided to suspend these proposals pending further consultation. The limitations were originally proposed because the government was concerned about the potential loss of current tax revenues due to increased pension fund investment in income trusts. We note that accurately estimating the impact on government tax revenue is extremely difficult, as many variables and assumptions need to be taken into consideration. Various studies on this issue have resulted in different estimates as to the impact on the federal fiscal framework, ranging from materially zero to a \$1 billion tax loss.

Although we view the suspension of the limits as a positive development, we believe that some uncertainty remains as to what measures the government may eventually implement. In the 2005 federal budget, the Department of Finance indicated that it will shortly release a consultation paper on the tax issues surrounding business income trusts and other flow-through entities (e.g., limited partnerships). Future initiatives, if any, will be taken following a consultation process with due consideration to the costs and benefits related to business trusts and other flow-through entities. In our opinion, this clearly indicates continued concern about potential erosion of corporate income tax revenue arising from increased investment by tax-deferred entities (e.g., registered pension plans). The promise of an open and transparent consultative process with stakeholders on tax issues merely addresses the concerns expressed in the 2004 budget but does not imply closure has been reached.

Business Trusts

Chris Blake – (416) 863-7067

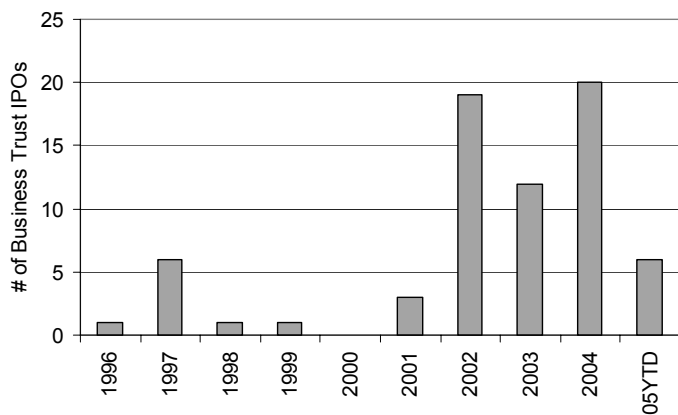
Navdeep Malik, MBA – (416) 863-7499

Maggie Fanari, CA – (416) 863-7423

Turan Quettawala, MBA, CFA – (416) 863-7065

Evolution and History

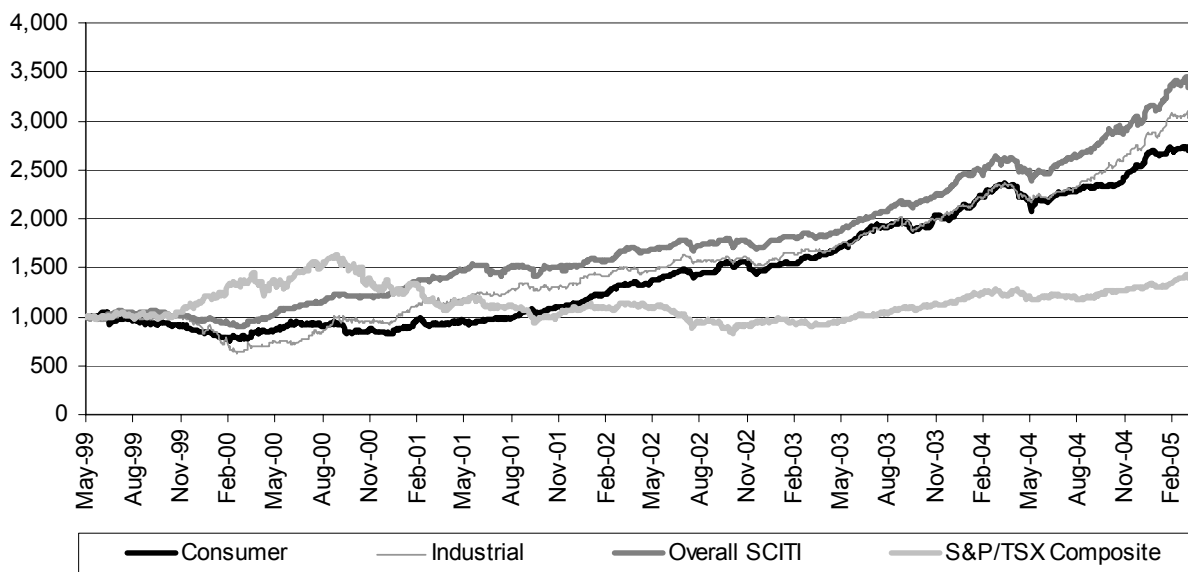
Exhibit 15 – Business Trust Issues by Year



Source: Scotia Capital.

Over the past few years, business trusts have been the fastest-growing segment of the overall income trust market. The market has grown to include businesses in industries such as telecommunications, food services, casinos, waste management, cheque printing, retailing, transportation, and logistics. Of the 179 trusts that make up the Scotia Capital Income Trust Index, 88 are business trusts, or 49% of the total number of issues. Over the past three years, 55 business trusts have been created, compared to just 12 created from 1996 to 2001 (Exhibit 15). On a float capitalization basis, business trusts account for just under \$32 billion, or 27% of the overall index. In terms of overall price performance over the past six years, business trusts have clearly outperformed the broader S&P/TSX index and slightly underperformed the SCITI as a result of the strength in the SCITI resource sub-index (see Exhibit 16).

Exhibit 16 – Price Performance of Consumer and Industrial Groups



Source: Scotia Capital; Bloomberg.

Key Drivers of Performance

Broadly speaking, the health of the overall economy is an important consideration that may impact a number of both consumer- and industrial-oriented trusts. Unlike other income trust sub-sectors (such as power, real estate, and oil and gas), business trusts as a group have very few operating similarities. The variety of underlying businesses means that it is difficult to point to specific growth or performance drivers that apply to the entire sector. Therefore, we look at various broad Canadian and U.S. economic indicators including GDP, industrial production, housing activity, consumer prices, employment data, manufacturing activity, and import/export trade statistics, to name a few. An assessment of each trust dictates the degree to which its specific underlying business is affected by these economic factors.

The ideal business for an income trust is generally one that has a dominant market position in its industry, the ability to generate stable cash flow with moderate growth potential, and low leverage and payout ratios. Relative maturity is also desirable, so as not to require significant capital expenditure and reinvestment. Many early adopters of the business trust structure had most if not all of these characteristics. With strong investor interest persisting over the past few years, however, the market has evolved to include trusts that are more growth oriented and cyclical than had historically been the case. This does not necessarily mean that these trusts are poor investments; some have been very successful to date in allowing unitholders to participate in cash flows arising from strong business cycles.

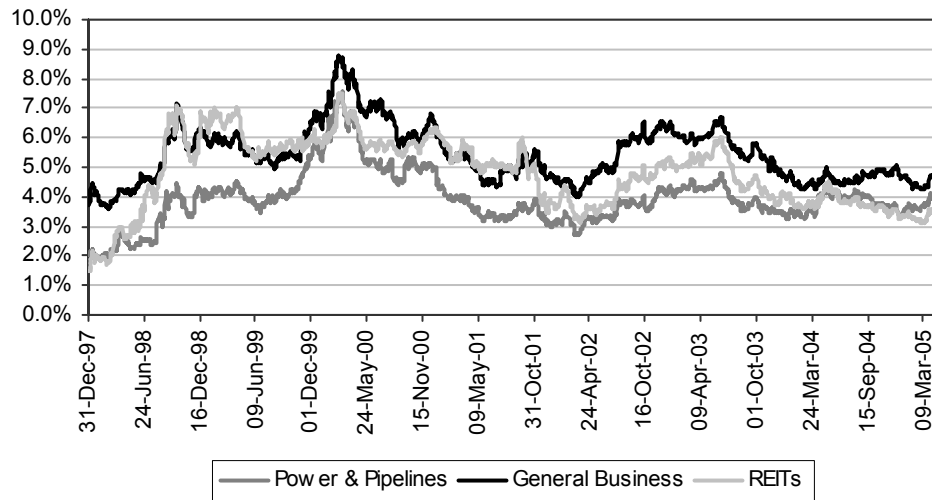
Investors should be aware of the risks associated with each particular underlying business when assessing the stability and ongoing sustainability of a trust's distributions. Some specific factors we use when assessing the investment merits of a business trust include, but are not limited to, its financial position, competitive position, asset quality, industry trends, management expertise, operational risks, growth potential, and capital expenditure requirements. We believe trusts that have a higher degree of stability, and therefore less risk to their distributions, should generally trade at higher valuations than those with more risk.

Valuation

Methodology

Business trusts operate in various industries of the broader equity market, so our approach to valuing the sector is not unlike that used for common equity investments. We focus on traditional equity valuation measures when evaluating and comparing business trusts, such as EV/EBITDA, price/cash flow, and to a lesser extent cash yield. We caution investors not to use yield as the sole valuation tool because, in our opinion, yield does not factor in the future growth opportunities of the underlying business or key operational risks. In addition, yield takes into account only the distribution that is actually being paid by the fund, which is at the discretion of management and the board, and does not consider the sustainable level of distributions, which could be much higher or lower than the actual level of distributions. Instead we prefer to use yield as a relative measure to risk-free bonds.

Given that business trusts are an emerging asset class competing with other income-oriented securities, we also look at the yield spread over the Government of Canada 10-year bond. Business trusts have historically traded at a wider yield spread than utility-oriented trusts and REITs (Exhibit 17). We believe this is due to the greater growth opportunities and operating risks associated with business trusts, and their higher economic sensitivities.

Exhibit 17 – Comparative Yield Spreads


Source: Scotia Capital; Bloomberg.

Since most business trusts are in very different industries, from a valuation standpoint it is difficult to compare one trust directly with another. We attempt, however, to classify these businesses into broader groups with similar operational characteristics, such as industrials, consumer products, and infrastructure. In addition, indirect comparisons of different trusts may be possible, on the basis of cash flow stability and overall risk levels. We caution that such comparisons should be made only after a thorough analysis of each specific business, the industries that those businesses operate in, the relative market position of each business in its industry, and the macroeconomic and business-specific factors that could impact each trust.

Current Valuation Levels

Valuation levels have benefited in recent years from strong cash inflows into the income trust market and a declining interest rate environment. The consumer and industrial trusts in the SCITI Index have increased at an average annual rate of approximately 15% over the past three years. In addition, although most business trusts have a relatively short trading history, investors have been willing to apply higher valuation multiples to those trusts that have developed track records of stable and moderately growing distributions.

To provide an indication of changes in valuation levels, on an EV/EBITDA, price/cash flow, and cash yield basis, the business trusts in our coverage universe currently trade at 10.7x, 10.0x, and 8.6% yields, respectively. This compares with 7.5x–8.0x, 9.0x, and 10.0%–11.0% ranges at the start of 2003, corresponding to a 20%–30% increase in the value of the sector. Over the same two-year period, the S&P/TSX price/earnings multiple has contracted by some 15%.

Recent concerns over inflation pressures and rising interest rates have resulted in unit price weakness for most trusts. However, Scotia Economics is forecasting bond yields to remain relatively low in Canada. Our one-year forward Government of Canada 10-year bond yield forecast is 4.35%, which is largely in line with current yields. As business trusts are somewhat interest-rate sensitive (although, we would argue, to a lesser degree than certain other types of income trusts), the low interest rate environment should provide continued support for income trust valuations. In addition, we expect demand for income-oriented products will remain healthy going forward due to the resolution of the limited liability issue and the pending inclusion of trusts into the benchmark S&P/TSX Composite Index.

Interest Rate Sensitivity

The fundamentals of many business trusts are typically linked to the economic cycle, and during periods of economic expansion and rising interest rates, an improvement in underlying cash flow can partially offset the detrimental impact of higher interest rates on valuation. While any yield-oriented investment exhibits a certain amount of sensitivity to interest rates, the degree to which interest rates impact unit prices depends on the variability of the underlying cash flow of each trust. Some businesses exhibit more elasticity than others. Trusts with low variability of cash flow tend to be more sensitive to interest rate fluctuations, while trusts whose underlying cash flow varies significantly with broad economic activity tend to be less sensitive to interest rates. For example, trusts selling consumer staples may be less economically sensitive than consumer discretionary trusts.

Benefits to Investing

Beyond the general benefits of investing in income trusts, business trusts specifically provide portfolio diversification, and allow investors to invest in companies that generally have a higher degree of economic sensitivity. The growth of the sector allows investors to be selective and to invest in industries that may not be represented by common stock counterparts. This provides investors with the opportunity to gain exposure to sectors or industries that previously may not have existed in the public markets.

Although the trust structure has historically been used for mature, low-growth businesses, many income trust managers are increasingly expanding through acquisition. Some companies in the business trust universe operate in “old economy” industries that are highly fragmented. Attractively valued units have been used as acquisition currency, allowing many business trusts to expand their operations, improve their competitive position, and increase distributions to unitholders. Examples of successful trusts in this regard include Superior Plus Income Fund, BFI Canada Income Fund, and Chemtrade Logistics Income Fund. This strategy of actively acquiring other companies is not without risk; however, trusts with a successful record of making accretive acquisitions generally attract premium valuations.

Compared to common equity corporations, trusts offer investors additional choice as to how they receive their equity returns. Trust unitholders receive regular distribution payments (which may be considered income, dividends, or a return of capital) based on the cash flow generated by the underlying business. Stocks, however, typically retain their earnings for future growth (in addition to paying dividends, where applicable) and, as such, investors’ returns come primarily in the form of capital gains and to a lesser extent, dividends. Because income, dividends, and capital gains are taxed at different rates, the additional choice could benefit investors, depending on whether the money being invested is in a taxable or a tax-sheltered account. Further, we would argue that many investors would prefer to receive the cash flow and make decisions about what to do with the money rather than leaving it in the hands of management.

Risks

While many business trusts have delivered stable and growing distributions, a few have inevitably stumbled along the way. The trusts that have cut or suspended distributions have received much attention, likely because the distribution reduction not only impacts unitholders' income streams, but also typically decreases the trading price of the units. In most cases the unit price reduction has been substantial. For example, Advanced Fiber Technologies (AFT) Income Fund cited competitive pricing pressure, rising steel costs, and foreign currency exposure as reasons behind its 50% distribution reduction in September 2004. The units plummeted 41% the next trading day. Similarly, Hot House Growers Income Fund suspended its distributions in August 2004 because of historically weak tomato prices and, as a result, its unit price dropped by 43%.

We believe these examples illustrate an important point: income trusts are equity investments and, as such, distributions are dependent on the health of the underlying business. In addition, the number and diversity of companies that have adopted an income trust structure means that the risks associated with each specific underlying business should be considered when making an investment decision.

While our research approach considers a number of factors when assessing the stability and long-term sustainability of distributions, we feel that one of the key financial metrics is the payout ratio. The payout ratio is typically defined as the percentage of distributable cash (i.e., cash flow from operations less maintenance capital expenditures) that is paid to unitholders. Lower payout ratios imply that the distributions are likely to be sustained or even increased. A payout ratio in excess of 100%, however, signifies that a trust is paying out more cash to unitholders than the underlying business is generating. In the short term, this may be possible, as the shortfall could be made up with debt or by dipping into a previously established cash reserve. But a payout ratio over 100% is likely not sustainable in the longer term. It is also important to take into consideration the seasonality of the underlying operating business. Certain trusts may have one or two quarters per year when the payout ratio exceeds 100% but, on an annual basis, still generate sufficient distributable cash to meet distribution requirements.

We emphasize that no one metric is sufficient to base an investment decision upon. Given the diverse nature of businesses in the trust sector, the operating risks specific to each individual trust must be considered when assessing distribution sustainability.

Top Picks

Hardwoods Distribution Income Fund (HWD.UN) remains our top pick despite the 9% price return since we initiated coverage on January 27, 2005. We expect the fund's financial performance to be solid in 2005 as it continues to benefit from a buoyant North American residential housing market, increased home renovations, and non-residential construction spending, which all point to good demand for Hardwoods' products. Currently, the units trade at 8.5x EV/2006E EBITDA, corresponding to a 20% discount relative to the Scotia Capital Business Trust Universe, and providing investors with an attractive expected cash yield of 9.5%. Expected payout ratios for 2004 and 2005 also compare favourably with the group at 85% and 83%, respectively. Other attractive features include the hedging of 85% of expected U.S. dollar cash flow at a rate of C\$1.30 through April 2008 and a subordination feature in place until March of next year.

Home Equity Income Trust (HEQ.UN). We believe the income generated by Home Equity's reverse mortgage portfolio represents a stable source of distributions to unitholders, with minimal risk. The company is the only national provider of reverse mortgages in Canada and has grown its mortgage portfolio at an average annual rate of approximately 17% over the past five years, while maintaining stable net interest spreads. We expect favourable demographic trends, in addition to Home Equity's marketing campaigns and referral relationships with financial institutions, to continue to result in consistent growth of the mortgage portfolio.

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REITs

Himalaya Jain, MBA, CFA – (416) 863-7218

Mario Saric, CA, CFA – (416) 863-7824

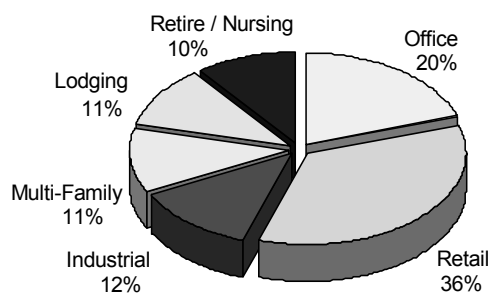
The Dominant Publicly Traded Vehicle for Real Estate

The publicly traded real estate sector in Canada has undergone a fundamental transformation over the past decade. Almost a decade ago, the real estate component of the TSE 300 included 15 real estate stocks, including such large companies as Cambridge Shopping Centres, Oxford Properties, and TrizecHahn. Through merger and acquisition activity (instigated by Canadian pension funds), reclassification, bankruptcy, and conversion to the REIT structure, the real estate representation in the current S&P/TSX Composite Index has been reduced to one company: Brookfield Properties Corp. (primarily a holder of U.S. office properties). (MI Developments was recently removed from the S&P/TSX Composite due to low liquidity in its trading volume.) With the exception of large pension funds, we assert that most Canadian institutional investors have steadily become underweight in the real estate sector.

There are currently 25 publicly traded REITs in Canada, representing a market capitalization of over \$18.1 billion. In the United States, where REITs have been in existence since 1960, there are currently over 180 REITs with a combined market capitalization over US\$200 billion, and total assets of over US\$375 billion. While the Canadian REIT sector has room to mature further relative to the U.S. sector, Canadian REITs offer investors access to each real estate sub-sector, including office, retail, industrial, multi-family, and lodging (see Exhibit 18). REITs are now the only practical method for most investors to efficiently gain access to this asset class.

Despite the rapid increase in the size of the Canadian REIT sector, the privately owned market for income-producing real estate remains significant. Private investors (individual and institutional), owner/occupiers, and government are the primary holders of real estate in Canada. As presented in Exhibit 19, REITs and other Canadian public real estate companies presently own a small fraction of the total inventory of income-producing real estate in Canada. With an established business model and access to capital markets, we believe REITs have tremendous growth opportunities. Over time, we expect REIT ownership of income-producing real estate to increase. The government of Canada's intention to sell up to \$3 billion of office space (and then lease it back) should forward this trend.

Exhibit 18 – Composition of Canadian REIT Sector (by Market Capitalization)



Source: Scotia Capital.

Exhibit 19 – Percentage of Income-Producing Real Estate Owned by REITs and Public Real Estate Companies

Retail *	19%
Office *	12%
Lodging **	10%
Multi-family **	6%
Industrial *	6%

* By square footage

** By rooms/units

Source: Company reports.

Occupancy and Rental Rates Drive Performance

As a component of the broad economy, the demand side of real estate fundamentals is tied to the health of the economy. Real estate fundamentals, however, lag the general economy because of the contractual lease nature of cash flow. The length of the lag is a function of the lease term, with short-lease assets (e.g., hotels) being highly sensitive to economic activity, and long-lease assets (e.g., office buildings) being the least sensitive. The supply side of the equation (i.e., new development) attempts to track demand, but often over- or underdelivers. In the past, real estate cycles have been driven primarily by the supply side.

Key operational variables that we track are same-property income growth, occupancy, scheduled lease expiries, market and in-place rental rates, leasing costs, and capital expenditures. Portfolio quality, management track record, structure, and governance are qualitative factors that we consider important. With essentially all free cash flow distributed to unitholders, growth in REIT AFFO (adjusted funds from operations) comes either from internal sources (increases in occupancy and rent) or through accretive acquisition activity. The long-term nature of leases, combined with competitive acquisition markets, suggests that growth in AFFO is relatively modest for REITs when compared with business income trusts. The reciprocal of this characteristic is that REIT cash flows have above-average stability and predictability, resulting in a lower risk profile.

Valuation Sophistication Has Improved over Time

In the beginning, there was yield, and issuers thought it was good. Despite having the benefit of lessons learned by the U.S. REIT sector, REIT valuation in Canada was initially limited to yield. Convenience and widespread understanding of yield-based valuation were the likely factors supporting this low level of sophistication. The fundamental problem with this approach was that the distribution rate was entirely in the hands of each REIT. The primary focus on yield tempted REITs to raise distributions and thus increase their unit price. A brief virtuous circle of increased distribution, higher unit price, new equity issuance, and further distribution increases resulted in a sharp increase in payout ratios to unsustainable levels. Although the ride was initially profitable for REIT investors, the sharp correction in 1998–99 weaned many analysts and investors away from yield toward metrics that were based on REIT cash flow, and ultimately free cash flow.

Then the emphasis shifted to distributable income, but it too was flawed. As instructed by their respective declarations of trust, Canadian REITs are obliged to report distributable income (DI), a cash flow metric, and are required to distribute a minimum fixed percentage (usually 85%–90%) of the achieved DI. DI per unit has been used occasionally by some analysts as a performance metric or basis for valuation. As with yield, DI's fundamental flaw is that every REIT is entitled to define its calculation as it sees fit. Varying definitions of DI make it less comparable across the REIT sector. For example, Legacy Hotels REIT subtracts a capex reserve in its definition of DI, while Canadian Hotel Income Properties REIT (CHIP) does not deduct a reserve. The difference in definition renders the reported DI for these two lodging REITs unusable.

Enter FFO: more consistent, but some costs were still left out. Following the lead of the National Association of Real Estate Investment Trusts (NAREIT) in the United States, the Real Property Association of Canada (RealPac) compiled a handbook of accounting conventions tailored to the real estate industry. The handbook includes a definition of operating performance named funds from operations (FFO), a term coined in the United States. FFO is similar in many regards to the conventional method of calculating cash flow. The attraction of FFO lies in its consistent application, rather than its ability to measure true cash flow. Recent changes in accounting rules, such as the requirement to report rental revenue on a straight-line basis and include certain gains, have distorted FFO and increased volatility in reported results. Nevertheless, we use FFO as a starting point to arrive at an estimate of free cash flow.

Exhibit 20 – Annual Capex and Leasing Reserve Rates

Property Type	Maintenance Capex Reserve Rate	Leasing Reserve*
Office	\$0.25 / sq.ft.	New = \$15 / sq.ft. Renew = \$5 / sq.ft.
Industrial	\$0.12 / sq.ft.	New = \$3.50 / sq.ft. Renew = \$1.25 / sq.ft.
Retail	\$0.20 / sq.ft.	New = \$15 / sq.ft. Renew = \$3 / sq.ft.
Lodging	5% of Revenue**	-
Apartments	\$400 per Suite	-
Retirement	1.5% of Revenue	-

*It is assumed that 75% of commercial leases are renewed at expiry.

**Includes furniture, fixture, and equipment reserve.

Source: Scotia Capital.

Now there is AFFO, a good estimate of free cash flow, but complex and open to judgment. Borrowing liberally from U.S. practice, most Canadian real estate analysts have adopted adjusted funds from operations (AFFO) as their primary valuation metric. Because of the long-lived nature of real estate, AFFO estimates are calculated by deducting reserves for capex and leasing costs from FFO to arrive at a sustainable cash flow that is available to be distributed to unitholders. We determine these reserves through analysis of each REIT's portfolio, namely, assessing its quality and lease term structure (see Exhibit 20). In measuring sustainability of distributions, we compare actual distributions to AFFO, and prefer REITs with payout ratios below 100%. Over the course of their maturation, most Canadian REITs have gradually lowered their payout ratios to sustainable levels (by growing AFFO faster than distributions).

GAAP EPS would bring REITs into the mainstream; but it is not likely to be applied in the near term. Although we consider AFFO a good proxy for "true EPS" in the real estate industry, AFFO remains a foreign

concept to many investors, both retail and institutional. While EPS is widely understood, we believe the arbitrary application of conventional depreciation and amortization of assets (based on historical cost) results in a less meaningful metric for the real estate industry.

We also use net asset value as a secondary means of valuation. Past experience, both here and in the United States, suggests that REITs have generally traded within a band 20%–25% above and below their respective NAVs. We apply "normalized" cap rates in determining NAV rather than "spot" cap rates. This normalized approach in the application of cap rates allows investors to assess REIT prices in relation to a "smoothed" valuation based on historical experience. Over the course of a real estate cycle, we expect REITs to trade in a discount/premium to NAV range of -15% to +25%. The presently low interest rate environment is responsible for most REITs trading at a premium to their normalized NAVs.

Recent Valuation Driven by Low Interest Rates, Not Underlying Fundamentals

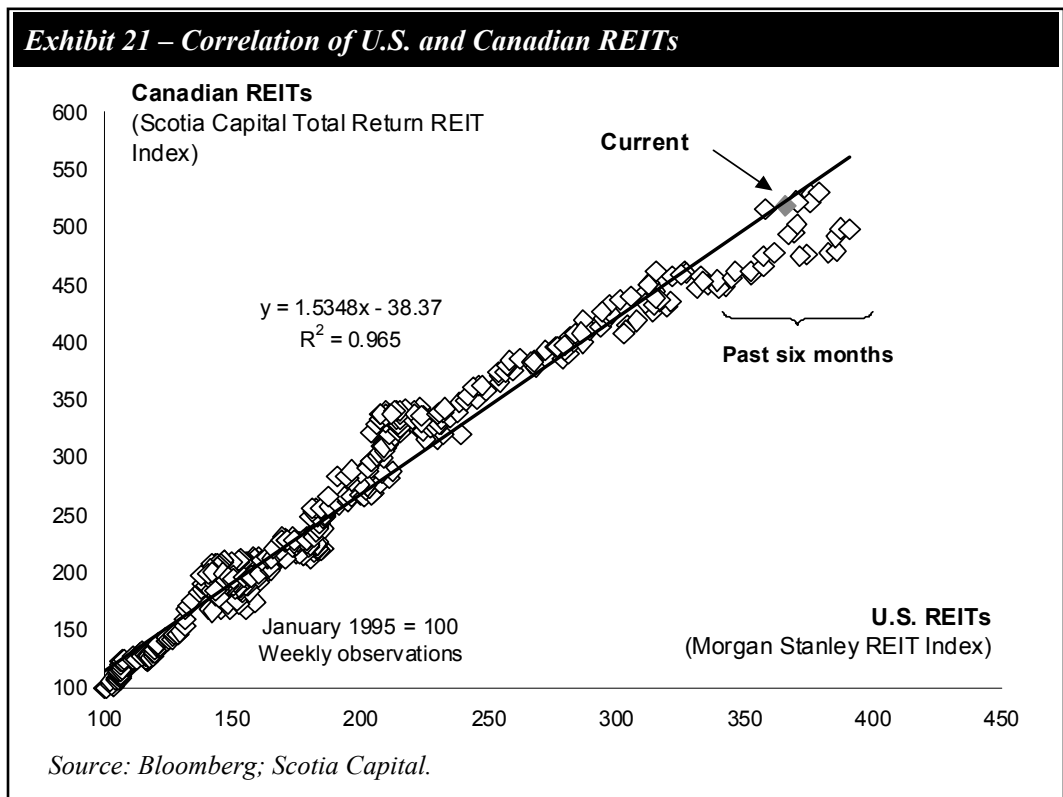
On a price-only basis, the Canadian REIT sector has appreciated 1.8% in the past 12 months, and 27.3% over the past 24 months (to March 31, 2005). However, underlying fundamentals for income-producing real estate in Canada were relatively flat over these periods. Although leasing activity appears to be heating up, we expect only nominal growth in 2005 and 2006. Outside the retail segment, landlords of office, industrial, and multi-family real estate continue to lack pricing power in most geographic markets. Therefore, in our view the improvement in the sector's valuation has largely been due to flow of funds, momentum, and spread compression. We believe pricing power should return if the pace of economic activity improves.

The REIT sector is trading at a 12x weighted average multiple of estimated 2006 AFFO. We recently raised our AFFO valuation multiples by 0.6 multiple points, on average. While our increased valuation multiples are based primarily on expectations of a benign interest rate environment, potential index inclusion could support valuations in the short term. We expect larger REITs with good track records to attract a disproportionate amount of interest from institutional investors. With a target valuation range of 10x–14x AFFO, we assign multiples based on portfolio quality, management track record, stability of underlying cash flow, prospects for growth, and structure.

Based on our net asset value estimates, REITs are trading at an average premium to NAV of 11%. Our normalized NAVs are based on cap rates that we believe are representative of cyclical averages. Rather than use “spot” cap rates, we acknowledge that REITs will trade within a discount/premium band of -15% to +25% over a normal real estate cycle.

Canadian REIT Sector Closely Tracks the Well-Developed U.S. REIT Sector

In the United States, where REITs have existed for decades, there are presently over 180 REITs, with an aggregate market capitalization over US\$200 billion. As of December 31, 2004, the 20-year compound annual total return for U.S. REITs was 12.7%, versus a 13.2% compound annual total return for the S&P 500 and a 11.5% compound annual total return for the Russell 2000 Index over the same period. Over the same period, U.S. REIT volatility has been 12.5%, compared with 15.4% for the S&P 500 and 19.3% for the Russell 2000. The Canadian REIT sector is highly correlated to the U.S. REIT sector (see Exhibit 21).



Major Differences Include Structure, Payout Ratios, and Yield

- **Structure.** Whereas Canadian REITs are trusts, U.S. REITs are corporations. The U.S. structure also allows owners of real estate to roll property into a REIT in exchange for REIT shares without triggering capital gains tax. In Canada, the sale of property into a REIT typically triggers capital gains for the vendor. U.S. REITs are also permitted to “recycle” their property portfolios by deferring capital gains tax on dispositions, so long as they replace dispositions with new acquisitions. The Canadian REIT model, in which dispositions typically attract capital gains tax, tends to be a buy-and-hold model.
- **Payout Ratios and Yield.** AFFO payout ratios for U.S. REITs generally range from 75% to 85%, compared to the Canadian REIT average of 97%. While U.S. REIT legislation requires REITs to distribute at least 90% of their taxable income, Canadian trusts are required to distribute at least 100% of taxable income.

Because of the well-developed U.S. REIT sector, U.S. ownership of Canadian REITs remains relatively low. With the exception of RioCan, which has approximately 15% non-Canadian ownership interest, we believe most REITs have nominal non-Canadian ownership.

Sensitivity to Various Economic Drivers

Interest Rate Sensitivity Depends on Nature and Length of Leases

It is appropriate to classify real estate as interest rate sensitive. However, we believe such broad generalization can be dangerous. We think a greater understanding of the source of interest rate sensitivity should help investors make more informed investment decisions. In our view, the degree of sensitivity to interest rates rests mainly on the average lease term of income-producing real estate. A fully leased property with a long lease term may generate a stable stream of cash flow, but lease rates are typically fixed and cannot be repriced as market conditions fluctuate. This type of property would be analogous to a long-duration bond, whose price is more sensitive to interest rate changes than a short-duration bond. Office and retail properties typically fall into this category. Conversely, asset classes such as lodging and multi-family have shorter lease terms and are able to reprice their space more regularly as demand permits. We suggest that these asset classes are less interest rate sensitive (see Exhibit 22).

REITs appear to be sensitive to interest rates over the short term, but are more correlated with equity markets over longer periods. While a rising interest rate environment would erode the value of fixed lease revenue, the degree of vacancy is also an important determinant of sensitivity. A property with a sufficient vacancy should experience cash flow growth as interest rates rise, assuming the rise in rates is due to improving economic conditions. Notwithstanding the discussion above, REITs appear to be highly correlated to interest rates over the short term. Over a longer period, however, we believe they are more closely correlated to equity markets. U.S. REIT statistics support this contention (see Exhibit 23).

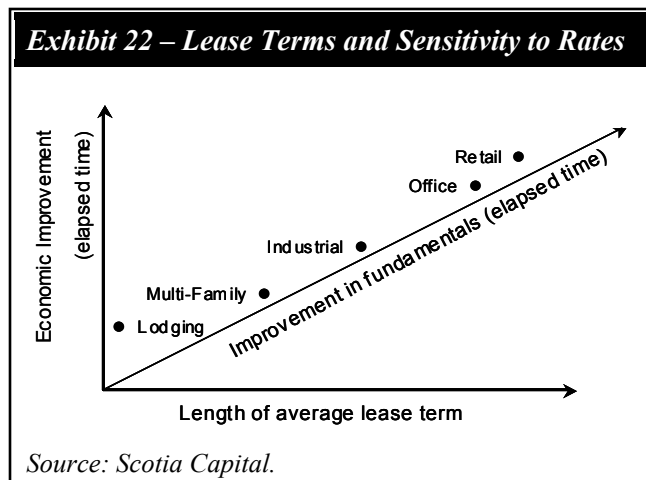


Exhibit 23 – Correlation of Total Returns (U.S. REITs)

		10-year data period (Jan 1995 - Jan 2005)					
		NAREIT Equity	S&P500	Dow Jones Ind Avg	Russell 2000	Nasdaq Composite	ML Govt/Corp Bond
30-year data period (Jan 1976 - Jan 2005)	NAREIT Equity	1.00	0.28	0.31	0.45	0.17	0.07
	S&P500	0.51	1.00	0.92	0.71	0.80	-0.05
	Dow Jones Ind Avg	0.50	0.95	1.00	0.62	0.64	-0.11
	Russell 2000	0.61	0.80	0.75	1.00	0.84	-0.14
	Nasdaq Composite	0.46	0.80	0.74	0.89	1.00	-0.12
	ML Govt/Corp Bond	0.20	0.23	0.19	0.12	0.12	1.00

Source: NAREIT.

Low Sensitivity to Exchange Rates

Since Canadian REITs predominantly own Canadian real estate, fluctuations in the Canadian/U.S. dollar exchange rate do not have a meaningful impact on REIT cash flow. Two exceptions to this generalization are IPC US REIT (IUR.UN) and TGS North American REIT (NAR.UN). Through highly elaborate trust structures, these two REITs own U.S. property and are able to repatriate cash flow to Canadian unitholders without any negative tax consequences. One hundred percent of IPC’s cash flow and a majority of TGS’s cash flow is U.S. dollar denominated, leaving both of these REITs highly susceptible to fluctuations in the exchange rate.

To a much lesser degree, the four lodging REITs are indirectly affected by changes in the exchange rate, in that travel and tourism statistics suggest that exchange rates play a role in cross-border travel patterns. A higher Canadian dollar discourages U.S. travel to Canada, while encouraging Canadians to travel abroad. We estimate that U.S. customers represent 15%–30% of the total guest base for the four Canadian lodging REITs.

Benefits to Investing

Real estate can be a good long-term hedge against inflation. As suggested earlier, the REIT sector is the only practical way to invest in real estate for most investors. Income-producing real estate offers investors relatively stable and predictable cash flow and a relatively high level of capital protection. Since REITs generally trade in line with their net asset values, we consider the protection of capital aspect of REITs as highly unique among trusts. The stability of REIT cash flows is a result of contractual recurring lease income. Although growth is not a marquee feature for REITs, real estate does tend to provide a good hedge against inflation, as rental rates generally rise over time. So long as buildings are maintained, rising rental rates generally translate into increased property values over the long term (i.e., property values do not deplete). Since REITs are operated as actively managed businesses, investors also benefit from professional management.

Because real estate fundamentals lag the broad economy, REITs offer diversification benefits to investment portfolios. Statistical analysis of U.S. REIT data suggests REIT returns have relatively low correlation to equity markets and bond markets.

Real Estate–Specific Risks: Fundamentals, Leverage, Sustainability of Distribution, and Related-Party Transactions

Speculative building, combined with softening fundamentals, can lead to deterioration in cash flow. As stated earlier, new supply growth has tended to be the primary source of volatility in the real estate sector. Due to the lag between initiation of construction and completion, speculative development has often resulted in overbuilding in previous cycles. Although the speculative component of real estate may always exist, lenders have generally become more disciplined in their underwriting by demanding specific pre-leasing levels before development can start.

Interest rates present a dual risk to REIT investors, by impacting both valuation and cash flow. Since REITs are large users of debt (54% average debt-to-assets ratio), rising interest rates can result in higher interest expense, as well as lower public market valuation. REITs attempt to mitigate the former by locking into fixed rate long-term debt and by staggering debt maturities. REITs generally carry low levels of floating rate debt, if any. Each REIT subjects itself (through its declaration of trust) to a maximum debt ratio, amount of floating rate debt, and level of development activity.

Although REITs are in compliance with all regulatory requirements, related-party agreements are potential sources of conflict of interest for a handful of REITs. Eleven of the 25 REITs have external property management agreements with related parties. In some situations, members of the REIT management team also have an interest in the external property management company. In other cases, the REIT's largest shareholder has an interest in the property management company. Although these contracts are transparent and generally at market rates, we typically prefer all activities of the REIT to be internal. A reasonably high level of insider ownership (as a percentage of personal wealth) partially mitigates these risks.

While it may appear that the market does not presently differentiate between fully internalized and externalized REITs, we prefer internalized structures. In addition to removing conflicts, we think internalized structures ultimately lead to higher unitholder returns. RioCan's incremental fee income supports our assertion. RioCan's dominance in the retail real estate sector has attracted institutional investors that are willing to pay for RioCan's expertise. With an internalized structure, the benefits of this expertise accrue directly to unitholders, rather than to a privately held property management company. With greater institutional investor scrutiny, we expect renewed pressure to internalize.

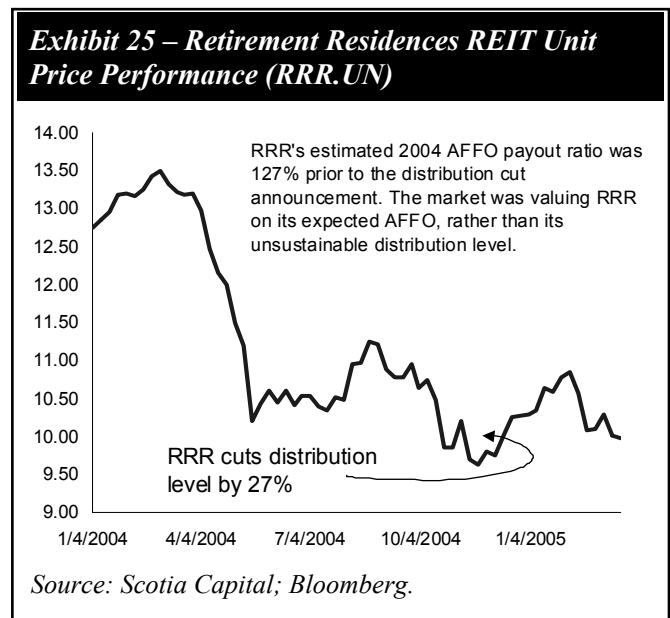
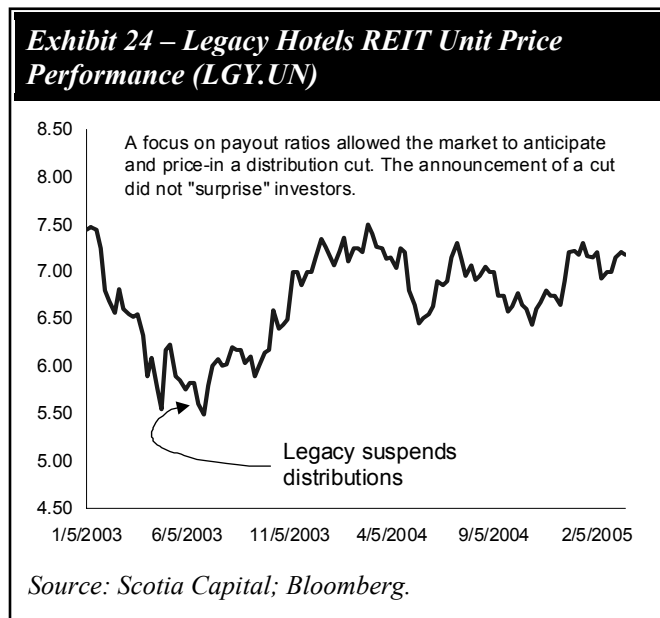
Suitability of Operations and Payout Ratios

Real estate is ideally suited for the trust structure because cash flows are generally stable, predictable, and recurring in nature. Although real estate does not "deplete," we assert that landlords must physically maintain their buildings in order for them to remain competitive. REITs must also incur the ongoing cost of tenant inducements and leasing commissions. Our focus on AFFO accounts for leasing costs and capex, the two major recurring costs that are not properly accounted for on the income statement. Under GAAP accounting, these costs are capitalized and amortized over time, and therefore are not reflected in conventional cash flow calculations. Furthermore, amortization of these amounts is based on historical spending and arbitrary amortization periods. Our reserve-based method for calculating AFFO attempts to correct for these flaws.

Payout ratios differ by asset class. Although we prefer all REITs to distribute less than 100% of AFFO, we think REITs with long-term leases could theoretically operate closer to the 100% level, while REITs with less stable cash flow (i.e., hotels, retirement homes) should have lower payout ratios. We believe lower payout ratios reduce the risk of distribution cuts, and thus should ultimately attract premium valuations.

Payout ratios have been gradually declining. With distributable income (DI) being the primary measurement tool during the mid-to-late 1990s, payout ratios were typically calculated as a function of DI. Although REITs were required to distribute at least 85%–90% of DI, many were distributing close to 100%, because a higher distribution generally resulted in a higher valuation in a yield-oriented marketplace. The bear market of 1998–2000 led to many favourable trends, including AFFO-based valuation and internalization of management. Since most REIT payout ratios were too high on an AFFO basis, the REIT sector embarked on a multi-year process of lowering AFFO payout ratios by increasing distributions at a slower rate than AFFO growth. The REITs that have successfully accomplished this goal are now able to raise distributions at a rate similar to AFFO growth.

We believe the focus on AFFO payout ratios has provided REIT investors with ample warning in past instances of distribution cuts. In each of the two recent high-profile REIT distribution cuts (Legacy Hotels REIT in June 2003 and Retirement Residences REIT in November 2004), we assert that unit prices adequately reflected the risk of a distribution cut, suggesting that investors were not “surprised” (see Exhibits 24 and 25). We consider the forward-looking nature of AFFO payout ratios to be further evidence of the maturity level of the REIT sector.



Outlook and Top Picks: We Favour a Flight to Quality

Qualitative factors are just as important as quantitative ones. With few exceptions, the dispersion of total expected returns in our coverage universe is relatively narrow. Assigning ratings in this situation is relatively difficult and sometimes akin to splitting hairs. Therefore, in addition to our return expectations, we rely heavily on qualitative factors such as portfolio quality, management track record, trust structure and governance, prospects for distribution growth, and payout ratio.

Risk premiums have contracted and are now likely to widen. In recent years, income-oriented securities have benefited from both declining interest rates and a compression in risk premiums. Under these circumstances, a “flight to risk” investment strategy resulted in above-average returns. However, with this trend having run its course, we think income-oriented securities face the dual risk of potentially higher interest rates and a widening of risk premiums. While all REITs may be vulnerable in an absolute sense under this scenario, we believe higher-quality REITs should outperform on a relative basis.

Three Themes: Quality, Growth, and Value

Quality. Although we consider CREIT, CAP REIT, Cominar, H&R, and Summit to be high-quality REITs, we currently rate only RioCan and Boardwalk as 1-Sector Outperform.

- **RioCan REIT (REI.UN)** – In addition to being the largest REIT, RioCan is the largest landlord of retail real estate in Canada. RioCan has started to leverage its expertise and dominance by creating recurring fee income streams. Although RioCan’s size makes growth more difficult to achieve, we expect modest internal growth going forward.
- **Boardwalk REIT (BEI.UN)** – Boardwalk is Canada’s largest owner of multi-family real estate. The Canadian multi-family real estate sector remains highly fragmented, giving Boardwalk ample growth opportunity. Boardwalk has an excellent track record of discipline and governance.

Growth. With a general reduction in the pace of acquisition (in percentage growth terms), we believe smaller REITs with highly focused strategies will experience above-average growth. While Northern Property REIT also fits this profile, we rate Allied Properties a 1-Sector Outperform.

- **Allied Properties REIT (AP.UN)** – Allied owns a portfolio of “brick and beam” office and retail real estate, primarily in Toronto. Despite its relatively small size (compared with other REITs), Allied is the dominant player in its field. We expect Allied’s relatively low cost of capital should allow it to accretively consolidate its niche sector and expand into other Canadian markets.

Value. REITs that cut distributions generally fall out of favour with investors. We rate Legacy Hotels REIT highly not on its track record but because the market, in our opinion, has overreacted to the cut and is not yet valuing Legacy on its full potential.

- **Legacy Hotels REIT (LGY.UN)** – Legacy is the most compelling value story in our coverage universe. We raised our rating to a 1-Sector Outperform in June 2003 when Legacy suspended distributions. Our contention then, and now, was that a short-term recession in cash flow would not permanently impair the value of the REIT’s hotel portfolio. Despite appreciating nearly 40% since our upgrade, Legacy continues to trade below its NAV.

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Oil and Gas Royalty Trusts

Brian Ector, CFA – (403) 213-7332
Kristian Schneck, MBA – (403) 213-7759

Grant Hofer, CFA – (403) 213-7345
Karma Roste-Hagen, CA – (403) 213-7750

Market Evolution and Growth of Sector

The Scotia Capital Energy Trust Index today comprises 32 oil and gas royalty trusts that are publicly traded in Canada, with a combined market float capitalization of \$39.6 billion. The largest oil and gas royalty trusts in Canada today, by market float capitalization, are Enerplus Resources Fund (\$4.7 billion), ARC Energy Trust (\$3.4 billion), Pengrowth Energy Trust (\$2.7 billion), and Peyto Energy Trust (\$2.4 billion); there are currently 15 oil and gas royalty trusts with a market capitalization in excess of \$1.0 billion. This marks a dramatic and rapid rise for a sector that 10 years ago comprised just five oil and gas royalty trusts with a combined market capitalization of \$0.6 billion: Enerplus Resources Fund, Petrofund Energy Trust (then named NCE Petrofund), Pengrowth Energy Trust, Westrock Energy Income Fund I, and Westrock Energy Income Fund II.

The impressive growth of the oil and gas royalty trust sector has been fuelled by a strong demand for yield. Due to the continued low interest rate environment, a healthy acquisition market (both property and corporate), continued access to equity in order to finance these acquisitions, and the conversion of corporate entities to the trust structure, the Canadian oil and gas royalty trust sector has experienced dramatic growth. Contributing to this growth has been improved flow of funds toward dividend and income mutual funds, whose net sales have steadily increased since late 2000, and strong investor demand for high yielding equity investments in both Canada and the United States.

The initial growth spurt of the oil and gas royalty trust sector took place during what we call the initial public offering (IPO) boom of 1996. That year, \$1.3 billion of equity was raised through nine transactions: ARC Energy Trust, APF Energy Trust, Freehold Royalty Trust, Maximum Energy Trust (renamed Ultima Energy Trust in 2001 and subsequently acquired by Petrofund Energy Trust in 2004), NAL Oil & Gas Trust, PrimeWest Energy Trust, Shiningbank Energy Income Fund, Starcor Energy Royalty Fund (acquired by ARC Energy Trust in March 1999), and Viking Energy Royalty Trust. In addition, 1996 also saw the first exploration and production (E&P) company converted into a royalty trust when Mark Resources became EnerMark Income Fund (which merged with Enerplus Resources Fund in 2001) in a \$0.7 billion conversion. In 1997, the trust sector saw two additional IPOs, WestCastle Energy Trust (March) and Orion Energy Trust (May), representing total equity of \$344 million.

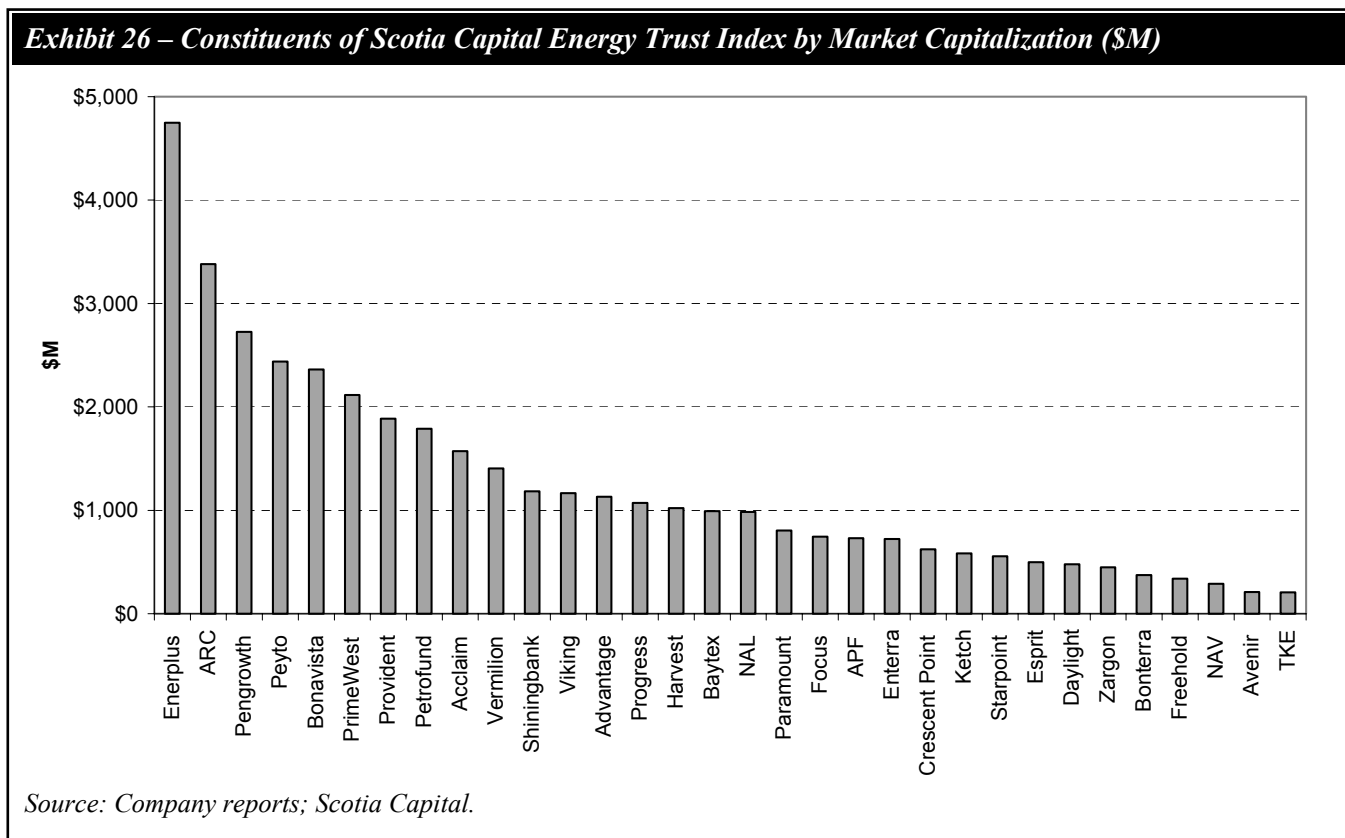
Following this growth spurt in the sector, a consolidation theme emerged. OPTUS Natural Gas Distribution Income Fund acquired WestCastle Energy Trust in November 1998, and, in March 1999, ARC Energy Trust acquired both Orion Energy Trust and Starcor Energy Royalty Fund. In June 2000, Enerplus Resources Fund merged with Westrock Energy Income Fund I and Westrock Energy Income Fund II, and one year later, Enerplus merged with EnerMark Income Fund.

In 2001, we witnessed the first material wave of industry conversions, whereby junior and intermediate exploration and production companies converted to oil and gas royalty trusts. This trend was driven by a combination of higher valuation multiples being accorded the trusts (versus that of E&P companies), a lower cost of capital (which made the newly formed entity more competitive in the acquisition market), and tax efficiencies found within the trust structure. New trusts formed in 2001 included Acclaim Energy Trust, Advantage Energy Income Fund, Bonterra Energy Trust, and Provident Energy Trust. The year 2002 saw the creation of Focus Energy Trust and the Harvest Energy Trust IPO. In 2003, the conversion boom really took hold, with the emergence of Vermilion Energy Trust

(January), Paramount Energy Trust (February), Peyto Energy Trust (July), Bonavista Energy Trust (July), Baytex Energy Trust (September), Crescent Point Energy Trust (September), Enterra Energy Trust (November), and NAV Energy Trust (December). Also in 2003, Calpine Natural Gas Trust was formed through a \$203 million IPO in October.

Conversions continued in 2004 and the early part of 2005 with new names such as Progress Energy Trust (July 2004), Zargon Energy Trust (July 2004), Esprit Energy Trust (October 2004), TKE Energy Trust (November 2004), Daylight Energy Trust (December 2004), StarPoint Energy Trust (January 2005, created through the conversion of StarPoint Energy Ltd. and E3 Energy Inc.), Ketch Resources Trust (January 2005, created through the conversion of Ketch Resources Ltd. and Bear Creek Energy Ltd.) and Trilogy Energy Trust, which commenced trading on April 6 subsequent to the spinout by Paramount Resources. As well, on February 1, 2005, we witnessed the merger of Calpine Natural Gas Trust with Viking Energy Royalty Trust. Also pending is the recently announced merger of StarPoint Energy Trust and APF Energy Trust, which is expected to close mid-year.

Pending additions to the Scotia Capital Energy Trust Index (Exhibit 26) include Fairborne Energy Trust (through the conversion of Fairborne Energy Ltd.), Sequoia Oil & Gas Trust (through the merger and conversion of Argo Energy Ltd. and Lightning Energy Ltd.) and PennWest Petroleum, which recently received a satisfactory tax ruling for its plan to convert to a trust. Another potential conversion candidate is Thunder Energy Inc., which has announced a review of strategic alternatives.



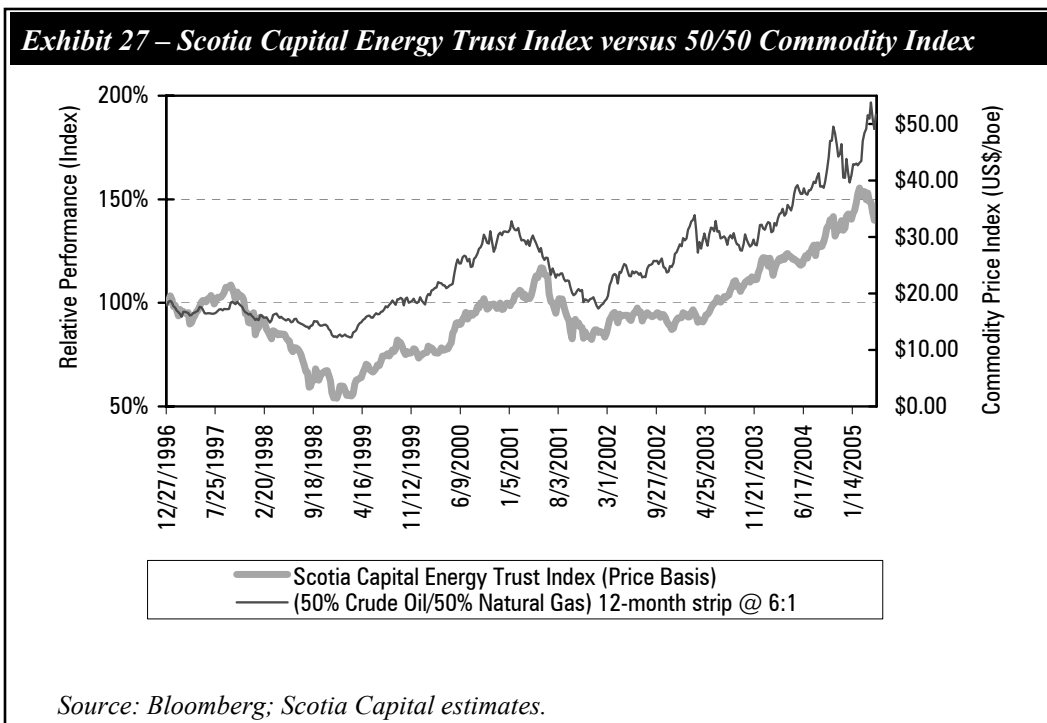
Highest Yield Among Income Trust Universe

The oil and gas royalty trust sector provides investors with the highest cash yield within the income trust universe: based on current monthly cash distribution rates, the running cash yield for the sector is 12.5%. This above-average cash yield, which is down from 13.9% in January 2004 and 16.8% in January 2003, reflects the unique investment attributes of the oil and gas royalty trust sector. These include commodity price exposure (which can be either beneficial or detrimental to market performance), the capital-intensive nature of the business (development capital expenditures represent, on average, about 42% of operating cash flow on an annual basis, with a portion of these expenditures generally being funded via additional bank borrowings, and ultimately through additional equity), and the depleting nature of each trust's asset base (average production decline rates are approximately 17%–18%).

Notwithstanding these unique characteristics of the industry, there is no denying the strong market performance of the group over the past six years. The Scotia Capital Energy Trust Index generated a total return of 29.8% in 2004, thus marking the sixth consecutive year of not only positive total returns, but also of outperforming the broader S&P/TSX Composite Index. This strong market performance was clearly driven by strong crude oil and natural gas prices, as well as continued strong flow of funds.

Commodity Prices Drive Performance

The effect of commodity prices with respect to the performance of oil and gas royalty trusts cannot be overstated. Given that cash distributions can fluctuate and be somewhat volatile, a decision to invest in the sector should be based not only on the attraction of a high cash yield, but also on an understanding of the risks associated with the sector. Based on production, the oil and gas royalty trusts in our coverage universe are weighted approximately 56% to natural gas and 44% to crude oil. Historically, we have found an approximate 87% correlation between the performance of the Scotia Capital Energy Trust Index on a price basis only (i.e., excluding cash distributions) and that of a commodity price index (50% weighted to each of WTI crude oil and Nymex natural gas; see Exhibit 27). Consequently, the future performance of the group is likely to be tied very closely to the direction in which commodity prices move. We note that a US\$1.00/bbl change in crude oil prices impacts cash flow in the sector, on average, by about 1.2%, and a C\$0.25/mcf change in natural gas prices impacts cash flow in the sector by approximately 2.4%. As such, in a period of rising commodity prices, royalty trusts perform well; conversely, in a declining commodity price environment, royalty trusts generally perform poorly. To mitigate the impact of volatile commodity prices on cash flow and cash distributions, many trusts engage in hedging activities. For 2005, on average 33% of crude oil volumes are hedged and 24% of natural gas volumes are hedged. As well, every US\$0.01 move in the Canadian dollar impacts cash flow within the trust sector by about 1.9% on average.



In addition to the overall impact of commodity prices, oil and gas royalty trusts face unique challenges including offsetting production declines, maintaining reasonable and stable cash distributions to unitholders, and managing debt leverage in the face of potentially volatile commodity prices. By nature, oil and gas is a depleting asset, and we estimate that production volumes within the trust sector will decline at a rate of about 17%–18% per year (ranging between 12% and 28%) prior to capital expenditures. For this reason, one of the largest challenges facing the sector is to offset this production decline, which generally occurs through a combination of low-risk development drilling and property/corporate acquisitions.

During 2004, oil and gas royalty trusts within our coverage universe transacted on acquisitions (both property and corporate) totalling \$6.7 billion. Identifying and acquiring high-quality oil and gas properties with reasonable decline rates and development upside continues to present a challenge for the sector. Furthermore, acquisition costs tend to rise in a competitive environment, limiting the potential accretion of a deal.

Maintaining balance sheet strength in an industry known for volatile commodity prices is essential. Development activities and acquisitions are generally financed through a combination of additional bank borrowings, new equity, and operating cash flow. The ability to access the equity markets provides increased flexibility with respect to the financing of property acquisitions and/or capital development programs. During periods when access to equity is limited or unavailable, royalty trusts must rely on additional bank borrowings and operating cash flow. This in turn can reduce cash available for distribution to unitholders and place downward pressure on trust unit prices. An overlevered trust may at some point be forced to reduce or suspend cash distributions in order to repay its outstanding bank debt, which would clearly put downward pressure on its unit price.

Valuation Methodology – More Than Just a Yield

A yield-based valuation implies a fixed income-type security, and, in our view, the distributions of oil and gas royalty trusts are anything but fixed. As the oil and gas royalty trust sector has grown, so too has the methodology by which trusts are generally valued within the marketplace. While investors continue to be attracted to high cash yields, those who look solely at yield ignore the fact that distribution levels are set at management's discretion and may not represent a sustainable distribution level. A trust's payout ratio (simply defined as cash distributions divided by operating cash flow) can assist in determining the sustainability of distribution level, although the impact of commodity price changes, leverage ratios, and production decline rates should also be considered.

Because oil and gas royalty trusts are an investment in oil and gas, our approach to valuing them is not unlike traditional approaches to valuing exploration and production companies. E&P companies are focused on cash flow growth through exploration, development, and acquisitions. Royalty trusts are focused on cash flow stability through development and acquisitions. In our analysis, we focus not only on cash yields, but also on operating cash flow, which has become increasingly important, given that most trusts now withhold a portion of cash flow to fund capital expenditures as opposed to paying out 100% of cash flow to unitholders. We have also witnessed an emerging trend in the sector toward reducing payout ratios in order to promote a more sustainable business model that is less reliant on outside sources of capital and acquisitions.

Sustainability has increasingly become a key theme in our identification of quality trusts. In determining the sustainability of each trust, we examine payout ratios, balance sheets, and assets in an effort to ascertain if the business model employed by each trust is sufficient to maintain production and distributions without relying on outside sources of capital. Over the longer term, we believe that trusts exhibiting a more sustainable business model should generate better per-unit results than their peers, and we would favour building a portfolio around those trusts – always bearing in mind relative valuations.

Commodity prices can fluctuate dramatically, and in an industry where the majority of cash flow is paid out to unitholders, mismanagement of the trust's balance sheet can very quickly escalate into a serious financial risk. If a trust finds itself overlevered, not only is the ability of the trust to pursue acquisition opportunities impaired, but also cash flow could potentially be withheld in order to reduce outstanding bank indebtedness. That said, we believe balance sheets today are, for the most part, in good shape, with an average year-end 2005E net long-term debt to 2005E cash flow ratio of 1.2x. We view this as a reasonable debt level, noting that in a more normalized commodity price environment, the ratio would probably yield results nearer to 1.5x cash flow.

Owing to the increasing use of convertible debentures, we also look at debt ratios using total debt (i.e., net debt plus convertible debentures). The treatment of these instruments as debt or equity can be a contentious issue; however, we have elected to be conservative and classify convertible debentures as debt. We expect the total debt to cash flow ratio for the group to be 1.5x at year-end 2005. Typically a traditional E&P company can easily manage a debt load of 2.0x cash flow, but we prefer to see trusts at or below 1.5x as a general rule.

We use debt-adjusted cash flow multiples because they take into account a trust's financial leverage and payout ratio in measuring value. In our assessment of target multiples and target prices, we take into account the quality of a trust's asset base, measured through an analysis of proved reserves, reserve life indices, decline rates, finding, development and acquisition (FD&A) costs, and operating netbacks. In addition, we take into consideration the balance sheet strength of the trust and its historical record of value creation. In our opinion, a trust's net asset value is an important consideration, which we also include in our analysis; however, an approach using NAV exclusively to value the sector does not take into account the ability of management to make effective acquisitions or exploit its existing reserve base. Our investment ratings are then determined based on relative upside (i.e., total return) within our coverage universe. In the process of managing decline rates through acquisitions and development activity, oil and gas royalty trusts must continue to monitor the strength of their balance sheets.

Current Valuations

Based on our 2005 estimates, oil and gas royalty trusts are currently trading at an average enterprise value to debt-adjusted cash flow (EV/DACF) multiple of 7.8x and an average cash yield of 12.5% – all while trading at a price to net asset value (P/NAV) ratio of 168%. Our investment rating and one-year target prices are predicated on our 2005 estimates, which are currently based on commodity price assumptions of US\$42.00/bbl for crude oil and US\$6.00/mcf for natural gas, with a foreign exchange rate assumption of US\$0.815. These commodity price assumptions are considerably below current forward strip prices (US\$54.70/bbl for crude oil and US\$7.35/mcf for natural gas), under which our average 2005 EV/DACF multiple declines to 5.3x, and the P/NAV ratio falls to 104%.

Strong flow of funds is expected to continue contributing to strong performance going forward, as is U.S. investor demand and S&P's announcement that it intends to add income trusts to the S&P/TSX Composite Index. Incremental demand from index inclusion is expected to represent about 4% of a trust's market capitalization. In addition, crude oil and natural gas prices remain strong and should contribute to stable cash distributions through 2005. We are now forecasting a one-year total return for our coverage universe of 11% – our 1-Sector Outperform rated trusts are Acclaim Energy Trust, Bonavista Energy Trust, PrimeWest Energy Trust, and Vermilion Energy Trust.

Over the course of the past four months we believe that there has been a material multiple expansion, which has, in some cases, pushed cash yields well below the 10% level – moving the sector into uncharted territory. Currently, three trusts in our coverage universe trade at sub-10% yields: Enerplus Resources Fund, Focus Energy Trust, and Vermilion Energy Trust. With the futures markets for both oil and gas currently in contango (i.e., future prices are higher than spot prices), the outlook for cash flows is positive. In combination with the funds flow issues mentioned above, we believe this outlook has contributed to the multiple expansion. While we are always cautious about rising multiples in a rising commodity price environment (because multiples would be expected to contract as commodity prices rise and expand as commodities fall), we note that this multiple expansion appears more reasonable in the context of higher long-term commodity prices, which the market appears to be more comfortable with.

We believe the market today is currently discounting a long-term commodity price outlook of about US\$44.00/bbl to US\$46.00/bbl for crude oil and about US\$7.00/mcf for natural gas. At these constant commodity price assumptions, the oil and gas royalty trust sector would essentially be trading at between 120% and 130% of net asset value (a premium that we believe is reasonable), and at a price to cash flow (P/CF) multiple between 5.7x and 6.0x, which is consistent with the long-term historical average of 5.7x. Exhibit 28 summarizes our analysis and illustrates the constant commodity prices and costs implied by four trading scenarios, ranging from a low P/NAV ratio of 100% to a high P/NAV ratio of 130%. Note that the prices being discounted in the market are currently below the forward strip for 2005 of US\$54.70/bbl for crude oil and US\$7.35/mcf for natural gas. Therefore we believe the market is very reasonably valued in the context of current commodity prices. We are not currently forecasting lower cash distributions in 2005. Based on our estimates, we believe that crude oil prices would need to fall below US\$40.00/bbl for a sustained period (i.e., three months) before we would see widespread reductions in distribution rates.

Exhibit 28 – NAV Analysis Using Constant Commodity Prices and Costs

Group Average P/NAV	Group Average P/NAV			
	100%	110%	120%	130%
Implied:				
Oil Price - WTI (US\$/bbl)	\$52.25	\$49.00	\$46.50	\$44.50
Gas Price - NYMEX (US\$/mcf)	\$8.05	\$7.55	\$7.15	\$6.85
Price/Cash flow	5.0x	5.4x	5.7x	6.0x

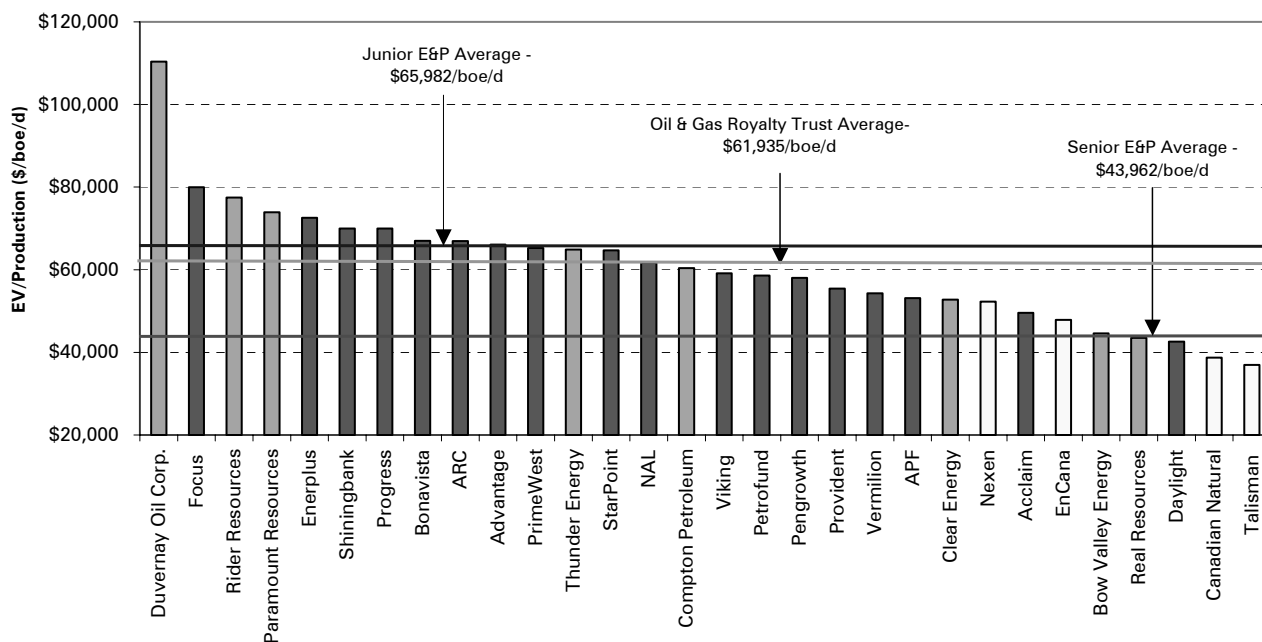
*Note: NAV calculations based off a 10% discount rate.
Source: Scotia Capital estimates.*

Trust Valuations at a Premium to E&P Companies

An interesting valuation metric within the oil and gas sector is enterprise value to daily barrels of oil equivalent produced (\$/boe/d), which allows us to compare valuations within the broader energy sector. This is an objective measure, with both inputs determined using publicly available figures for market value and production. Exhibit 29 provides a comparison of where each trust currently trades on an enterprise value to current production basis, relative to the same metric for both junior and senior oil and gas producers.

The oil and gas royalty trust sector trades at a premium to its senior E&P counterparts. On average, the oil and gas royalty trust sector currently trades at a ratio of \$61,935 per daily boe, whereas junior oil and gas producers (sourced from Scotia Capital equity research and comprising eight junior producers) trade at a ratio of \$65,982 per daily boe. The senior oil and gas producers (sourced from Scotia Capital equity research and comprising four senior producers) continue to be awarded the lowest valuations in the energy sector, with an average ratio of \$43,962 per daily boe. An obvious omission in this ratio is the fact that all production is not created equal. Properties have different decline rates, operating costs, and product qualities, to name just a few. Having recognized this shortfall, we believe that this analysis illustrates, using a simple measure (similar to other simple valuation measures such as P/CF multiples and current cash yields), the relatively high valuations being afforded the oil and gas royalty trust sector today.

Exhibit 29 – Valuation Comparison – Enterprise Value to Daily Boe of Production (\$/boe/d)



As at April 22, 2005, we were restricted on Crescent Point Energy Trust and Paramount Energy Trust.
 Source: Company reports; Scotia Capital estimates.

Investment Risks

As with all oil and gas companies, we highlight that the underlying business is still heavily reliant on estimates of reserves and production rates, which represent a major component of risk. The potential exists for unforeseeable geological complications, which could have a material impact on cash flows and unit prices. Inherent in a business model that relies on acquisitions is increased reserve risk and financial risk from acquisitions.

Equally important to the reserve risk is commodity price risk. While our price deck reflects our best estimate of commodity prices, the constantly changing global political environment is almost impossible to predict, leading to considerable volatility in crude oil markets, in particular. In a similar vein, natural gas prices in North America are often a hostage of both weather and crude oil prices, which can outweigh signals from the physical market (i.e., storage levels). Foreign exchange risk is also present, but only inasmuch as the U.S. dollar exchange rate influences Canadian dollar-denominated commodity prices in western Canada.

In addition to the above, we highlight several additional risks associated with the oil and gas royalty trust sector:

- Production Declines.** Oil and gas by its very nature is a depleting asset – we estimate the average decline rate in the sector at approximately 17%. Consequently, royalty trusts engage in development activity and acquisitions in order to maintain production volumes. If development activity is unsuccessful, or a trust cannot successfully complete an acquisition, production declines are likely to set in, resulting in lower revenues and cash distributions to unitholders, and downward pressure on trust unit prices.

- **Debt Leverage.** Development activities and property acquisitions are generally financed through a combination of additional bank borrowings and operating cash flow. Maintaining balance sheet strength is essential in an industry known for volatile commodity prices. An overlevered trust may at some point be forced to reduce or suspend cash distributions in order to repay its outstanding bank debt, which in turn, would put downward pressure on trust unit prices.
- **Availability of Quality Properties.** Identifying and acquiring high-quality oil and gas properties with reasonable decline rates and development upside is always a challenge. Over the last several years, royalty trusts have been active participants in industry consolidation, which has resulted in the disappearance of many junior oil and gas producers. In a competitive environment, acquisition costs tend to rise, limiting the potential accretion of a deal. If such a trend were to continue over time, it could place downward pressure on trust unit prices.
- **Integration.** The integration of assets, people, and processes surrounding both property and corporate acquisitions can pose a significant challenge for management. Those that manage this process most effectively have the greatest possibility of realizing full value for the assets acquired.
- **Access to Equity.** The ability to access the equity markets provides increased flexibility with respect to the financing of property acquisitions and capital development programs. During periods when access to equity is limited or unavailable, royalty trusts must rely on additional bank borrowings and operating cash flow – this in turn can reduce cash available for distribution to unitholders and place downward pressure on trust unit prices.

It is prudent, we believe, to look back to 1998, when after two years of interest surrounding oil and gas royalty trusts (including the IPO boom and the excitement of instalment receipts in 1996), investors were awakened to the hard reality that in an environment of weaker commodity prices, balance sheets that were once considered healthy can quickly deteriorate, and cash distributions once thought secure can quickly decline. The Scotia Capital Energy Trust Index generated a negative 34.5% total return in 1998 – this is the last year that we saw negative total returns generated by the oil and gas royalty trust sector.

Tax Implications Reliant on Distribution Classification

Investors receive a distribution or cash payment from an oil and gas royalty trust on a monthly basis based on the net revenues derived from producing oil and gas fields. This annual cash distribution, when divided by the current trust unit price, results in a cash yield. Cash distributions fluctuate with changes in crude oil and natural gas prices, production volumes, and operating, administrative, and financing costs. In addition, cash flow can be withheld to fund a portion of capital expenditures or for the repayment of long-term debt, thus reducing the cash available for distribution to unitholders.

For income tax purposes, cash distributions are treated as either a return of capital, thus reducing the adjusted cost base of the trust units, or as “other income” to be reported on an individual’s income tax return. This breakdown is determined at year-end by each trust and is based on the availability of tax pools to shelter the income. In 2004, about 74%, on average, of cash distributions will be taxable as “other income” with 26% being a return of capital. Unitholders are required to reduce the adjusted cost base of their units by an amount equal to the cumulative cash received from distributions less the taxable amounts reported as “Other Income” on their slips, if any.

For trust units held inside an RRSP, RRIF, or DPSP, no amounts are required to be reported as income on an investor’s income tax return. For unitholders, a T3 Supplementary slip is issued by the broker or intermediary by March 31. Registered unitholders receive their T3 Supplementary slip directly from the transfer agent. The amount reported in box (26) on the T3 slip should be reported on the Income Tax Return as “Other Income.”

Our Top Picks – BNP.UN, VET.UN

Our key theme is sustainability. We have identified two trusts that we believe will be strong performers over the next 12 months: Bonavista Energy Trust (BNP.UN) and Vermilion Energy Trust (VET.UN). In both cases, we highlight what we consider to be exceptionally strong management teams who employ a conservative financial structure and have in place what we consider to be more sustainable business models – thus ensuring, we believe, greater stability in cash distributions over the coming 12 to 18 months.

Bonavista Energy Trust – 1-Sector Outperform; One-Year Target: \$30.00 per Unit

Brian Ector, CFA – (403) 213-7332

We believe the factors that led to the success of Bonavista as an exploration and production company continue to contribute greatly to its success as a trust – highly efficient, low-cost operations with a strong management and technical team, and sound financial discipline. Bonavista was formed on July 2, 2003, through a plan of arrangement involving the reorganization of Bonavista Petroleum Ltd., a highly successful intermediate exploration and production company. In 2004, Bonavista generated an impressive total return (including cash distributions) of 43.8%, versus a 29.8% total return for the Scotia Capital Energy Trust Index. This strong performance has continued YTD in 2005 with a total return of 18.0%, which compares favourably to the 7.2% total return generated by the Scotia Capital Energy Trust Index.

Bonavista’s proved plus probable (P+P) reserves totalled 164.1 mmboe at year-end 2004, about 2% higher than our forecast. Reserve additions of 72.9 mmboe occurred at a very reasonable FD&A cost of \$10.31 per boe (excluding future development capital). The resulting recycle ratio (cash flow of \$22.10 per boe divided by FD&A costs) is an impressive 2.1x, among the highest realized within our coverage universe in 2004. Based on an estimated year-end production rate, we calculate reserve life indices on a proved developed producing, total proved, and proved plus probable basis of 5.6 years, 6.9 years, and 8.5 years, respectively (versus industry averages of 6.0 years, 7.3 years, and 9.8 years, respectively). Bonavista’s proved developed producing reserves represent a very reasonable 81% of total proved reserves.

We expect 100% of Bonavista’s capital development program to be funded from operating cash flow. Bonavista’s capital development program for 2005 is expected to total about \$190 million, with total expenditures (including complementary tuck-in property acquisitions) between \$210 million and \$230 million. Bonavista expects to drill about 280 to 290 gross wells in 2005, and currently has a prospect inventory of about 383 wells, upwards of a two-year drilling inventory. Bonavista is currently producing about 52,100 boe/d (57% weighted toward natural gas), and for 2005, we are forecasting an average production rate of 52,000 boe/d.

Bonavista’s financial discipline is clearly evident, with a year-end 2005E net long-term debt to 2005E cash flow ratio of 1.0x and a total debt-to-cash flow ratio (including convertible debentures) of 1.5x. Bonavista currently has 93.2 million units outstanding (including 14.4 million exchangeable shares that are convertible into 17.6 million trust units), net long-term debt of about \$325 million, and two series of convertible debentures totalling \$198 million. In addition, **Bonavista’s payout ratio is among the strongest in the trust sector.** No cash distributions are paid in respect of the exchangeable shares, and Bonavista’s policy is to retain the cash flow attributable to the exchangeable shares, essentially providing the fund with a mechanism for debt reduction or funding capital expenditures. We estimate Bonavista’s basic payout ratio (including cash flow withheld for exchangeables) for 2005 at 63%, with an adjusted payout ratio (after taking into consideration capital expenditures) of 144%.

Based on our estimates, Bonavista currently trades at a 2006E EV/DACF multiple of 8.6x, versus an industry average of 8.3x, and provides investors with a forecast cash yield of 10.6%, versus an industry average of 12.0%. Our investment rating remains 1-Sector Outperform, with a one-year target price of \$30.00 per unit.

**Vermilion Energy Trust – 1-Sector Outperform;
One-Year Target: \$22.75 per Unit**

Grant Hofer, CFA – (403) 213-7345

Vermilion Energy Trust continues to be one of our top picks in the trust space owing to its international exposure and strong management. The trust has producing assets in western Canada, France, the Netherlands, and now Australia. In addition, Vermilion also has equity interests in two other ventures: a 54% ownership stake in Verenex Energy Inc. (VNX:TSX Venture) and a 35% equity interest in Glacier Energy Limited, which is a private company focused on coalbed methane and shallow natural gas. Vermilion acquired each of these interests primarily through a contribution of undeveloped land to each company.

Vermilion's production in 2005 is expected to be 25,415 boe/d, 46% weighted to natural gas, and is expected to come from Canada (43% of total trust production, 55% natural gas), France (23% of total, 4% gas), the Netherlands (21% of total, 99% gas), and offshore Australia (14% of trust production, 0% gas). Primarily because of its assets in France and Australia, the trust has a longer than average reserve life, at 7.6 years (proved) and 10.6 years (proved plus probable).

We believe that Vermilion has demonstrated the merits of its international exposure through its two most recent acquisitions in Australia and the Netherlands. With transaction metrics below \$20,000/boe/d and less than \$10.00/boe (proved), we contend that **Vermilion is acquiring production at metrics cheaper than the cost for most trusts to drill for oil and gas in western Canada.** While international operations clearly introduce a number of operational and financial concerns, Vermilion has been operating in France since 1997 and also operated in Trinidad through its Aventura subsidiary (which was divested in early 2004). We point out, however, that Vermilion pays taxes in each foreign jurisdiction, and enjoys the tax-advantaged trust structure only in Canada.

We have also been made aware of an attractive asset package that is currently being marketed by ExxonMobil in France, of which Vermilion would be the natural buyer. This package represents the second sale of ExxonMobil's French production, the first of which was purchased by Vermilion in 1997. As such, **these assets offer an almost ideal fit with the trust's current properties, with production coming from both the Paris and Aquitaine basins.** Production from these properties averaged 5,630 boe/d in 2003; however, this figure is likely nearer to 5,000 boe/d today, primarily weighted to crude oil. Based on a potential transaction multiple range of \$20,000/boe/d to \$30,000/boe/d, we would estimate that the assets could be worth as much as \$150 million in an auction process. The bid date for the assets is mid-April, meaning that the winning bid would likely not be announced until mid-year.

We currently rate Vermilion as a 1-Sector Outperform with a \$22.75 target price. Our target is based on a 2006E EV/DACF multiple of 7.6x, which is below the group average of 8.2x. The trust is currently trading at a 2006E EV/DACF multiple of 7.1x, which is below the group average of 8.3x, while providing a forecast cash yield of 9.7%, versus the industry average of 12.0%. Vermilion also has below-average debt levels, at 0.8x cash flow, which compares to the group average of 1.2x.

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Power and Energy Utility Trusts

Tony Courtright, MBA, CA – (416) 945-4536

Evolution, History, and Current Size of Sector

There are 12 issuers within the power sub-index of the Scotia Capital Income Trust Index (SCITI), with a total market capitalization of over \$7 billion and total enterprise value (funded capital consisting of debt and equity) of almost \$9 billion. The power sub-index currently represents about 5% of the overall SCITI and has fluctuated over the sub-index's six-year history from a high of over 10% in early 2002 to its current low level, which primarily reflects the dilutive impact of the growth in energy and other business trusts since 2001.

The related SCITI utilities and infrastructure sub-index, which is dominated by pipeline energy utility income funds, has 13 issuers with a total market capitalization and enterprise value of about \$12 billion and \$20 billion, respectively. It currently represents 8% of the overall SCITI, and is steadily declining from its initial 18% weighting at the outset of the sub-index in 1999.

Power and pipeline energy utility income funds are among the oldest business trusts, as distinct from the separate and long-established real estate and energy and resource royalty trusts. The oldest pipeline income fund began trading in 1993, and more pipeline and power funds arose in the mid-to-late 1990s. The power funds consisted primarily of Ontario-based non-utility generators that were contracted long-term to the provincial utility and owned either by stand-alone independent power producers or by large corporate sponsors. Subsequent power income funds have consisted of a mix of assets contracted to provincial or local utilities, intermediary corporate counterparties or industrial host energy customers. The geographic range of assets now spans the provinces from New Brunswick to British Columbia as well as various states in the United States. The pipeline income funds are located primarily in the western Canadian oil and gas producing provinces and also include a Quebec-based gas transmission and distribution utility.

Key Drivers of Performance

Long-maturity, well-matched supply/sales or service delivery contracts with creditworthy counterparties or projected returns from a stable regulated rate base are key to establishing a base of predictable distributions. A diversified portfolio of generating facilities, especially low-cost, indefinite-life assets contracted at or near current market prices, a history of stable or slowly growing distributions within the limits of distributable cash generated (i.e., payout ratios $\leq 100\%$), and evidence of gradual expansion and extension of the term to maturity of contracts to ensure future sustainability are the hallmarks of an ideal power income fund.

Power funds generate operating profit in two ways. Contractual sales of electricity at specified prices are offset against matched fuel contracts or fuel cost pass-through. Alternatively, funds receive capacity payments regardless of actual production providing the facility remains available for generation. Few power funds currently have any merchant (un-contracted) power market risk, although exposure to this risk may eventually increase should they be unable to successfully re-contract facilities at maturity of their existing long-term contracts.

Existing hydroelectric and wind generating facilities are likely to remain viable at any future power price because of their low operating costs (low-cost or free fuel), and growing concern with global warming and government support of renewable energy standards. The future viability of higher-cost thermal (gas- and coal-fired) generating facilities, however, is likely to depend upon the prevailing balance of supply and demand and relative fuel costs/efficiency. Another important factor is the ability to schedule dispatch of generation rather than being dependent upon intermittent sources of energy (wind or waterflow).

Expansion through asset acquisitions or new project development with extended contracts is becoming increasingly important to established power and pipeline income funds. Otherwise, they face a gradual or sudden decline in their relatively predictable distributable cash flows as their regulated rate base is recovered or their generally fixed-margin electricity contracts mature. In addition, without expansion, growth in distributable cash flow is generally negligible since most indexation, if any, in existing contracts is primarily intended to offset increased costs rather than improve return on capital. Expansion requires additional equity, given the capital-intensive nature of the business. Accordingly, it tends to become increasingly difficult to achieve material increases in distributable cash per unit as the unit denominator expands. Power and pipeline funds with the lowest cost of capital (generally equivalent to the lowest distribution yield) have an advantage in pursuing third-party acquisitions because they can issue fewer units to raise equivalent capital. Employing debt leverage can augment returns in the short-to-medium term, but eventual amortization or refinancing of incurred debt must be recognized as a claim on future cash flows.

Avenues for future growth in power funds include: (1) acquisition or development of new generation contracted long-term to utilities or governmental authorities, especially facilities intended to satisfy renewable energy policy objectives; (2) related-party acquisitions from corporate sponsors of existing non-core assets with suitable contracts in place; (3) third-party acquisition from divesting corporations or utilities of existing assets with suitable contracts in place or a high probability of re-contracting.

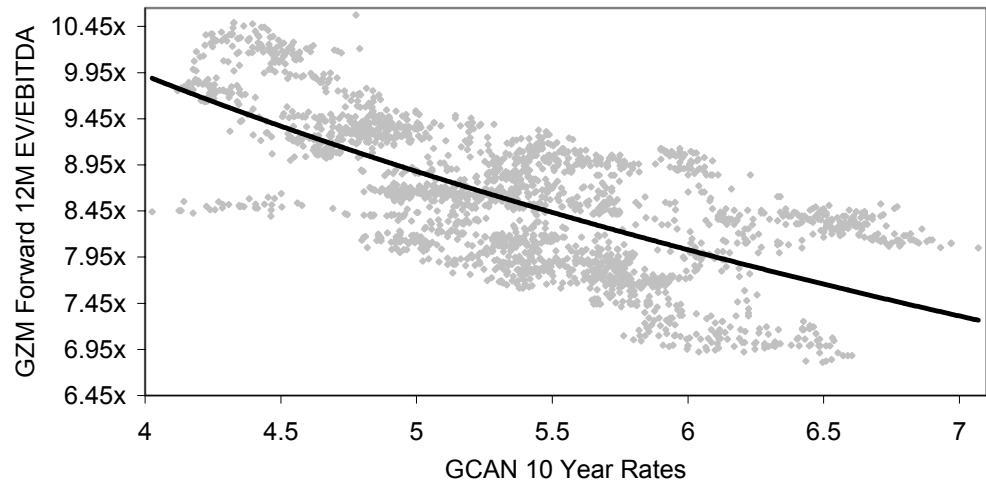
Valuation

Methodology

Our valuation targets consist of a blend of target yield based on our estimated future cash distributions and an EV/EBITDA multiple based on forward EBITDA estimates. The target distribution yield is adjusted for such factors as anticipated future bond yields and the short-term sustainability of distributions, as measured by the payout ratio of forecast distributions to recurring distributable cash flow. Other factors include the distribution yield premium relative to underlying enterprise debt (since the cost of equity capital should exceed that of senior debt), and distribution growth potential from pricing power, revenue escalation, and accretive acquisition/expansion opportunities.

Forward EV/EBITDA multiples provide a pre-distribution valuation metric, indifferent to capital structure, that can also be used to evaluate an income fund against private or public equity comparables. Power and pipeline energy utility income funds generally enjoy a premium of 1.5x to 2.5x on forward EV/EBITDA multiples because of the implicit monetization of the tax burden, given the lack of complete tax integration (i.e., the dividend tax credit does not offset corporate income taxes). There tends to be an inverse correlation between interest rates and EV/EBITDA multiples. The strength of the empirical data to support this correlation among power income funds is weak due, we believe, to limited time series data (short lifespan) and the distorting effects, both negative and positive, that the technology stock bubble and its collapse had on flow of funds into income trusts. Exhibit 30 illustrates this relationship for one of the older energy utility income funds – Gaz Metro, L.P.

Exhibit 30 – Scatter Plot of Forward 12-Month EV/EBITDA for GZM.UN versus 10-Year Rates



Note: Based on data from October 1996 to March 31, 2005.

Source: Scotia Capital; Bloomberg.

Sustainability

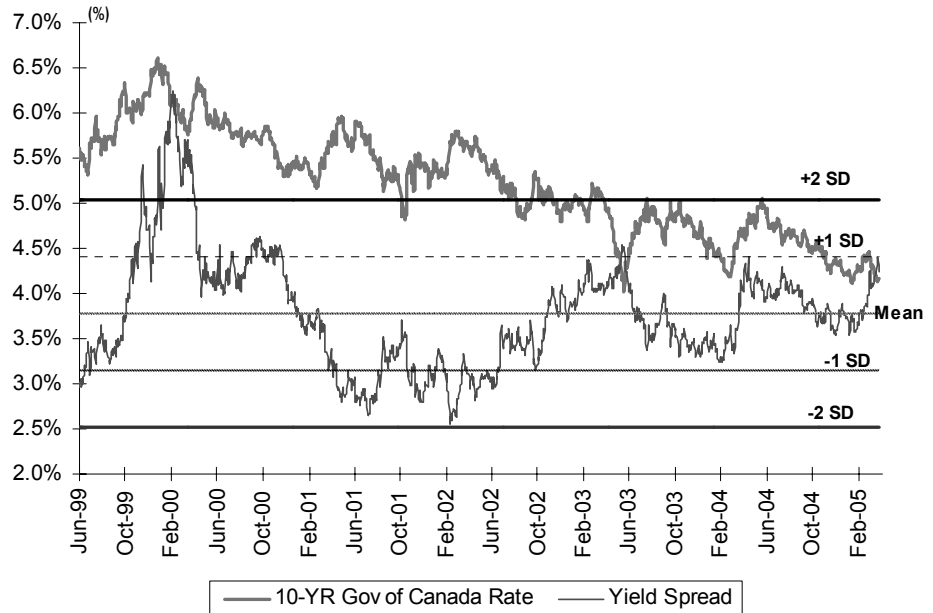
In the short and medium term, sales contracts (power purchase, tolling, and ship-or-pay) and social customs (e.g., renting water heater appliances) provide for generally stable and predictable cash flows. Longer term (10 to 15 years from now), maturing contracts, technological improvements, escalating fuel costs, evolving environmental regulations, increasingly competitive energy markets, and declining production from known hydrocarbon basins are likely to challenge the viability and sustainability of many existing infrastructure investments upon which current cash distributions depend.

Since distributions from capital-intensive power and pipeline energy utility income funds generally incorporate a component of return of capital (depreciation), most of the initial capital costs of the depreciating assets will have been recaptured at maturity of existing contracts. This may result in reduced future revenues/distributable cash from existing assets upon re-contracting at maturity, depending upon the future competitive economics of those assets and the prevailing regulatory environment. Because of this, we believe it is important that capital-intensive power and energy utility funds undertake periodic or continual (incremental) investment in new assets in order to sustain their distributable cash beyond existing contract maturities, especially if the existing contracts have above-market prices.

Current Valuation Levels

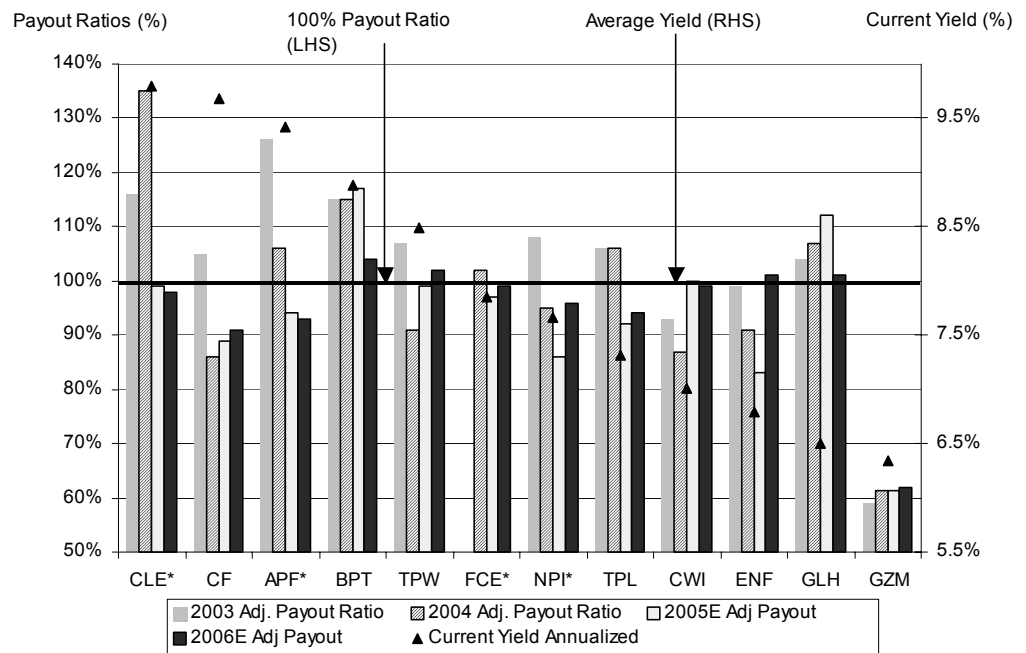
In our opinion, power and most energy utility funds are appropriately or slightly undervalued in relation to prevailing interest rates on a pure distribution yield spread analysis relative to benchmark 10-year Canada bond yields (Exhibit 31). The period from December 2004 through February 2005 saw the annual price run-up due to RRSP seasonal flow of funds, which we believe has now largely been corrected. From a sustainability perspective, however, we believe certain typically smaller issuers have had and may continue to experience high ($\geq 100\%$) payout ratios due to natural variability in production, levelization of future escalation, and the timing of capital expenditures (Exhibit 32). Should Scotia Economics' expectations of generally stable bond yields materialize, we anticipate limited price movement other than for changes in cash distributions or major departures in expected payout ratios.

Exhibit 31 – Power Fund Distribution Yield Spread Graph



Source: Scotia Capital; Bloomberg.

Exhibit 32 – Power and Energy Utility Historical and Projected Payout Ratios



* Shown on a fully diluted basis.

Source: Scotia Capital estimates as at April 22, 2005.

Sensitivity to Interest Rates

The importance of interest rates and relative yield to income trusts is nowhere better illustrated than in the case of power income funds. This is because power funds derive their value more from the net operating margins obtained from their long-term contracts than from any intrinsic value as an investment in generating assets per se. This contrasts with energy royalty and other resource trusts as well as REITs, whose values can vary because of cyclical commodity prices and market fundamentals (real estate location, supply/demand). A power fund is essentially an investment in a future stream of contractual cash flows. It is seldom viewed as an investment in the underlying physical generating plant, subject to depreciating wear-and-tear, for which there are typically few barriers preventing new investment in competing capacity.

Valuation Considerations

Contractual Cash Flow. The importance of contractual cash flows to power funds is due to the extreme volatility of spot market electricity prices, which can experience not only seasonal but *daily* and *hourly* fluctuations. Without long-term sales contracts, even comparatively indefinite-life, low-operating-cost hydroelectric assets generate unpredictable cash flows. This explains why any non-dispatchable (i.e., unable to schedule output) form of generation, particularly intermittent wind or hydroelectric generation, typically depends upon contractual sales prices rather than spot market economics. Thermal (e.g., gas- and coal-fired) generating facilities, whose output can be scheduled (dispatched) to coincide with peak power prices, also produce similarly unpredictable operating margins if their main input variable, fuel costs, is not committed under long-term supply contracts and is instead subject to price volatility.

Operational Metrics of Limited Value during Life of Contracts. Because of the importance of contracts, objective valuation metrics such as replacement cost new per MW capacity or spark spreads per MWh (i.e., gross margin net of fuel costs) compared to current market conditions are of limited benefit other than to illustrate that the majority of the generating asset's value is attributable to its existing supply/sales contracts. Post-contract-maturity, substantial caution should be applied to any projections based on a purely uncontracted merchant power plant, due to the *daily* and *hourly* variation in electricity prices and generally variable fuel prices. A possible alternative deployment post-contract-maturity would be for owners of plants to rent out their generating potential or capacity to convert fuel into electricity for counterparties willing to assume fuel price risk, and thus secure a more modest but likely more predictable return.

Benefits/Reasons to Invest in Sector

The primary attraction of investing in power and some pipeline income funds is the relatively high predictability of distributions due primarily to their long-term contracts. The contractual underpinnings generally protect against downturns in economic activity and for the most part shelter power income funds from the vicissitudes of commodity price cycles. Offsetting the benefits of predictability and economic insensitivity is the generally low growth in cash distributions because of locked-in margins and the challenges of delivering accretive expansion within a capital-intensive business without assuming undue development or leverage risks.

Risks/Lessons Learned

Power funds are exposed to regulatory and counterparty credit risks as well as typical financial and business risks such as foreign exchange rates, taxes on U.S. or foreign investments, interest rates, and refinancing risk on term debt. None of these are unique to power funds, other than possibly counterparty credit. The risk of material contract default by a counterparty warrants caution, especially for large exposures to counterparties below investment grade.

The two principal risks facing power income funds specifically are operating performance and contract mismatch and maturity.

Operating Risks

Operational shortfalls can arise because of overoptimistic design and performance targets at new facilities, which have not yet been commissioned but are acquired or are being developed by power funds. Such shortfalls can sometimes be permanent in nature and dilute or negate the anticipated accretive benefit of these investments. For this reason, developing or acquiring new generating facilities without proven track records increases the risk profile of a power fund and reduces the predictability of future distributions, particularly if distributions were prematurely increased based solely upon anticipated benefits.

Existing facilities with demonstrated performance records can also suffer production shortfalls due to unexpected equipment failure or natural variations in the flow of water or wind. The impact of unexpected shortfalls can be overcome with suitable diversification among various facilities and appropriate insurance policies. Natural variability can be mitigated by distribution stabilization reserves or borrowing facilities, providing there are adequate data to support the claim that current production shortfalls will be offset by future production above the long-term average. The lesson learned is not to confound the effect of natural variations with other permanent shortfalls and thus unwittingly accept unsustainably high distributions. A persistent record of high payout ratios is a clear signal that future distributions may be in jeopardy.

Contract Risks

Contract mismatch can result in fuel or other cost escalation not being adequately offset by increases in sales revenues, and thus lead to margin deterioration. Contract maturity of power sales or tolling agreements can abruptly reduce or eliminate contribution margins, since many “legacy” non-utility generating contracts were negotiated on the basis of a monopoly utility’s “avoided cost” rather than in relation to a competitive marketplace, as is now typically the norm. The lesson here is to anticipate, where possible, what impact prevailing fuel and power prices are likely to have on contracts with near-term maturities. Estimating the impact of future market conditions on longer-dated contracts is necessarily more difficult due to greater uncertainty about future market conditions some 10 to 15 years hence. Long-life, low-variable-cost hydroelectric (and possibly wind generating) facilities are likely to remain viable regardless of future market conditions due to their low fuel costs and zero emissions status.

Governance

Virtually all power income funds retain external managers because operating existing capital-intensive assets under long-term contracts provides limited scope for value-added managerial input. In addition, sharing operations and maintenance expertise among a broader portfolio of assets owned or managed by the corporate sponsor or fund promoter/developer typically results in economies of scale. Should recent instances of power funds backstopping project development become a trend, however, there may be increased justification for internalizing management.

Outlook

We expect several power and energy utility income funds to be eventually included in the expanded S&P/TSX Composite Index along with other income trusts. This should be supportive of current valuations and may increase liquidity among those names. A major issue that remains uncertain is whether limited partnerships will be included in the expanded S&P/TSX Composite Index. This affects five of the larger market capitalization issuers within the power and energy utility income fund sector. Fort Chicago Energy Partners L.P., TransCanada Power L.P., TransAlta Power L.P., Gaz Metro L.P., and Inter Pipeline Income Fund are all structured as limited partnerships whose ownership is restricted to Canadian residents in order for the limited partnership to maintain its status.

We expect generally stable distributions and unit prices in relation to prevailing long-term interest rates. There is, however, a close relationship between distribution yields and benchmark Canada bond yields. Accordingly, should there be an unexpected sharp backup in long Canada bond yields, we would expect corresponding unit price depreciation. Beyond these macroeconomic factors, we believe those issuers able to grow their distributions within sustainable payout ratios while maintaining similar risk profiles should perform better than others. We note some power funds are adopting higher-risk development strategies, while another fund has a large exposure to a non-investment-grade counterparty, both of which are departures from traditional power income fund practices.

Top Picks

Fort Chicago Energy Partners L.P. (FCE.UN) is one of our two 1-Sector Outperform rated issuers. This limited partnership owns a 50% interest in the Alliance pipeline and associated Aux Sable natural gas liquids extraction facility, and recently completed the acquisition of a 100% interest in the Alberta Ethane Gathering System. We believe Fort Chicago's current distributions are sustainable primarily on the basis of its long-term ship-or-pay contracts, yet it stands to benefit from the upside of higher NGL fractionation margins at its Aux Sable facility.

The Consumers' Waterheater Income Fund (CWI.UN) is the second of our 1-Sector Outperform rated issuers. It has a quasi-monopolistic franchise of Ontario-based residential rental appliances and a clear market focus, constantly reinvesting to sustain and gradually expand its large portfolio of 1.3 million residential rental appliances. Consumers' Waterheater has decoupled rents from CPI indexation and recently increased them by 3.5% across its largely captive portfolio, thereby exercising pricing power. The fund is also expanding its focus and has re-entered the rental market for commercial waterheater appliances.

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Appendix 1 - Scotia Capital Income Trust Coverage

Exhibit 1.1 - Pertinent Unit Information																									
Analyst ¹	Apr-25-05	Price	Units	O/S (M)	Cap (M)	Mkt	Distributions		Rsrv.	Cash Flow ²		EBITDA	EVI	2005E Payout		Debt	Risk								
							2005E	2006E		2005E	2006E			Simple	Adj			Flow	EBITDA ^{4,5}	Ratio (%) ³	Target	One-Year			
							2005E	2006E	Life	2005E	2006E	2005E	2006E	Simple	Adj	Flow	EBITDA ^{4,5}	Ratio (%) ³	Target	One-Year					
Power Income Funds																									
TC		\$10.00	69.7	696.9			\$0.92	\$0.92	9.2%		\$0.92	\$0.96	10.9x	10.4x	100%	107%	\$87	11.5x	100%	107%	3.6x	4.2%	H	3	
TC		\$10.38	59.1	613.2			\$0.90	\$0.90	8.7%		\$0.84	\$0.89	12.4x	11.7x	107%	117%	\$62	11.5x	107%	117%	2.0x	5.0%	M	2	
TC		\$9.88	61.7	610.0			\$0.98	\$0.99	9.9%		\$1.48	\$1.42	7.0x	7.0x	92%	92%	\$84	8.0x	92%	92%	3.1x	6.1%	M	2	
TC		\$7.13	35.4	252.2			\$0.70	\$0.70	9.8%		\$0.72	\$0.72	9.9x	9.9x	97%	99%	\$31	11.5x	97%	99%	3.1x	8.0%	H	3	
TC		\$18.99	48.3	616.8			\$1.22	\$1.23	6.4%		\$1.58	\$1.59	12.0x	11.9x	78%	112%	\$110	13.1x	78%	112%	4.2x	1.2%	M	3	
TC		\$13.58	47.9	650.8			\$1.02	\$1.04	7.5%		\$1.25	\$1.16	10.9x	11.7x	82%	86%	\$70	11.8x	82%	86%	2.6x	5.1%	M	2	
TC		\$9.31	72.0	670.3			\$0.80	\$0.80	8.6%		\$0.94	\$0.91	9.9x	10.2x	85%	98%	\$69	10.8x	85%	98%	0.8x	7.9%	L	2	
TC		\$34.45	47.4	1,632.9			\$2.52	\$2.52	7.3%		\$3.07	\$3.00	11.2x	11.5x	92%	92%	\$162	12.8x	92%	92%	2.6x	6.0%	L	2	
Float Weighted Averages																									
									8.3%			10.5x	10.6x	11.4x	85%	98%	2.4x					5.5%			
Consumer Income Funds																									
CB		\$13.85	47.6	659.3			\$1.20	\$1.25	8.7%		\$1.43	\$1.56	9.7x	8.9x	86%	100%	\$88	9.1x	86%	100%	1.7x	17.0%	H	2	
MG		\$7.86	52.8	415.0			\$0.84	\$0.84	10.7%		\$0.86	\$0.96	9.1x	8.2x	84%	-	\$73	8.3x	84%	-	1.7x	\$8.60	20.1%	M	2
CB		\$22.63	37.9	858.1			\$1.46	\$1.50	6.5%		\$2.08	\$2.17	10.9x	10.4x	70%	81%	\$85	10.7x	70%	81%	0.6x	1.5%	M	2	
NM		\$13.89	12.3	171.1			\$1.08	\$1.12	7.8%		\$0.83	\$0.90	16.7x	15.4x	NA	NA	NA	NA	131%	94%	NA	15.0%	15.8%	M	1
NM		\$20.45	12.2	249.9			\$1.80	\$1.80	8.8%		\$2.34	\$2.46	8.7x	8.3x	\$31	8.6x	\$31	8.6x	77%	99%	0.4x	\$21.00	11.5%	H	2
Float Weighted Averages																									
									8.0%			10.7x	10.1x	9.7x	81%	89%	1.0x					9.1%			
Industrial Income Funds																									
NM		\$5.95	13.9	82.4			\$0.60	\$0.63	10.1%		\$0.93	\$0.94	6.4x	6.3x	64%	74%	\$17	7.7x	64%	74%	2.8x	\$5.65	5.0%	H	3
CB		\$5.98	65.1	389.3			\$0.00	\$0.00	0.0%		\$0.82	\$0.69	8.8x	8.7x	0%	-	\$57	9.5x	0%	-	2.9x	\$5.25	-12.2%	C	3
CB		\$14.95	23.5	350.9			\$1.80	\$1.80	12.0%		\$1.92	\$2.01	7.8x	7.4x	83%	94%	\$55	8.3x	94%	100%	2.0x	\$17.50	29.1%	H	2
CB		\$12.60	18.0	270.0			\$1.14	\$1.20	9.0%		\$1.34	\$1.37	9.4x	9.2x	85%	87%	\$31	8.5x	85%	87%	1.3x	\$13.50	16.2%	M	1
AM		\$8.43	49.0	413.1			\$0.90	\$0.90	10.7%		\$0.93	\$0.93	10.1x	9.1x	86%	98%	\$28	10.5x	86%	98%	2.8x	\$8.00	5.6%	M	3
BE		\$30.33	75.9	2,302.1			\$2.46	\$2.52	8.1%		\$2.87	\$3.00	10.6x	10.1x	93%	93%	\$278	11.6x	93%	93%	2.8x	\$30.75	9.6%	M	2
NM		\$12.50	13.4	167.3			\$1.27	\$1.51	10.2%		\$1.48	\$1.77	8.4x	7.1x	86%	90%	\$34	7.5x	86%	90%	1.7x	\$13.00	14.6%	H	2
CB		\$15.10	21.9	330.7			\$1.50	\$1.50	9.9%		\$1.66	\$1.69	9.1x	8.9x	93%	100%	\$44	8.3x	93%	100%	0.8x	\$15.75	14.2%	H	2
CB		\$8.75	24.1	210.9			\$0.93	\$0.96	11.0%		\$1.00	\$1.04	8.8x	8.4x	90%	90%	\$20	9.0x	90%	100%	2.4x	\$9.00	19.2%	H	2
AK		\$11.30	70.4	795.3			\$1.14	\$1.27	10.1%		\$1.21	\$1.35	9.3x	8.4x	95	10.2x	\$95	10.2x	-	-	0.0x	\$10.00	-1.4%	M	3
AM		\$13.51	343.2	4,636.6			\$1.02	\$1.11	7.5%		\$1.06	\$1.16	12.7x	11.6x	\$668	12.7x	\$668	12.7x	96%	104%	4.0x	\$16.00	26.0%	L	1
Float Weighted Averages																									
									8.0%			11.4x	10.5x	11.7x	91%	100%	3.2x					18.2%			
Infrastructure Income Funds																									
JKH		\$16.80	89.2	1,498.6			\$1.06	\$1.12	6.3%		\$1.28	\$1.30	13.1x	12.9x	57%	83%	\$182	-	57%	83%	1.0x	\$16.00	1.6%	L	2
TC		\$15.75	49.5	779.9			\$1.11	\$1.15	7.0%		\$2.39	\$2.58	6.6x	6.1x	79%	100%	\$137	9.4x	79%	100%	3.9x	\$15.50	5.5%	L	1
TC		\$13.35	34.6	462.2			\$0.91	\$0.92	6.8%		\$2.91	\$2.43	4.6x	5.5x	31%	83%	\$181	9.8x	31%	83%	4.7x	\$12.50	0.4%	M	2
TC		\$11.85	111.5	1,321.3			\$0.93	\$0.93	7.8%		\$1.63	\$1.55	7.3x	7.6x	57%	85%	\$368	9.1x	57%	85%	4.8x	\$12.00	8.9%	M	1
TC		\$21.35	117.4	2,505.9			\$1.37	\$1.40	6.4%		\$2.85	\$2.86	7.5x	7.5x	48%	61%	\$385	9.3x	48%	61%	2.8x	\$21.50	7.2%	L	2
BE		\$9.52	181.1	1,723.8			\$0.75	\$0.75	7.9%		\$0.96	\$0.93	9.9x	10.2x	78%	86%	\$194	11.4x	78%	86%	2.6x	\$9.25	5.0%	M	2
GH		\$15.15	57.4	869.6			\$1.25	\$1.29	8.3%		\$1.42	\$1.34	10.7x	11.3x	85%	92%	\$102	12.1x	85%	92%	3.2x	\$15.25	9.0%	M	1
BE		\$13.82	102.9	1,422.5			\$1.05	\$1.05	7.6%		\$1.10	\$1.10	12.6x	12.6x	91%	169%	\$167	13.4x	91%	169%	4.4x	\$13.00	1.7%	M	2
Float Weighted Averages																									
									7.5%			9.6x	9.8x	11.0x	72%	101%	3.5x					5.3%			
Resource Funds																									
BE		\$87.61	91.7	8,033.8			\$2.00	\$3.00	2.3%		\$6.54	\$8.16	13.4x	10.7x	31%	49%	\$866	11.4x	31%	49%	2.8x	\$90.00	5.3%	M	2
AK		\$116.85	49.0	5,725.7			\$15.20	\$16.81	13.0%		\$17.64	\$18.84	6.6x	6.2x	-	-	\$1,039	5.5x	-	-	-	\$145.00	40.6%	H	1
BL		\$5.72	59.3	338.9			\$0.63	\$0.73	11.0%		\$0.85	\$0.86	6.7x	6.7x	74%	100%	\$59	7.4x	74%	100%	1.8x	\$7.70	45.6%	H	2
BL		\$15.00	75.9	1,138.5			\$1.08	\$1.08	7.2%		\$1.10	\$1.07	13.6x	14.0x	98%	98%	\$107	12.4x	98%	98%	1.9x	\$15.50	10.5%	M	3
Float Weighted Averages																									
									6.2%			11.1x	9.5x	9.3x	41%	57%	1.9x					17.7%			

¹ CB = Chris Blake; TC = Tony Courtwright; BE = Brian Ector; MG = Murray Gainer; JKH = John Henderson; GH = Grant Hofer; HU = Himalaya Jain; AK = Alec Kodatsky; BL = Benoit Laprade; NM = Navdeep Malik; AM = Andrew Mitchell.
² Cash flow for REITs = funds from operations (FFO).
³ Payout ratio (%): Simple = (est. basic cash distributions net of com. debt interest); adj. = (est. basic cash distributions net of com. debt interest, before working capital); Adjusted = simple adjusted for analyst's estimate of maintenance and sustaining capital expenditure.
⁴ Net debt to assets for REITs; Net debt to EBITDA for Inter Pipeline, Pembina Pipeline, Superior Plus, and Keyera Facilities Income Fund.
⁵ Debt includes convertible debentures; debt/cash flow is net of com. debt interest expense.
⁶ Risk rankings from lowest to highest: Low, Medium, High, Caution Warranted, Venture.
⁷ Ratings: based on total return of each analyst's coverage universe by sector over the next 12 months: 1 = Sector Outperform; 2 = Sector Perform; 3 = Sector Underperform; R = Restricted.
 Source: Reuters; Scotia Capital estimates.

Appendix 2 – Income Trust Structures

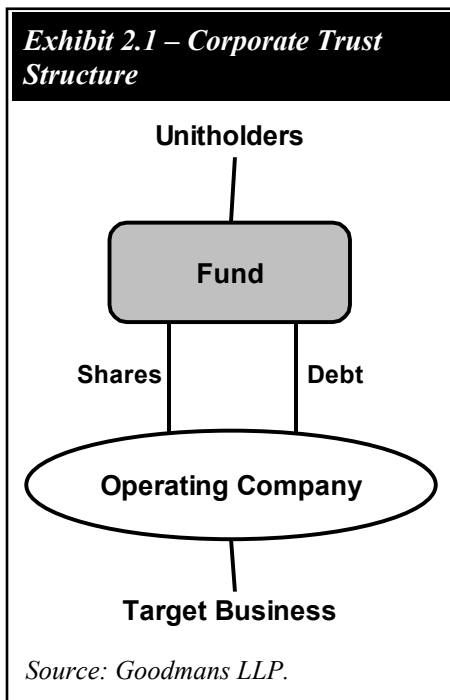
While income trust structures can be complicated, we have attempted to provide a summary of the key issues related to the primary structures in existence today. We would like to thank Goodmans LLP for their assistance in the preparation of this appendix.

Although the exact structure of an income trust will depend on a variety of factors, the basic objective of all income trusts is the same: to provide a more tax-efficient manner with which to distribute cash flow to investors. The structure is determined after considering a number of factors including, but not limited to: the type of business and nature of assets to be held by the income trust, the location of assets (Canada, United States, or elsewhere), the retained interest to be held by existing equityholders, the income projections of the business, and the trust's future growth and acquisition strategy.

Generally, an income trust is structured to qualify as a mutual fund trust for tax purposes. In order to be considered a mutual fund trust, the fund must:

- Qualify as a “unit trust” that is resident in Canada (a unit trust is an inter vivos trust with investors' interests expressed in units);
- Limit its activities to the passive investing of its funds;
- Comply with certain conditions with respect to distribution and ownership of fund units; and
- Not be established primarily for the benefit of non-residents.

Corporate Trust Structure (“Trust-on-Corporation”)



Essentially, these income trusts are structured such that proceeds from a public offering are invested in some combination of equity and interest-bearing debt of a subsidiary operating company (Exhibit 2.1). The interest payments on the debt effectively serve to reduce the taxable income, and therefore taxes payable, of the underlying operating company. The fund then uses the interest and dividend payments received to pay distributions to unitholders.

The amount of debt used in the structure is determined after considering the taxable income projections of the underlying business. Based on these projections, a level of debt is put in place that should effectively shelter much of the taxable income generated. However, if the actual performance of the business is much better than initially projected, the interest payments on the debt may not completely offset the taxable income of the underlying company, resulting in tax leakage. Therefore, the corporate trust structure works well for stable businesses that do not have significant organic growth potential.

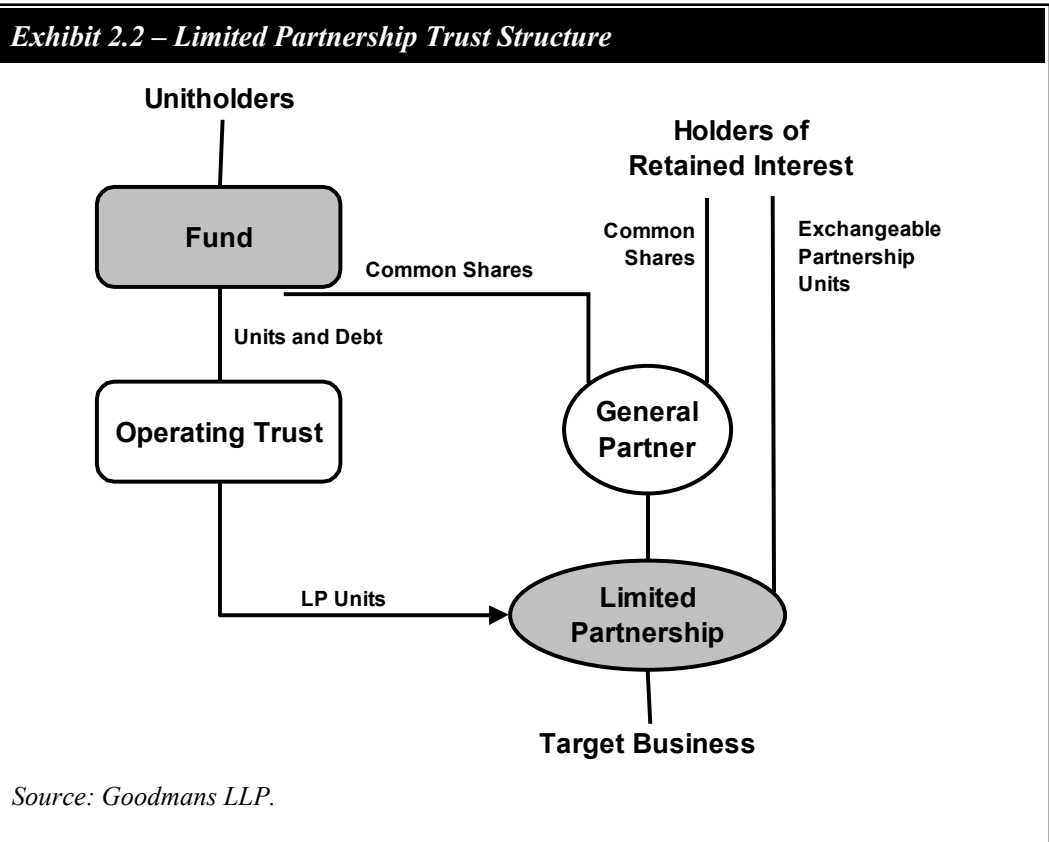
Limited Partnership Trust Structure (“Trust-on-Trust-on-LP”)

Under this structure, the underlying business is held by a limited partnership, which is essentially a flow-through vehicle for tax purposes (Exhibit 2.2). That is, a partnership is not a taxable entity in and of itself, but rather its individual partners are subject to tax on their portion of income. As a result, this structure provides a more tax-efficient manner of distributing income to unitholders without the need for interest payments on debt.

Another benefit of this structure is that it provides an effective method by which previous equityholders may hold an interest upon reorganization of a business into a trust structure. The general partner holds an interest in the business and is responsible for managing the activities of the partnership.

The income generated by the underlying business flows through the limited partnership to a “middle trust,” and then to a “top trust” through which it is passed to unitholders. The middle trust layer served primarily to ensure that the trust would not be considered foreign property in registered plans, but following developments contained in the 2005 federal budget, this requirement is no longer necessary. However, the middle trust layer is still useful, as it allows the trust to execute acquisitions and provides existing equityholders of the target business with a tax deferral mechanism.

The limited partnership trust structure addresses the issue of tax leakage for organically growing businesses and, as a result, has become the most common structure to establish an income fund for Canadian businesses. To date, one trust (Davis + Henderson Income Fund) has reorganized from the corporate trust structure to the limited partnership trust structure, and we believe certain other trusts may be considering doing the same.



Cross-Border Income Securities

In 2002 and 2003, the Canadian income fund market evolved to include trusts based primarily on U.S. assets. Initially, these businesses were structured as fixed investment trusts (FITs). FITs use a combination of equity and debt to shift cash flow from the underlying U.S. operating business to Canadian income trust unitholders in a tax-efficient manner. Essentially, interest payments on the debt reduce taxable income, and therefore taxes payable, by the U.S. operating company. Concerns arose in late 2003 that the U.S. Internal Revenue Service (IRS) might characterize the debt as equity and therefore challenge the deductibility of interest. This created considerable uncertainty surrounding trusts structured as FITs and, as a result, a different structure is now used to hold U.S. assets.

Cross-border trusts are now generally referred to as “income securities” and are structured to consist of a dividend-paying common share and a high-yield interest-bearing note that are “clipped” together. The two components initially trade as a single unit but are separable into their underlying components at the option of the holder after a certain amount of time. This separability increases the likelihood that the IRS will not re-characterize the debt component as equity, thus allowing interest payments to offset taxable income at the operating level.

Income securities may be issued for a Canadian business; however, they have mainly been used to structure U.S. businesses into an income trust-like product. Depending on certain structural nuances, these products are then marketed either primarily to U.S. investors or primarily to Canadian investors. While the structure was initially developed to export the business trust concept to U.S. investors, it has had more success bringing U.S. businesses to the Canadian market.

In December 2003, the first income security deal was completed for Centreplate (formerly Volume Services America Holdings), the majority of whose investors were located in the United States. Since that time, the majority of income securities offerings have been targeted to Canadian investors. These include Medical Facilities Corporation, Atlantic Power Corporation, Student Transportation of America, Keystone North America, and FMF Capital Group.

Cross-border income securities have two basic structures: a flow-through structure and a “C” corporation structure (Exhibits 2.3 and 2.4). The flow-through structure is used when the target business is currently owned by a flow-through entity, while the “C” corporation structure is used when the target business is already owned by a U.S. “C” corporation.

Exhibit 2.3 – Cross-Border Flow-Through Structure

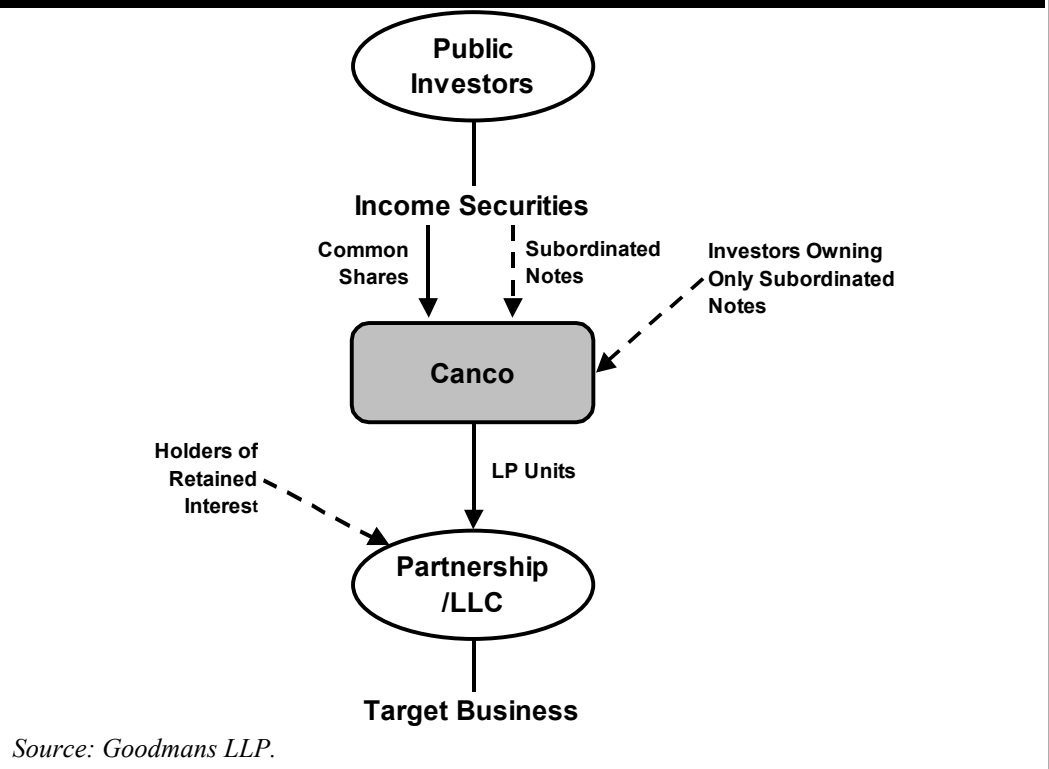
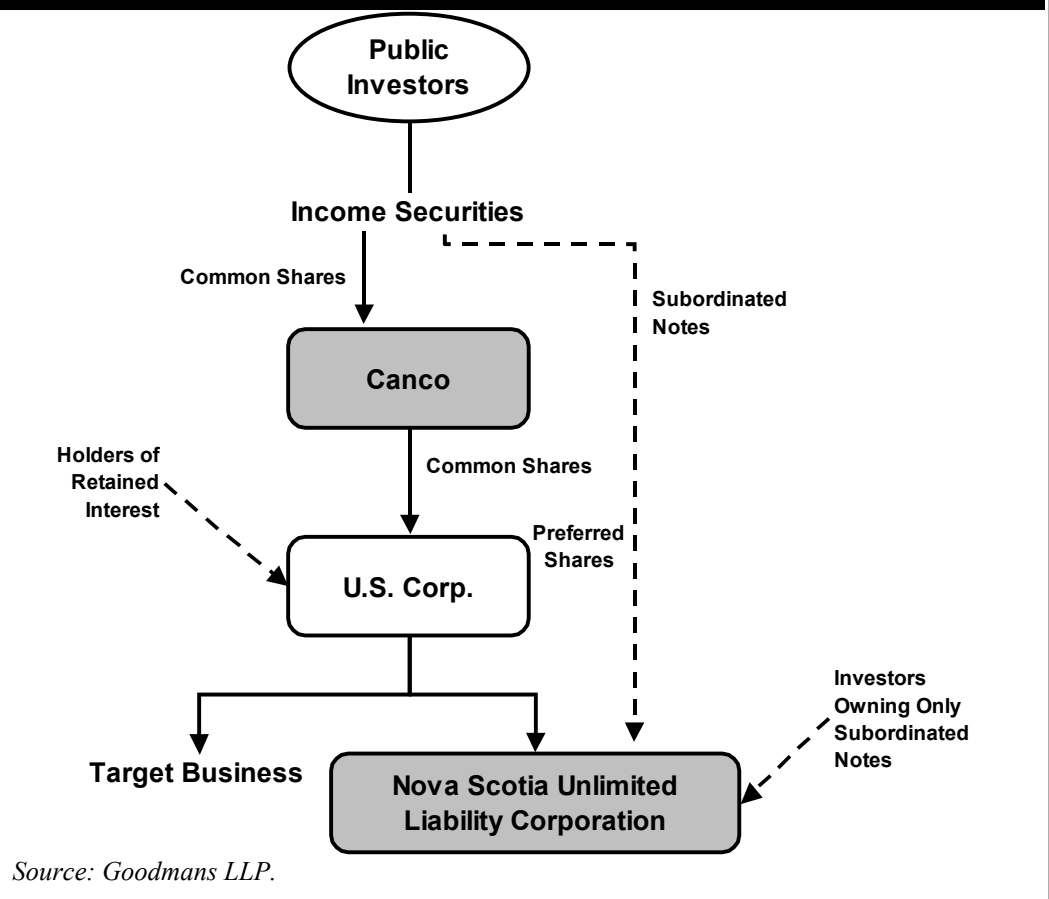
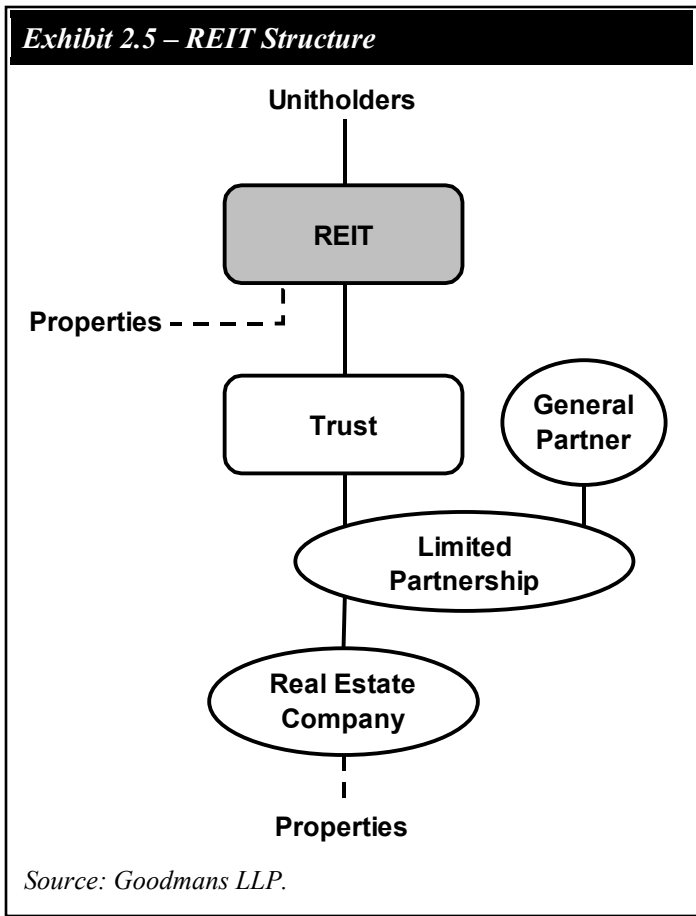


Exhibit 2.4 – Cross-Border “C” Corporation Structure





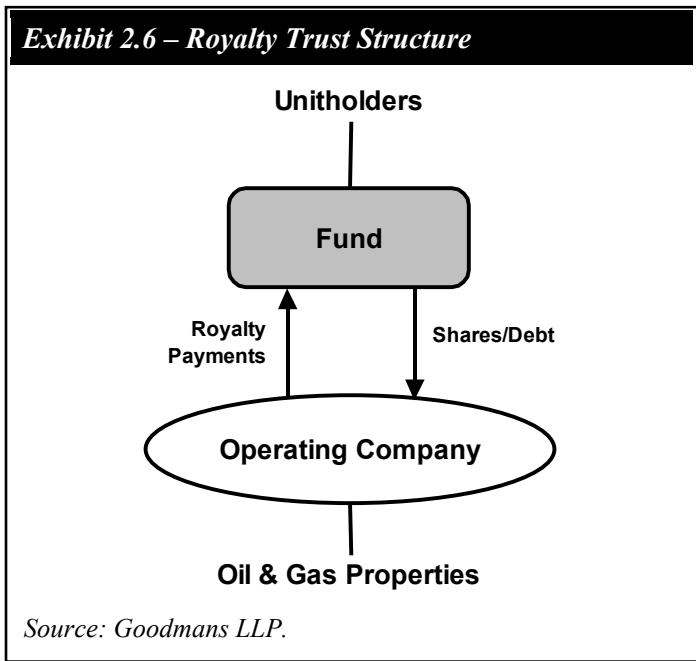
Real Estate Investment Trusts (REITs)

REITs may own a direct interest in a variety of income-producing properties. Unlike other trusts, which establish a wholly owned subsidiary, REITs can hold a direct investment in real estate assets. REITs are typically not able to directly undertake development activities or carry on an operating business; however, a subsidiary of the REIT (i.e., a corporation or limited partnership) may undertake these activities. In recent years, REIT structures have evolved to resemble other income trust structures (Exhibit 2.5).

Oil and Gas Royalty Trusts

Oil and gas royalty trusts were designed to allow investors to participate in the cash generated from producing oil and gas properties. The trust holds a tax-deductible royalty on the assets of the operating company (Exhibit 2.6). Cash is generated in the form of royalty payments on the producing assets, and the principal and interest on debt held by the trust.

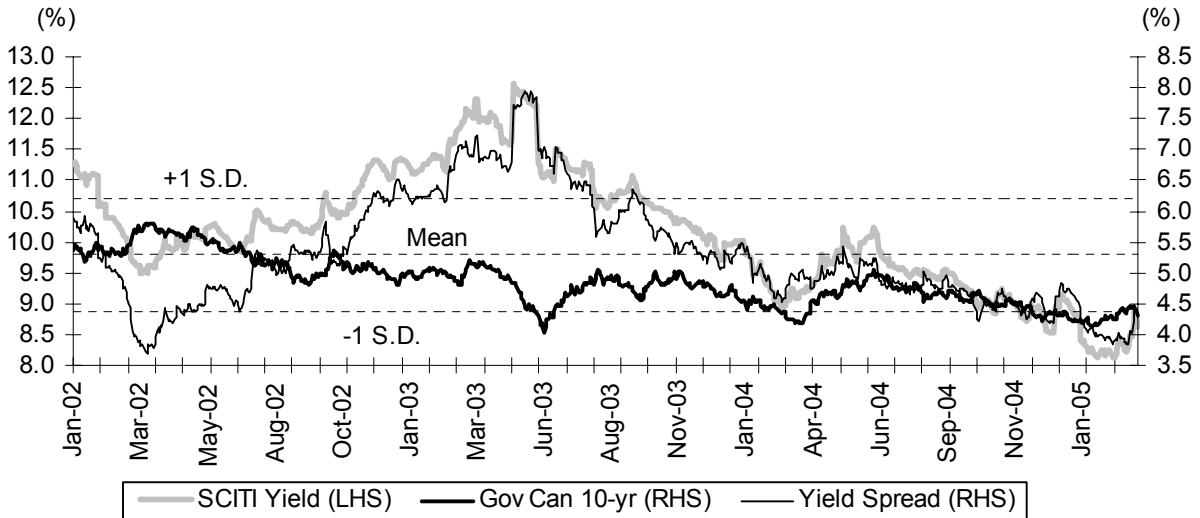
Tax credits inherent to oil and gas producing properties (i.e., resource allocation deductions, Canadian oil and gas expense, Canadian development expense, and capital cost allowance) flow through to unitholders to reduce the taxable portion of distributions.



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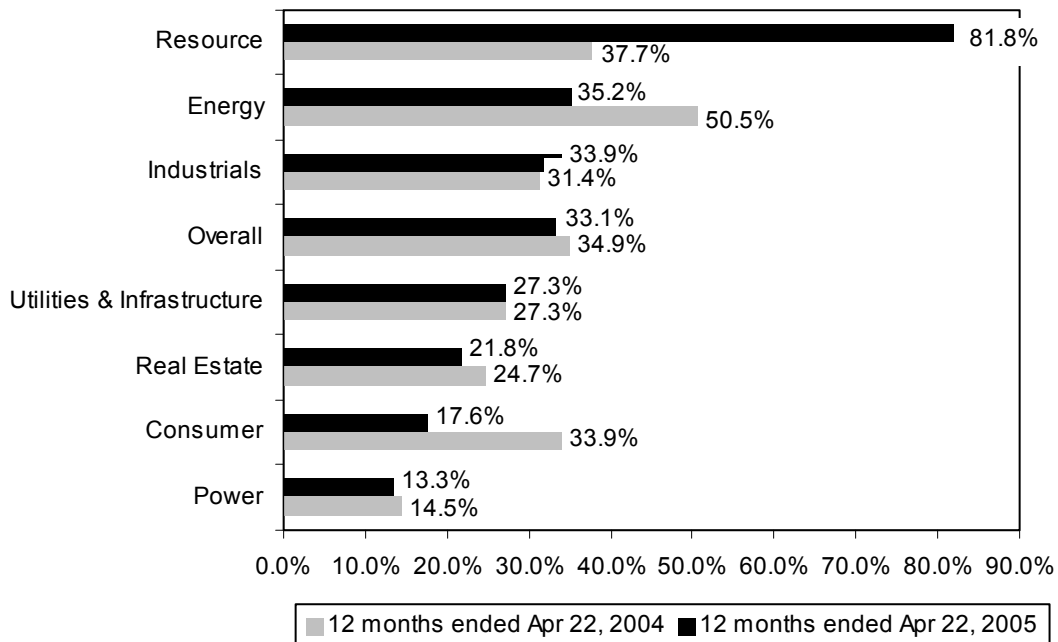
Appendix 3 – Income Trust Returns

Exhibit 3.1 – SCITI Yield Spreads over Government of Canada 10-Year Bond Index



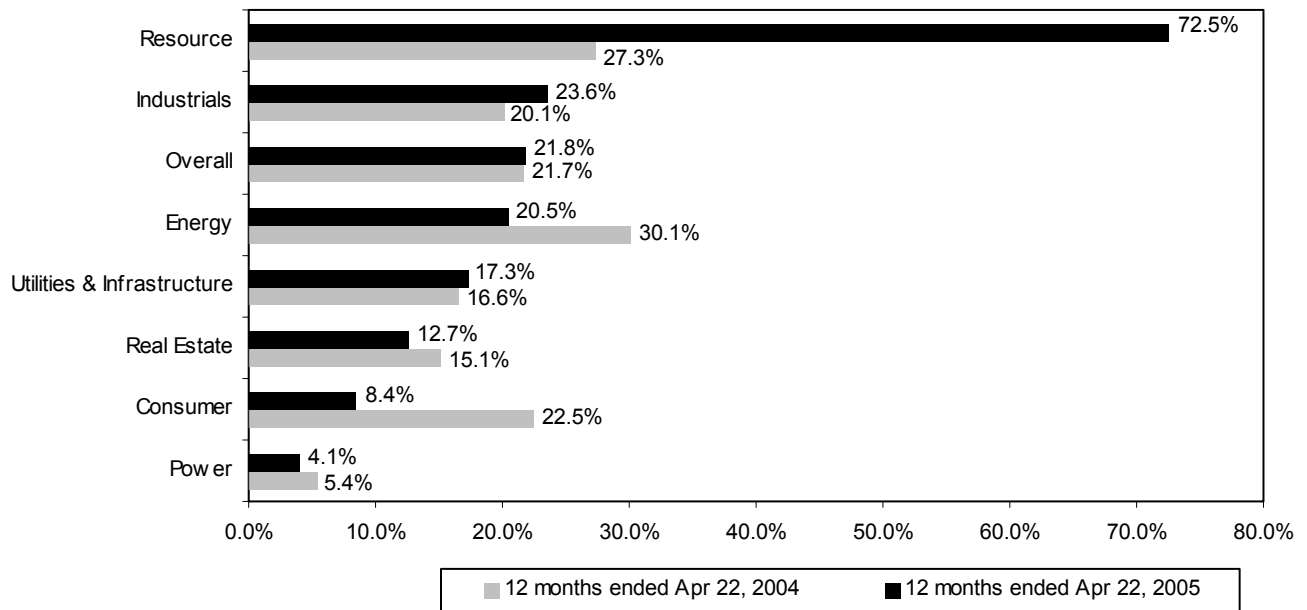
Source: Bloomberg; Global Insight, Inc.; Scotia Capital.

Exhibit 3.2 – SCITI 12-Month Total Return Performance



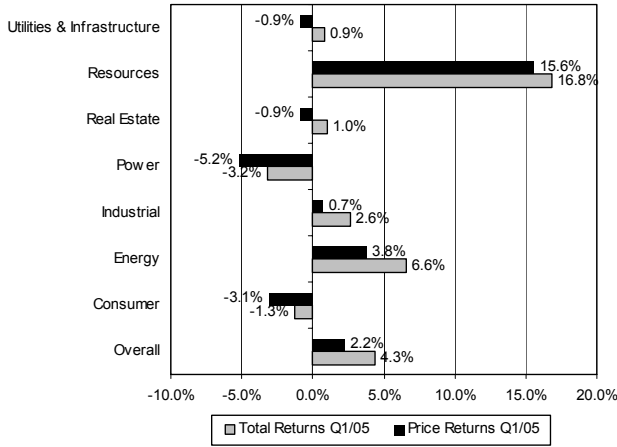
Source: Bloomberg; Global Insight, Inc.; Scotia Capital.

Exhibit 3.3 – SCITI 12-Month Price Return Performance



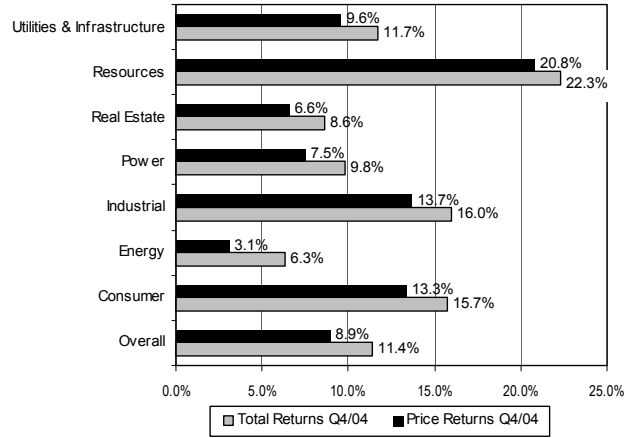
Source: Bloomberg; Global Insight, Inc.; Scotia Capital.

Exhibit 3.4 – Returns for Quarter Ended 3/31/2005



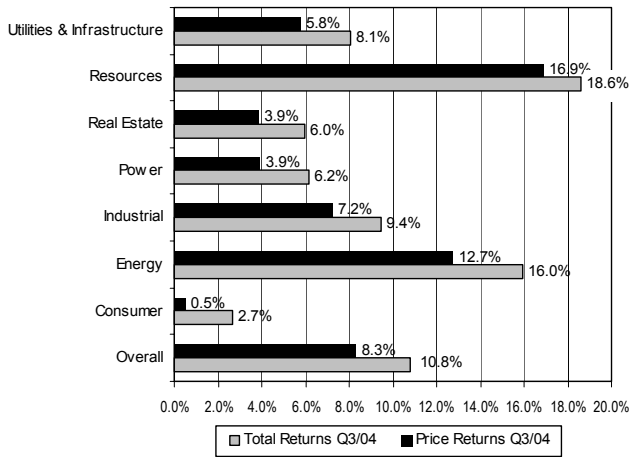
Source: Reuters; Scotia Capital; Global Insight, Inc.

Exhibit 3.5 – Returns for Quarter Ended 12/30/2004



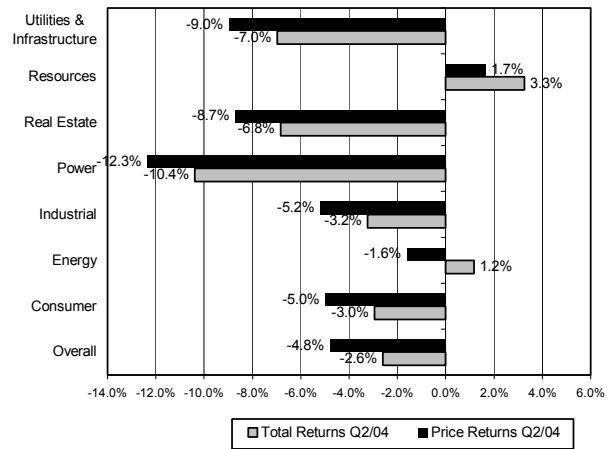
Source: Reuters; Scotia Capital; Global Insight, Inc.

Exhibit 3.6 – Returns for Quarter Ended 9/30/2004



Source: Reuters; Scotia Capital; Global Insight, Inc.

Exhibit 3.7 – Returns for Quarter Ended 6/30/2004



Source: Reuters; Scotia Capital; Global Insight, Inc.

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Appendix 4 – Scotia Capital Income Trust Indices

Description

The Scotia Capital Income Trust Index (SCITI) has been developed to track the performance of all eligible listed income units (Trusts, LPs, Income Participating Shares (IPS) of a Corporation) trading on the Toronto Stock Exchange (TSX). These indices are available on **SC Online** in the **equity section** under the **Tools and Indices** header. The following rules, which govern the calculation of the SCITI, came into effect on October 17, 2002. At present, the SCITI includes 181 issuers with a total float capitalization of \$119 billion (see Exhibit 4.1).

Purpose of the Index

The purpose of SCITI is to track the performance of the income trust sector in Canada. It is a viable benchmarking tool for investments in income units and for analysts covering the sector.

Eligibility Criteria

The following rules govern inclusion of any income trust in the SCITI.

1. The income unit must be listed on the TSX. Eligible constituents include those income units that are of a Canadian domiciled entity (Trust, Corporation, LP, etc.). Income Depository Units (IDS) of U.S. domiciled entities, which are inter-listed, will not be included in the index.
2. TSX Venture Exchange-listed trusts are not eligible for inclusion in the index.
3. The units must have underlying operations supporting their cash flows. Trusts of trusts are not eligible for inclusion in the index.
4. For IPOs, a listing period of one month is applicable before inclusion. Scotia Capital may decide to waive the waiting period for exceptionally large IPOs, in excess of 5% of the total float cap of the index. All new constituents will be added to the index after close on the last day after the one-month waiting period.
5. Index constituents will be immediately removed from the index upon de-listing.
6. In case of mergers and acquisitions, the requisite changes will be made on the first day that the transaction is known to be successful.

Calculation Criteria

A price and total return index as well as yields are being calculated for the overall index and each sub-index. The indices are float cap weighted using the following:

1. The daily closing price of each trading unit.
2. Number of float units outstanding. Units only include one class of issuance for each constituent; however, any directly exchangeable shares/units are added in the float. All control blocks of 20% or more are subtracted. Control blocks are assessed during quarterly reviews of the index. Any changes for quarterly reviews will be made after close on the last business day of March, June, September, and December.
3. Other changes to float units, due to buy-backs, distribution reinvestment plans, unit option plans, etc., will also be made during the quarterly review.
4. New issues of equity are adjusted on the day the offering closes.
5. For calculation of total return indices, all distributions are included on the ex-date.
6. The formulas for calculation of the index are as follows:

Total Return Indices

t is the date with business frequency.

price[t] is price of trust x on date t.

div[t] is distribution amount going Ex on date t.

Relwt[t] is the relative weight by float value of trust x on date t.

a[t] is the TRI for the index on date t.

$$a[t] = a[t-1] * (1 + (z))$$

$$Z = \sum_{x \in a} \text{Relwt}[t-1] * ((\text{price}[t] + \text{div}[t] - \text{price}[t-1]) / \text{price}[t-1])$$

Price Return Indices

t is the date with business frequency.

price[t] is price of trust x on date t.

Relwt [t] is the relative weight by float value of trust x on date t.

a[t] is the PRI for the index on date t.

$$a[t] = a[t-1] * (1 + (z))$$

$$Z = \sum_{x \in a} \text{Relwt}[t-1] * ((\text{price}[t] - \text{price}[t-1]) / \text{price}[t-1])$$

Yield

Yields for the SCITI and all sub-indices are also available on *SC Online*. The yield is calculated by annualizing the last available distribution. The yield of each trust is float cap weighted in the index. Historical data is available starting from January 2002.

t is the date with business frequency.

Relwt [t] is the relative weight by float value of trust x on date t.

Dist [t] is the last distribution.

Freq is the frequency of the distribution (monthly or quarterly).

a[t] is the yield for the index on date t.

$$a[t] = \sum_{x \in a} \text{Relwt}[t] * \text{Dist}[t]$$

Sub-indices

The Scotia Capital Income Trust Indices constitute the overall SCITI and the following seven sub-indices.

- a) **Energy** – This sub-index includes all oil & gas royalty trusts. The exception to this is Canadian Oil Sands (COS.UN), which has crude oil as the driver of its business model. However, we distinguish it from conventional oil & gas trusts, which face a depleting asset base. As such, we view Canadian Oil Sands as resource trust (primarily a mining operation). The SCITI Energy Sub-index excludes trusts that do not have direct *exposure* to commodity prices (such as Energy Service or Equipment trusts), which are classified as industrial trusts.
- b) **Real Estate** – This sub-index includes all REITs.
- c) **Utilities and Infrastructure** – This sub-sector encompasses constituents that operate pipelines or hold other infrastructure assets, or have the business characteristics of a utility.
- d) **Power** – This sub-index includes all eligible entities that operate as independent generators of electricity.
- e) **Resources** – This sub-index includes units of entities that have a direct exposure to a variety of commodities. Included in this sector are pulp & paper, as well as metal & mining trusts. As described above, Canadian Oil Sands has been included in this sub-sector.
- f) **Industrial** – This sub-index includes all constituents that manufacture and distribute capital goods, building products, equipment and machinery, and other commercial product and service sales. This sector includes oil & gas services, as well as publishing and printing companies that have the commercial sector as their main customers (source of revenue).
- g) **Consumer** – This sub-index includes both Discretionary and Staples. Consumer discretionary companies are those that are more sensitive to economic cycles, such as household durable goods and leisure equipment and services. Consumer staples include businesses that are less sensitive to economic cycles, such as food and beverage producers and distributors, as well as non-durable goods. Eligible Healthcare entities are also included in this sub-index, as they are sensitive to consumer demand for their products/services.

The constituents are categorized into various sub-indices depending on their business model and customer base. Membership of each sub-index and its relative weight is available on *SC Online*.

Exhibit 4.1 – Constituents of Scotia Capital Income Trust Index

Ticker	Name	Float Cap (\$ M)	Wt. In Index
Energy			
AE.UN	Acclaim Energy Trust	\$1,572.1	1.32%
AVN.UN	Advantage Energy Income Fund	\$1,130.5	0.95%
AY.UN	APF Energy Trust	\$730.9	0.61%
AET.UN	ARC Energy Trust	\$3,380.9	2.84%
AVF.UN	Avenir Diversified Income Trust	\$209.7	0.18%
BTE.UN	Baytex Energy Trust	\$990.7	0.83%
BNP.UN	Bonavista Energy Trust	\$2,361.1	1.98%
BNE.UN	Bonterra Energy Trust	\$373.2	0.31%
CPG.UN	Crescent Point Energy Trust	\$622.7	0.52%
DAY.UN	Daylight Energy Trust	\$477.2	0.40%
ERF.UN	Enerplus Resources Fund	\$4,749.1	3.99%
ENT.UN	Enterra Energy Trust	\$721.6	0.61%
EEE.b	Esprit Energy Trust	\$498.9	0.42%
FET.UN	Focus Energy Trust	\$744.2	0.63%
FRU.UN	Freehold Royalty Trust	\$339.3	0.29%
HTE.UN	Harvest Energy Trust	\$1,021.2	0.86%
KER.UN	Ketch Resources Trust	\$582.7	0.49%
NAE.UN	NAL Oil & Gas Trust	\$982.8	0.83%
NVG.UN	NAV Energy Trust	\$290.0	0.24%
PTF.UN	Petrofund Energy Trust	\$1,788.0	1.50%
PMT.UN	Paramount Energy Trust	\$805.6	0.68%
PGF.B	Pengrowth Energy Trust	\$2,726.0	2.29%
PEY.UN	Peyto Energy Trust	\$2,439.1	2.05%
PWI.UN	PrimeWest Energy Trust	\$2,115.5	1.78%
PGX.UN	Progress Energy Trust	\$1,071.0	0.90%
PVE.UN	Provident Energy Trust	\$1,885.9	1.58%
SHN.UN	Shiningbank Energy Income Fund	\$1,182.2	0.99%
SPN.UN	Starpoint Energy Trust	\$555.9	0.47%
TKE.UN	TKE Energy Trust	\$206.1	0.17%
VET.UN	Vermilion Energy Trust	\$1,404.8	1.18%
VKR.UN	Viking Energy Royalty Trust	\$1,165.6	0.98%
ZAR.UN	Zargon Energy Trust	\$448.9	0.38%
Total Energy		\$39,573.3	33.2%
Resource			
COS.UN	Canadian Oil Sands Trust	\$7,922.9	6.66%
FDG.UN	Fording Canadian Coal Trust	\$4,209.2	3.54%
LIF.UN	Labrador Iron Ore Royalty Income Fund	\$750.4	0.63%
NIF.UN	Noranda Income Fund	\$459.4	0.39%
SFK.UN	SFK Pulp Fund	\$343.7	0.29%
GRO.UN	Sun Gro Horticulture Income Fund	\$182.6	0.15%
TWF.UN	TimberWest Forest Corporation	\$1,153.6	0.97%
Total Resource		\$15,021.7	12.6%
Power			
APF.UN	Algonquin Power Income Fund	\$680.2	0.57%
ATP.UN	Atlantic Power Corporation	\$395.6	0.33%
BPT.UN	Borex Power Income Fund	\$462.1	0.39%
CF.UN	Calpine Power Income Fund	\$626.1	0.53%
CLE.UN	Clean Power Income Fund	\$256.1	0.22%
COU.UN	Countryside Power Income Fund	\$137.6	0.12%
GLH.UN	Great Lakes Hydro Income Fund	\$451.4	0.38%
IEF.UN	Innergex Power Income Fund	\$264.1	0.22%
MPT.UN	Macquarie Power Income Fund	\$231.8	0.19%
NPI.UN	Northland Power Income Fund	\$637.3	0.54%
TPW.UN	TransAlta Power, LP	\$674.5	0.57%
TPL.UN	TransCanada Power, LP	\$1,133.1	0.95%
Total Power		\$5,949.7	5.00%

Note: Prices as of April 22, 2005.

Source: Scotia Capital; Reuters; Global Insight, Inc.

Exhibit 4.1 – Constituents of Scotia Capital Income Trust Index (cont'd)

Ticker	Name	Float Cap (\$ M)	Wt. In Index
Consumer			
AW.UN	A & W Revenue Royalties Income Fund	\$104.4	0.09%
AG.UN	Arctic Glacier Income Fund	\$271.4	0.23%
AIM.UN	Art In Motion Income Fund	\$55.6	0.05%
ABF.UN	Associated Brands Income Fund	\$90.1	0.08%
BR.UN	Big Rock Brewery Income Fund	\$106.2	0.09%
BPF.UN	Boston Pizza Royalties Income Fund	\$132.2	0.11%
BRK.UN	The Brick Group Income Fund	\$460.1	0.39%
CGX.UN	Cineplex Galaxy Income Fund	\$289.1	0.24%
CLR.UN	Clearwater Seafoods Income Fund	\$232.6	0.20%
CLC.UN	CML Healthcare Income Fund	\$1,148.0	0.96%
CBF.UN	Connors Brothers Income Fund	\$987.7	0.83%
CDI.UN	Custom Direct Income Fund	\$267.4	0.22%
DHF.UN	Davis & Henderson Income Fund	\$858.9	0.72%
SIF.UN	Energy Savings Income Fund	\$1,626.2	1.37%
FC.UN	Firm Capital Mortgage Investment Trust	\$116.2	0.10%
GCI.UN	Gateway Casinos Income Fund	\$536.3	0.45%
GLF.UN	Golf Town Income Fund	\$148.1	0.12%
HEQ.UN	Home Equity Income Trust	\$168.8	0.14%
VEG.UN	Hot House Growers Income Fund	\$48.1	0.04%
KCP.UN	KCP Income Fund	\$341.3	0.29%
KEG.UN	Keg Royalties Income Fund	\$138.4	0.12%
LIQ.UN	Liquor Store Income Fund	\$104.1	0.09%
DR.UN	Medical Facilities Corporation	\$288.0	0.24%
MHG.UN	Medisys Health Group Income Fund	\$46.0	0.04%
MEW.UN	Menu Foods Income Fund	\$263.7	0.22%
FLM.UN	Movie Distribution Income Fund	\$236.8	0.20%
NWF.UN	North West Company Fund	\$467.7	0.39%
PKI.UN	Parkland Industries Income Fund	\$254.2	0.21%
PDM.UN	PDM Royalties Income Fund	\$62.2	0.05%
EAT.UN	Prime Restaurants Royalty Income Fund	\$60.1	0.05%
QSR.UN	Prizm Canadian Income Fund	\$216.9	0.18%
RNK.UN	Rainmaker Income Fund	\$42.6	0.04%
RSI.UN	Rogers Sugar Income Fund	\$372.9	0.31%
ROW.UN	Row Entertainment Income Fund	\$198.9	0.17%
RSF.UN	Royal Lepage Franchise Services	\$134.8	0.11%
SMN.UN	SCI Income Trust	\$96.7	0.08%
SCU.UN	Second Cup Royalty Income Fund	\$100.1	0.08%
SRV.UN	SIR Royalty Income Fund	\$59.2	0.05%
Z.UN	Sleep Country Canada Income Fund	\$265.5	0.22%
SOM.UN	Somerset Income Fund	\$99.2	0.08%
HAM.UN	Specialty Foods Group Income Fund	\$81.5	0.07%
SWS.UN	Swiss Water Decaffeinated Coffee Income Fund	\$90.8	0.08%
	Total Consumer	\$11,669.3	9.8%

Note: Prices as of April 22, 2005.

Source: Scotia Capital; Reuters; Global Insight, Inc.

Exhibit 4.1– Constituents of Scotia Capital Income Trust Index (cont'd)

Ticker	Name	Float Cap (\$ M)	Wt. In Index
	Industrials		
AYP.UN	ACS Media Income Fund	\$194.8	0.16%
AFT.UN	Advanced Fiber Technologies Income Fund	\$86.6	0.07%
AFN.UN	AG Growth Income Fund	\$127.1	0.11%
AIN.UN	Arriscraft International Income Fund	\$99.1	0.08%
ARF.UN	Armtec Infrastructure Income Fund	\$124.9	0.10%
FZR.UN	Atlas Cold Storage Income Trust	\$388.0	0.33%
BAD.UN	Badger Income Fund	\$170.5	0.14%
BET.UN	Builders Energy Services Trust	\$130.3	0.11%
BFC.UN	BFI Canada Income Fund	\$1,147.2	0.96%
BYD.UN	Boyd Group Income Fund	\$55.7	0.05%
CCR.UN	Canadian Crude Separators Income Fund	\$1,075.5	0.90%
CET.UN	Cathedral Energy Services Income Fund	\$115.3	0.10%
CHE.UN	Chemtrade Logistics Income Fund	\$352.1	0.30%
CSS.UN	Contrans Income Fund	\$363.9	0.31%
DGI.UN	The Data Group Income Fund	\$154.8	0.13%
DCI.UN	Direct Cash Income Fund	\$103.1	0.09%
FMO.UN	Foremost Industries Income Fund	\$73.6	0.06%
FP.UN	FP Newspapers Income Fund	\$47.0	0.04%
GDI.UN	General Donlee Income Fund	\$33.8	0.03%
GIF.UN	Gienow Windows & Doors Income Fund	\$182.0	0.15%
GLC.UN	Great Lakes Carbon Income Fund	\$363.6	0.31%
GBY.UN	Granby Industries Income Fund	\$81.1	0.07%
HAL.UN	Halterm Income Fund	\$43.6	0.04%
HWD.UN	Hardwoods Distribution Income Fund	\$181.6	0.15%
ACF.UN	IAT Air Cargo Facilities Income Trust	\$56.5	0.05%
IBG.UN	IBI Income Fund	\$55.3	0.05%
LIV.UN	Livingston International Income Fund	\$307.9	0.26%
NAL.UN	Newalta Income Fund	\$606.8	0.51%
OAX.UN	Oceanex Income Fund	\$141.3	0.12%
OSP.UN	Osprey Media Income Fund	\$190.0	0.16%
PBB.UN	PBB Global Logistics Income Fund	\$172.4	0.14%
PES.UN	Peak Energy Services Trust	\$213.1	0.18%
PHX.UN	Pheonix Technology Income Fund	\$82.4	0.07%
PRT.UN	PRT Forest Regeneration Income Fund	\$72.0	0.06%
RPI.UN	Richards Packaging Income Fund	\$118.9	0.10%
SPF.UN	Superior Plus Income Fund	\$2,312.9	1.94%
STB.UN	Student Transportation of America Ltd.	\$163.4	0.14%
SDG.UN	Stoneham Drilling Trust	\$112.4	0.09%
TI.UN	Terra Vest Income Fund	\$166.9	0.14%
TIF.UN	Transforce Income Fund	\$1,262.1	1.06%
TIL.UN	Tree Island Wire Income Fund	\$328.8	0.28%
TMA.UN	Trimac Income Fund	\$103.8	0.09%
TDG.UN	Trinidad Energy Services	\$543.1	0.46%
ICE.UN	Versacold Income Fund	\$203.2	0.17%
WTE.UN	Westshore Terminals Income Fund	\$791.8	0.67%
WLL.UN	Wellco Energy Services	\$134.6	0.11%
YLO.UN	Yellow Pages Income Fund	\$6,360.6	5.34%
	Total Industrials	\$20,195.4	17.0%

Note: Prices as of April 22, 2005.

Source: Scotia Capital; Reuters; Global Insight, Inc.

Exhibit 4.1 – Constituents of Scotia Capital Income Trust Index (cont'd)

Ticker	Name	Float Cap (\$ M)	Wt. In Index
REITs			
AN.UN	Alexis Nihon REIT	\$219.3	0.18%
AP.UN	Allied Properties REIT	\$199.5	0.17%
BEI.UN	Boardwalk REIT	\$759.8	0.64%
BRE.UN	Borealis REIT	\$452.3	0.38%
CWT.UN	Calloway REIT	\$690.8	0.58%
CAR.UN	Canadian Apartment Properties REIT	\$748.4	0.63%
REF.UN	Canadian REIT	\$1,044.5	0.88%
CSH.UN	Chartwell Seniors Housing Reit	\$634.2	0.53%
HOT.UN	Canadian Hotels Income Properties REIT	\$276.2	0.23%
CUF.UN	Cominar REIT	\$444.7	0.37%
D.UN	Dundee REIT	\$427.2	0.36%
HR.UN	H&R REIT	\$1,901.9	1.60%
INN.UN	Innvest REIT	\$531.9	0.45%
IUR.UN	IPC US REIT	\$449.7	0.38%
LGY.UN	Legacy Hotels REIT	\$572.2	0.48%
MRT.UN	Morguard REIT	\$235.5	0.20%
NPR.UN	Northern Property REIT	\$287.8	0.24%
OYR.UN	O&Y REIT	\$527.5	0.44%
RRR.UN	Retirement Residences REIT	\$866.3	0.73%
RMM.UN	Retrocom Mid-Market REIT	\$105.0	0.09%
REI.UN	RioCan REIT	\$3,583.3	3.01%
RYL.UN	Royal Host REIT	\$154.4	0.13%
SMU.UN	Summit REIT	\$1,171.3	0.98%
SZR.UN	Sunrise Senior Living REIT	\$303.4	0.25%
NAR.UN	TGS North American REIT	\$207.9	0.17%
Total REITs		\$16,794.8	14.11%
Utilities & Infrastructure			
ALA.UN	Altagas Income Trust	\$1,277.9	1.07%
AMT.UN	Amtelecom Income Fund	\$82.8	0.07%
BNQ.UN	Bell Nordiq Income Fund	\$533.0	0.45%
CWI.UN	Consumers' Waterheater Income Fund	\$627.6	0.53%
ENF.UN	Enbridge Income Fund	\$269.7	0.23%
FCE.UN	Fort Chicago Energy Partners LP	\$1,301.6	1.09%
GZM.UN	Gaz Metro LP	\$685.8	0.58%
HIF.UN	Heating Oil Partners Income Fund	\$110.4	0.09%
IPL.UN	Inter Pipeline Income Fund	\$1,702.3	1.43%
KEY.UN	Keyera Facilities Income Fund	\$869.8	0.73%
PIF.UN	Pembina Pipeline Income Fund	\$1,427.1	1.20%
TAY.UN	Taylor Gas Liquids L.P.	\$381.0	0.32%
UWH.UN	UE Waterheater Income Fund	\$570.8	0.48%
Total Utilities & Infrastructure		\$9,839.6	8.27%
Total Index		\$119,043.8	100.0%

Note: Prices as of April 22, 2005.

Source: Scotia Capital; Reuters; Global Insight, Inc.

Notes

Appendix A – Important Disclosures

Company	Ticker	Disclosures*
Acclaim Energy Trust	AE.UN	P, U
Advantage Energy Income Fund	AVN.UN	U
Alexis Nihon REIT	AN.UN	T, U
Algonquin Power Income Fund	APF.UN	U
Allied Properties REIT	AP.UN	D2, T, U
APF Energy Trust	AY.UN	U
ARC Energy Trust	AET.UN	H6
Arctic Glacier Income Fund	AG.UN	T
Bell Nordiq Income Fund	BNQ.UN	S
Bonavista Energy Trust	BNP.UN	U
Calpine Power Income Fund	CF.UN	T, U
Canadian Oil Sands Trust	COS.UN	H3, P, H7
CAP REIT	CAR.UN	U
CHIP REIT	HOT.UN	U
Clean Power Income Fund	CLE.UN	U
Clearwater Seafoods Income Fund	CLR.UN	T, S, U
Cominar REIT	CUF.UN	T, H6, U
Consumers' Waterheater Income Fund, The	CWI.UN	S
Crescent Point Energy Trust	CPG.UN	S, U
Dundee REIT	D.UN	T, U
Enerplus Resources Fund	ERF.UN	H5, H, U
Focus Energy Trust	FET.UN	S
Fording Canadian Coal Trust	FDG.UN	P
Fort Chicago Energy Partners L.P.	FCE.UN	U
Freehold Royalty Trust	FRU.UN	U
Gateway Casinos Income Fund	GCI.UN	U
Gaz Metro Limited Partnership	GZM.UN	U
H&R REIT	HR.UN	U
Hardwoods Distribution Income Fund	HWD.UN	T
Inter Pipeline Fund	IPL.UN	U
IPC US REIT	IUR.UN	T, U
Keyera Facilities Income Fund	KEY.UN	P

Appendix A – Important Disclosures (cont’d)

Livingston International Income Fund	LIV.UN	U
Northern Property REIT	NPR.UN	U
Northland Power Income Fund	NPI.UN	U
O&Y REIT	OYR.UN	U
Osprey Media Income Fund	OSP.UN	S
Paramount Energy Trust	PMT.UN	U
Pembina Pipeline Income Fund	PIF.UN	H6, S
Pengrowth Energy Trust	PGF.B	U
Petrofund Energy Trust	PTF.UN	U
PrimeWest Energy Trust	PWI.UN	U
Progress Energy Trust	PGX.UN	U
Provident Energy Trust	PVE.UN	H, P, U
Retirement Residences REIT	RRR.UN	U
RioCan REIT	REI.UN	H, U
StarPoint Energy Trust	SPN.UN	U
Summit REIT	SMU.UN	U
Superior Plus Income Fund	SPF.UN	P, H6, H5
TransForce Income Fund	TIF.UN	U
Tree Island Wire Income Fund	TIL.UN	T, U
Vermilion Energy Trust	VET.UN	H5
Versacold Income Fund	ICE.UN	T, U
Viking Energy Royalty Trust	VKR.UN	U
Yellow Pages Income Fund	YLO.UN	H, U1, U

The following analysts certify that (1) the views expressed in this report in connection with securities or issuers they analyze accurately reflect their personal views and (2) no part of their compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed by them in this report: Grant Hofer, Brian Ector, Himalaya Jain, Tony Courtright, Navdeep Malik, Chris Blake, John Henderson, Murray Gainer, Alec Kodatsky, Andrew Mitchell and Benoit Laprade.

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Appendix A – Important Disclosures (cont'd)

* *Legend*

- D2** Dan Sullivan, a Managing Director and Deputy Chairman of Scotia Capital Inc., is a trustee of Allied Properties REIT.
- H** The Research Analyst/Associate, in his/her own account or in a related account, owns securities of this issuer under his/her coverage.
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- H5** The Risk Arbitrage Analyst/Associate, in his/her own account or in a related account, owns securities of this issuer.
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- P** This issuer paid a portion of the travel-related expenses incurred by the Research Analyst/Associate to visit material operations of this issuer.
- S** Scotia Capital Inc. and its affiliates collectively beneficially own in excess of 1% of one or more classes of the issued and outstanding equity securities of this issuer.
- T** The Research Analyst/Associate has visited material operations of this issuer.
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Definition of Scotia Capital Equity Research Ratings & Risk Rankings

We have a three-tiered rating system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe.

Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

Ratings

1-Sector Outperform

The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

2-Sector Perform

The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe by sector over the next 12 months.

3-Sector Underperform

The stock is expected to underperform the average total return of the analyst's coverage universe by sector over the next 12 months.

Other Ratings

Tender – Investors are guided to tender to the terms of the takeover offer.

Under Review – The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.

Risk Rankings

Low

Low financial and operational risk, high predictability of financial results, low stock volatility.

Medium

Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.

High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

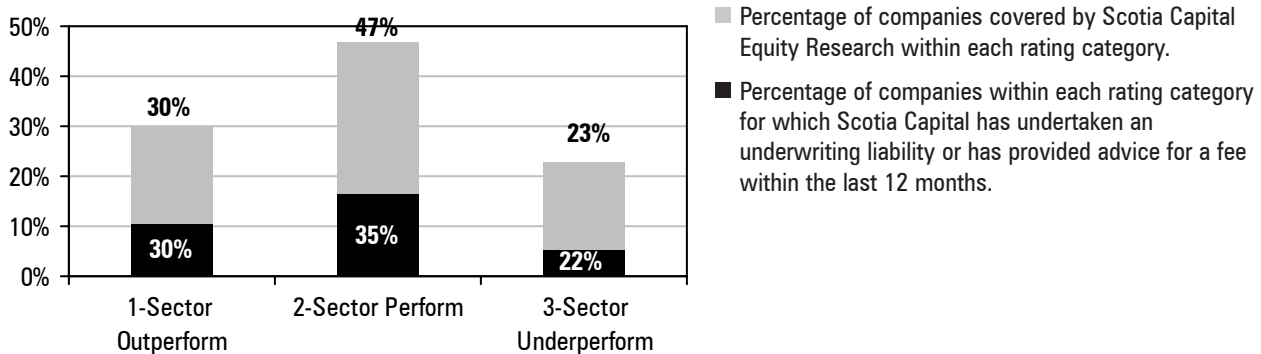
Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk-tolerant investors only.

Venture

Risk and return consistent with Venture Capital. For risk-tolerant investors only.

Scotia Capital Equity Research Ratings Distribution*

Distribution by Ratings and Equity and Equity-Related Financings*



*As at March 31, 2005.

Source: Scotia Capital.

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