The Wall Street Wish List — Company Addition

By Brady Willett & Todd Alway — Wish List 2006, January 2, 2006

The 'Wish List' is not direct investment advice: we the producers are private investors, not professional investment advisors. Please make your own final investment decisions.

Priszm Canadian Income Fund ~ QSR.UN (TSE)

Investment Position: Income

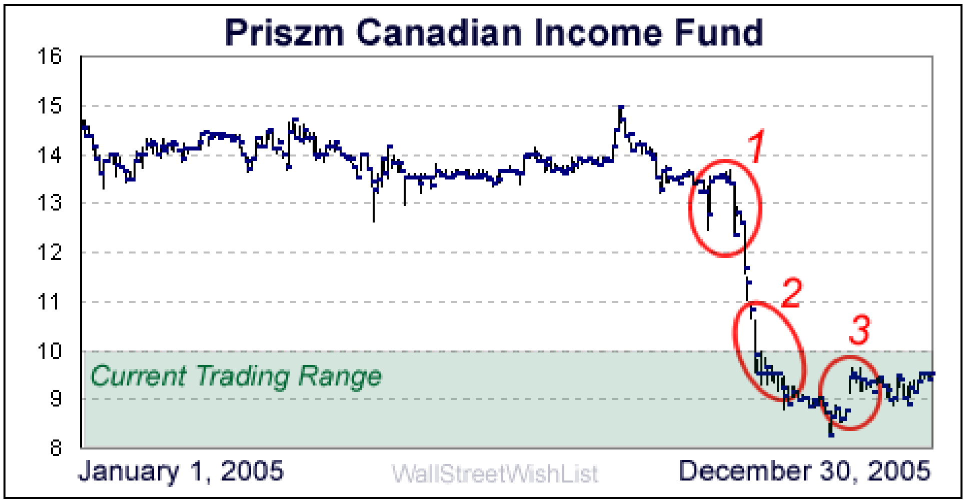
To note: Canadian income trusts (sometimes called unit trusts, royalty trusts, or income funds) are generally regarded as attractive income investments because the trusts' income (save depreciation and future investment capital) is regularly dispersed to unit-holders in the form of distributions. Beyond this income advantage, it should be noted that since trusts strive to pay no taxes, taxation occurs at the unitholder level. Please be fully aware of these tax implications and/or if you are not a Canadian investor please be aware of all the implications of buying any Canadian security. For the purposes of the Wish List, we will be recording the % gain/loss on the units as well as the % gain *less taxes* from any future distributions.

Investment Overview

We believe that Priszm, which operates Kentucky Fried Chicken (KFC) restaurants, can produce attractive returns for unitholders in 2006 by continuing to do what it has been doing since its IPO: 'multi-branding'. The company's multi-branding process is primarily accomplished by adding a new brand (primarily Taco Bell) to an existing KFC restaurant.

Although monthly distributions are ultimately decided by the performance of the company, we believe, and the company has indicated, that distributions will decline in 2006 compared to 2005. This is the case not only because the company's 2005 payout ratio (non GAAP) is above distributable cash, but also because new capital spending initiatives are expected to arrive primarily at the beginning of the 2006, or when business is seasonally soft. With that said, distributions should remain stable through the seasonally stronger summer months as the company benefits from more multi-branded stores coming online, lower store maintenance costs (compared to 2005), and, potentially, a turnaround in the company's weak Quebec operations.

We are selecting Priszm as an income investment leading into 2006 at $9.50 a share, or, preferably, on unit price weakness. Based on general technical indicators, we would not be enthusiastic about purchasing units, which can be illiquid, at or above $10 per unit. Our expected trading price range leading into 2006 is between $8.00-$10.00 per unit. This expectation is a general guide; it should be remembered that Priszm units can be influenced not only by the fundamental results of the business, but by investor sentiment (which can be extra volatile in the trust market), political dealings, inflation, and Canadian interest rates.



1. Sept 8, 05: Starting on September 8 with a 'White Paper' suggesting the government was losing $300+ million by not taxing trusts, and reaching a point of panic in late September with the Department of Finance suspending advance tax rulings on trusts, the Canadian trust market was thrown into dissaray. Priszm units lost more than 20% of their value.

2. Oct 14, 05: Weaker than expected quarterly earnings report adds to downwards unit price momentum.

3. Nov 23, 05: In a surprise announcement, the Canadian governments says that they will not tax trusts. The investment trust market rallies strongly. Priszm units jump by 8% in a day.

Trust Overview and Business Focus

The Priszm Canadian Income Fund was created on November 30, 2003 with a $150 million IPO priced at $10 per unit. Through its 60% interest in KIT Limited Partnership the company is the largest independent owner and operator of quick service restaurants by number of units in Canada. Unlike the structure of a Royalty trust or REIT, Priszm owns and operates the 480 restaurants.

After purchasing 120,000 units for approximately $1.17 million in the open market on December 12, 2005 ($9.36/unit average), the company's Chairman and CEO, John I. Bitove, now owns 40.37% of the units outstanding. It should be noted that Mr. Bitove also has controlling interest of Scott's REIT (which recently took over the Priszm's leases). All told, the trust has 25.82 million outstanding units. For an in-depth description of Fund Units (which include Exchangeable and Subordinate units) see the company's 2004 Annual Report filed at SEDAR.com (pg. 31).

Fund Units	15,550,000
Exchangeable Units	5,106,000
Subordinated Units	5,164,000
Total F, E, and S Units	**25,820,000**

As of 3Q05, the company had branded 9 new stores in 2005, with another 12 expected before year end or in early 2006. Total branded stored as of 3Q05 stood at 69, versus 411 stand alone stores. As per the company's latest conference call, the focus remains on adding Taco Bells to existing KFC stores. Management is taking a wait and see approach with its Pizza Hut and Long John Silver concepts.

Controlling 90% of the fried chicken occasion market in Canada, the company is quite right to say that 'KFC is Chicken in Canada'. Along with the Trust's focus on multi-branding its KFC assets to give customers more choice, the Taco Bell franchise is supposed to be the growth story. Some of the headline grabbing statistics in the company's 2004 annual report are that there is 220 Taco bells for every 1 million Americans in the United States versus 4 Taco bells for every 1-million Canadians, and that Taco Bell is already number 1 in Canada for Mexican Style.

The bullish statistics and viewpoint Priszm offers relating to Taco Bell, while by no means inaccurate, say little about a potentially dangerous fast food spending trend that has emerged in recent years: that being increased competition based upon price. Suffice to say, the growth potential for KFC and Taco Bell is well apparent in Canada, and mutli-branding has shown cost and return advantages over opening new stores. But at the end of the day Priszm has benefited not so much by its stable fast food brands, but by effective marketing and high growth discount products (i.e. KFC's Colonel's Snacker for $1.59 was a massive hit in 2005, to the point that the company could not stock enough supply for the demand).

Financially Speaking

In a recent report the Accountability Research Corporation said that three-quarters of Canadian investment trusts are paying out more than their net income. Unfortunately, after a weak start to 2005, Priszm falls into this category right now, as the distributions are running at a 111% of distributable cash (2005 year to date).

Non GAAP	3Q05	2Q05	1Q05	2004	3Q04	2Q04	1Q04
Payout ratio	89%	65%	389%	93%	62%	62%	227%

Incidentally, the term 'payout ratio' is non GAAP, and its methodology is determined – and can be changed – by the company. This is not an uncommon practice for an investment trust, but it does deserve some discussion.

Payout Statistics - Quarter ended (000s)	4-Sep-05	12-Jun-05	20-Mar-05
Cash provided by operating activities	10,328	9,281	2,988
Maintenance capital expenditures (non GAAP)	1,202	955	889
Distributable cash (non GAAP)	9,126	8,326	2,099
Distributions made (non GAAP)	8,133	5,422	8,133
Payout ratio (non GAAP)	89%	65%	389%
Purchase of P&E (From Cash Flows - capex)	5,072	6,375	2,819
Distributions (Income Statement)	6,507	4,388	6,507

As per the above statistical highlights, distributed cash (in the income statement) differs materially from the company's non GAAP distributed cash (see orange lines). This is because payouts to subordinate units (made quarterly not monthly) are estimated in the non GAAP figures but do not necessarily show up in the quarterly income statement. There is no glaring problem with this practice as the non GAAP numbers represent a more accurate reading of total payouts to investors.

Next, how the company calculates maintenance and capital expenditures differs materially from actual capital investments (see yellow lines). Under normal circumstances it would be outright fraud for a company to claim that capex is running at $1.2 million when actual capex (in statement of cash flows) is at more than $5 million. However, the figure Priszm uses to calculate capex insofar as distributions are concerned is the normal cost of sustaining existing business, not the added capital expenditures that arise from new store purchases and multi-branding. If this sounds confusing don't worry, it is, and this is a running theme in investment trusts -- exactly what is distributable cash?

The way we simplify the capital spending conundrum is to separate maintenance capital expenditures from all other capital expenditures on a quarterly basis and label this gap burn rate. What the burn rate tells us is how much the company is spending on growing the business from a capital spending perspective. Priszm's recent burn rates are highlighted below and, when compared to the trust's balance sheet, the trend strongly suggests that the company's current project of securing more flexible funding is prudent. These numbers do not necessarily carry with them negative or positive connotations – it takes capital investment to make stronger returns – but they do warrant close monitoring. Unfortunately due to accounting and distribution methodology changes, statistics for 2004 can not be calculated.

Capital Spending/Funding Trends (000s)	4-Sep-05	12-Jun-05	20-Mar-05	31-Dec-04
Purchase of property and equipment	5,072	6,375	2,819	6,102
Maintenance capital expenditures	1,202	955	889	1,512
Difference = Capital expenditures for growth	3,870	5,420	1,930	4,590
Working Capital	-15,397	-12,379	-10,925	-2,942
4-Quarter Burn rate average	$3.93M per quarter to fund growth			
4-Quarter average decline in Working Cap	$4.43M per quarter taken from working capital			
3-Quarter Unitholders' Equity burn average	$2.81M hit to net equity per quarter			

Turning to returns, it should first be noted that the Company operates on a 13 period accounting basis, with the first three quarters consisting of 12 weeks and the fourth quarter consisting of 16 weeks. This is an annoying structure, supposedly adopted due to the seasonality of the business.

Regardless, the company is growing the business from a total sales and same store sales (SSS) perspective, and SSS for multi-branded stores have recently been explosive. Moreover, if you assume that some of the costs in the income statement (i.e. G&A) are associated with growing the business, it is safe to assume that margins could be a little higher if existing stores were the only focus.

Statistical Highlights	3Q05	2Q05	1Q05	4Q04	3Q04	2Q04	1Q04
Interest income	73	93	126	219	121	103	110
Interest expense	766	786	745	952	717	704	726
Income B4 non-controlling interest	6,449	5,398	-696	5,372	9,996	6,153	676
Non-controlling interest of Sub Units	1,289	1,080	139	na			
Net income for the period	5,160	4,318	-557	4,298	7,997	4,922	541
Deficit – End of period	16,134	14,787	14,767	na			
Gross Margins	40.8%	41.1%	39.3%	40.1%	42.2%	40.4%	39.4%
Net Margins	4.18%	3.79%	-0.57%	2.95%	6.63%	4.51%	0.549%
SSSG	0.60%	2.40%	-2.64%	na			
SSSG at Multi-branded	8.70%	4.90%	1.30%	na			
Revenues (y-o-y)	2.43%	4.26%	-1.64%	na			
Ads as a % of sales	6.96%	5.82%	4.60%	4.50%	5.00%	5.03%	5.00%
Equity per unit	6.864	6.916	6.916	7.190	na		
Tangible equity per unit	0.783	0.835	0.836	1.109	na		
Per share hit from capex for growth*	-0.15	-0.21	-0.07	-0.18	na		
Net quarterly change in t-equity	-0.05	-0.001	-0.27	na			

* Recent history says that if capex to fund growth stopped the net equity position of the company would stop declining.

Company hopes to continue to capitalize in 4Q05 from summer advertising campaign

Along with readily noticeable seasonal variations in margins, notice also that subordinate unit-holders get their piece before net income. This is not an immediate worry for the average unitholder, but with the company trying to land a new five year, fixed rate debt facility, it is an issue that warrants attention. Quite frankly, the subordinate unitholders are higher up on the food chain and if, under the very worst possible set of outcomes, the fund is starved for capital, unit-holders would not fare well (the same can said about common stock compared to preferred shares or bonds).

Before making it sound like the company is scrambling for money, it should be noted that even with the initial prospectus growth was always a precondition of funding:

"Our five-year capital plan envisions $92 million of investment. This capital is expected to come from the capital pool that was established at the inception of the Company, increased future earnings and increased borrowings."

Increased borrowing at Priszm is not a concern so long as the business returns remain positive and growing. On this front there has been some pessimism in 2005, as a massive $20 marketing campaign (through 3Q05) did not work out as well as had been hoped for, and the company is probably in default of its covenants to end the year. In the context of distributions trending above distributable cash (and cash on an absolute basis for that matter), a new five year facility would certainly help alleviate uncertainty over near term distribution levels, as well as clarify interest expense and related issues going forward. This funding is especially important considering that the company is entering a seasonally weak operating period. On the plus side, it is certainly possible that by not completing a new deal by the end of year that the unit prices have been negatively impacted.

As the company continues to spend its IPO (or soon to be other) monies on growing the business, the month-to-month distributions are supposedly being paid out from business returns. Rarely in the investment trust world does this theory play out peacefully in practice. Rather, many trusts, including Priszm in 2005, invariably borrow from cash delegated to grow the business to fund payouts that are supposed to be from the business.

In short, the trust structure allows unitholders to profit rapidly from regular distributions, but can also regularly place the investor in the awkward position of trying to objectively judge whether or not the trust is about to dilute its unit base because of balance sheet degradation, cut the distribution because of falling earnings, or change the payout methodology to better reflect current business fundamentals and planned for capital expenditures. For the long-term investor confident that a trust can grow and remain profitable these issues are sometimes overwhelming…this was almost the case with Priszm. However, although Priszm does not have a long enough operations history to draw any conclusions on where the company will be many years from now, KFC does, and the Taco Bell multi-brand is working.

Investment Opinion and Conclusions

As an income producing vehicle Priszm's 13.2% distribution yield is extremely attractive. However, from an operations and business standpoint there is little doubt that the current meshing of distributions and profits can not be sustained. This presents the investor with some uncertainty in the near term, as either the distributions will have to be cut, new funding will have to secured (to continue a 100%+ payout ratio), and/or unitholder dilution will have to take place.

Management is not unaware of these issues, and on October 7 said that "The Company's distributable cash payout ratio in 2006 is expected to return to levels more consistent with those experienced in 2004." Using the $1.20 per unit payout in 2004 as a guide, this still represents an attractive 12.6% annual yield.

Ultimately the return to investors will be decided by the performance of the company's 480 and growing stores. Multi-branding has proven a successful and cost effective means to achieve increased sales, and KFC as a stand alone business is steady (albeit a discombobulated growth story when comparing strength in Canada west to weakness in Canada east). We anticipate that the company will perform better in Quebec (-3.9% SSS in 3Q05) with the introduction of the Colonel's Snacker and new management addition. We also anticipate that with more normalized weather patterns in Ontario in 2006 (2005 was a scorcher) that KFC will reap the benefits of what looks like an effective marketing campaign. More normalized weather in Ontario could also bring down the company's maintenance capital expenditures in 2006 due to less air conditioning breakdowns. Maintenance capital expenditures are expected to run at approximately $1 million per quarter going forward.

At $9.50 per unit we believe Priszm offers an attractive mix of risk and reward. On the risk side of the equation, the company needs to secure a new funding arrangement and the first quarter of 2006 should be more of the same (bad); possibly impacting the distribution payout more negatively than anticipated. On the reward side, the company will continue to aggressively pursue multi-branding opportunities in 1Q06 as momentum builds towards what is usually a strong middle of the year, and the company currently pays out an attractive monthly distribution. We are selecting Priszm as an income investment for the 2006 Wish List.

One final note, the entire Canadian investment trust industry was rocked in late 2005 when the government suggested that income trusts would start being taxed because of lost revenues. This speculation did not turn into reality, but Priszm units were nonetheless hurt. The Canadian elections on January 23, 2006, and any government actions relating to trusts that could come afterwards are a consideration for long-term trust owners.

Sincerely,

Brady Willett

Todd Alway