iA Wealth
Fund Research

Your Introduction to Flow-Through LPs: 2019 Edition

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The attractive tax benefits of flow-through limited partnerships (LPs) along with the prospects of hitting it big on a concentrated pool of junior resource names have made these issues appealing offerings to some investors. We are barely into 2019, but issuers have taken the usual route of bringing a number of them to market.

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

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

Year	Total Flow-Through LP Assets Raised	Year	Total Flow-Through LP Assets Raised
2005	$1.2 billion	2012	$0.6 billion
2006	$1.7 billion	2013	$0.4 billion
2007	$2.0 billion	2014	$0.4 billion
2008	$1.0 billion	2015	$0.3 billion
2009	$0.5 billion	2016	$0.2 billion
2010	$0.9 billion	2017	$0.2 billion
2011	$1.1 billion	2018	$0.2 billion

Source: iA Securities

The Basics

Flow-through shares are common shares issued by Canadian mining, oil and gas or certain types of renewable energy companies. The purpose of the proceeds received is to finance exploration activities. Although companies of any size can issue flow-through shares, it is typically only the junior players that do so.

After issuing shares and receiving capital from investors, these companies renounce certain exploration expenses to investors, and these expenses are generally fully deductible against all income sources. Apart from the flow-through share agreement and associated tax benefits, flow-through shares are identical to non-flow-through shares of the same class.

While investors may purchase individual flow-through securities themselves, a more convenient way to access these issues and to get the accompanying tax benefits is through a limited partnership. Flow-through LPs allow investors to access the expertise of money managers who have experience in this space while fully retaining the tax benefits that come with these securities.

Note that all LPs will be predominantly mining focused moving forward. This is because traditional oil and gas companies are no longer able to offer Canadian Exploration Expenses (CEE) equivalent deductions. As of January 1, 2019, oil and gas firms are limited to Canadian Development Expenses (CDE) only, which have a different tax treatment. A further explanation of the mechanics is found later in this piece.

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

It is worth noting that flow-through shares do not achieve their tax benefits through the exploitation of loopholes, rather, specific provisions within the Income Tax Act make these tax benefits possible. These are not tax shelters where there is a risk that the CRA will

come down and rescind all tax benefits on a retroactive basis if something is not up to snuff or if the Feds simply want to squeeze even more cash from investors.

History

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

Nuts and Bolts

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

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

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

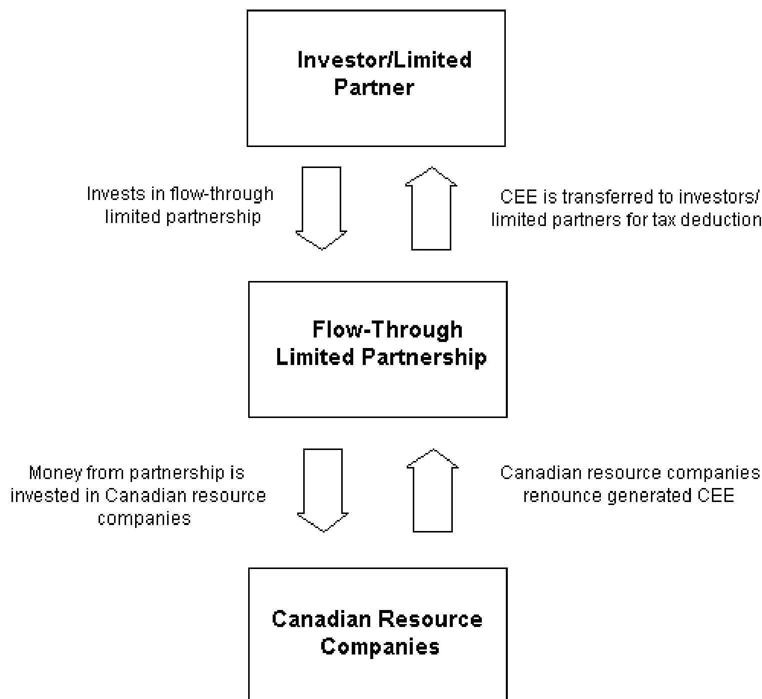
Investors receive a substantial amount of their original investment back in the form of tax savings. Depending on the investor’s marginal tax rate, these tax savings could come in at close to half the original investment. It is also important to note that because of the tax deductions, the adjusted cost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

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

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

Only IIROC-registered advisors are permitted to sell prospectus-issued flow-through LPs.

Figure I: Flow-Through LP Basics



The Tax Benefits

The tax advantages available via a flow-through LP are reasonably easy to understand and they are fully disclosed and described in the prospectuses of the products themselves. Table II provides a sample scenario. (Offering documents should be consulted for more specific tax-related numbers. Table II is for illustrative purposes only.)

Table II: Sample Flow-Through LP Tax Savings Scenario

	2019	2020 and Beyond	Total
Assumed Marginal Tax Rate	45%	45%	
Investment	$5,000	$ -	$5,000
Tax savings from deductions	($2,441)	($239)	($2,680)
Capital gains tax	$39	$145	$184
Total Net Income Tax Savings	($2,402)	($94)	($2,496)
Money at risk			$2,504
Break-even level			$3,231
Downside protection			35%

Source: iA Securities

The column furthest to the right in Table II is the most important. The assumption is that the investor moves $5,000 into the LP. Using that figure, the total tax savings comes in at $2,496.

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

$2,504 / (1 - (0.45 x 0.5)) = $3,231

What that number means is that the value of the initial investment can drop from $5,000 to $3,231 before the investor loses a penny on an after-tax basis. This implies an embedded level of downside protection of 35%.

The Rollover Process

Under normal circumstances, an investor in a flow-through LP is locked in (i.e., has no liquidity whatsoever) until the expected date of rollover into a mutual fund. The lock-up period is typically 18 to 20 months, although some offerings target a slightly shorter duration. Assets are then rolled into a mutual fund, which is typically resource oriented, and investors receive fund units one to two months

following the rollover. This one to two month window exists to ensure the manager has sufficient time to make any changes to the portfolio where needed without being forced to trade or sell any securities too quickly in the market, thereby putting unnecessary downward pressure on the fund's NAV. This rollover takes place on a tax-deferred basis, but once the mutual fund units are redeemed, a capital gain equal to the redemption amount is incurred. Again, this is because the ACB of the units is zero.

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

Primary Risks

Volatility

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

Liquidity

Liquidity affects flow-through LPs in two ways. As mentioned earlier, an investor is required to hold an LP until the partnership is dissolved. Again, this does not typically occur for 18 to 20 months after the time of purchase. In addition, the companies that underlie the LP may be highly illiquid themselves, meaning the manager may have difficulty moving into or out of positions in a timely manner.

Using Flow-Through LPs in a Portfolio

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

The benefits of using flow-through LPs are at their greatest when utilized by investors that are subject to the highest marginal tax rate. This could be on the corporate or individual level, and it could include recipients of large one-time lump sum payments.

Better Understanding the Benefits

In the scenarios laid out below, we run through three potential outcomes for a hypothetical investment in a flow through LP. In each case we assume the units are redeemed immediately after the rollover event. The numbers presented are net of all fees and expenses and a 45% marginal tax rate is assumed in all scenarios.

Scenario 1: Proceeds at rollover equal initial investment:

Here, from a cash flow standpoint, the investor is breakeven. $5,000 goes into the flow through initially and $5,000 comes out when the rollover takes place. However, the net benefit from an after tax standpoint is $1,371. Therefore, even though the real value of the investment didn't budge, the investor in this case experienced a 27.4% after tax gain.

	Cash Outlay	Proceeds	Tax Savings*	Capital Gains Tax	Out of Pocket Cost
Purchase	($5,000)		$2,496		($2,504)
Sale of Units After Rollover		$5,000		($1,125)	$3,875
Net Benefit					$1,371
After Tax Return					27.4%

**during the duration of the LP holding period*

Scenario 2: Proceeds at rollover show a gain over initial investment:

In this case, the securities in the flow through portfolio do very well, leading to a significant increase in the value of LP units. Upon rollover, units doubled in value, but note that the after tax return is marginally higher.

	Cash Outlay	Proceeds	Tax Savings*	Capital Gains Tax	Out of Pocket Cost
Purchase	($5,000)		$2,496		($2,504)
Sale of Units After Rollover		$10,000		($2,250)	$7,750
Net Benefit					$5,246
After Tax Return					104.9%

**during the duration of the LP holding period*

Scenario 3: Proceeds at rollover show a loss versus initial investment:

Here, the initial investment was $5,000 and the proceeds at the time of the rollover were $3,000. That's a 40% decline in the value of the investment. The tax benefits that come with an investment in flow through shares, however, mean this investor's after tax loss amounts to a much more manageable 3.6%.

	Cash Outlay	Proceeds	Tax Savings*	Capital Gains Tax	Out of Pocket Cost
Purchase	($5,000)		$2,496		($2,504)
Sale of Units After Rollover		$3,000		($675)	$2,325
Net Benefit					($179)
After Tax Return					-3.6%

**during the duration of the LP holding period*

Other Considerations

Tax Forms

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

Table III: Flow-Through LPs Available Today LPs Available Today or Soon to IIROC-Registered Advisors

Issue	Mgt. Fee*	Perf. Bonus**	Issue Size		Unit Price
			Minimum	Maximum	
Probity Mining 2019 Short Dur. Flow-Through LP - National Cl A Units^	N/A	N/A	$1.5M	$20MM	$10
Probity Mining 2019 Short Dur. Flow-Through LP - National Cl F Units^	N/A	N/A	$1.5M	$20MM	$10
Probity Mining 2019 Short Dur. Flow-Through LP - Québec Cl A Units^	N/A	N/A	$1.5M	$5MM	$10
Probity Mining 2019 Short Dur. Flow-Through LP - Québec Cl F Units^	N/A	N/A	$1.5M	$5MM	$10
Probity Mining 2019 Short Duration Flow-Through LP - BC Cl A Units^	N/A	N/A	$1.5M	$5MM	$10
Probity Mining 2019 Short Duration Flow-Through LP - BC Cl F Units^	N/A	N/A	$1.5M	$5MM	$10
CMP 2019 Resource Limited Partnership	2%	20% over 12%	$5M	$50M	$1,000
Maple Leaf Short Dur. 2019 Flow-Through LP - National Cl	2%	20% over 12%	$2.5M	$10M	$25
Maple Leaf Short Dur. 2019 Flow-Through LP - Quebec Cl	2%	20% over 12%	$2.5M	$15M	$25
Ninepoint 2019 Flow-Through Limited Partnership	2%	N/A	$5M	$60M	$25

** Excludes annual operating expenses service fee*

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

^Class P units entitled to an allocation of income of 30% of the balance of cumulative ordinary income that exceeds the amount equal to the gross proceeds

Source: iA Securities, company filings

The Bottom Line

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

The suitability of these products, given their nature, should be the primary consideration for potential investors. From a compliance standpoint, these securities will generally be assigned a risk rating of HIGH and an investment objective of SPECULATIVE. Investors should also understand that the performance of these LPs will be driven by the sector composition of the portfolio and the corresponding performance of those sectors. In 2019 and moving forward, LPs will be predominantly mining focused.

The tax benefits of flow-through LPs are powerful, especially for investors in the highest tax bracket, but we strongly recommend that individuals consult with a tax expert before moving money into these products.

For further information on any of the deals noted in Table III, please contact:

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Under Review:	The fund's participation on the Recommended List is under review.

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