Mainstreet's business model works

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Energy shares aren't the only ones that benefit from surging commodity prices. Other businesses will ride oil's coattails as Western provinces start reaping the benefits of higher revenues, should prices stay high.

One of them is Mainstreet Equity Corp. , a real estate concern with most of its 5,700 suites in Western Canada.

The company's business model is to buy poorly managed small apartment buildings, renovate them, apply professional management practices and crank up rents. The model works because this is an inefficient market - you can buy buildings, usually owned by mom and pop operators, for a good price. But it can be hard to track progress, because renovating buildings means temporarily higher costs and lower revenues (suites have to be empty to be renovated). So when you look at Mainstreet's latest quarterly, you might not be terribly impressed by funds from operations, a measure of profitability, of \$1.7-million. The market cap is about \$74-million. Earnings are negative.

But there are promising signs as you scan the financials. First, on a book basis, the company's equity is

negative, meaning the value of the assets as carried is less than the liabilities. The reason is that the real estate has increased in value over time - as substantiated by appraisals - but the value isn't marked up on the balance sheet. The increase in real value allows management to borrow more by refinancing.

The company managed to refinance a lot of properties recently, mostly through CMHC and at very attractive rates, and used some of the funds to buy back a lot of stock. The upshot is that debt rose but asset values didn't - on paper - and book value is negative. Businesses that run with no equity are akin to cars that run with no gas. Mainstreet's debt as a percentage of market value is 56 per cent.

As of the end of the latest quarter Mainstreet has $16-million in cash, about a buck-and-a-half per share, with another $10-million expected from refinancings. There are 22 clear-title buildings, meaning they have no debt against them - another source of funds if needed. In other words, the company is poised to make acquisitions when others property owners are likely squeezed and might forced to sell.

The question is whether the company can generate cash. The company says that with 95 per cent of properties rented at full market rates, it would generate $40-million in net operating income (basically, that's rent less the cost of operating the properties). But it's a long way from that now.

The bulk of Mainstreet's existing suites have been renovated but 16 per cent of them were sitting empty as at the end of Q2, because most renters move in the spring and summer. The vacancy rate in Edmonton was considerably higher.

And here's the rub: running apartment buildings is a high fixed-cost business, so additional revenue, once you've covered costs, flow to the bottom line.

For every point that vacancy falls, Mainstreet says $610,000 flows to the bottom line. So if the company can fill its empty units to the point where it's running at a vacancy rate of 5 per cent, shareholders can expect another 60 cents per share against a stock price of $7.

Another, more practical testimonial of the value at Mainstreet is that a big shareholder publicly aired its unhappiness with management. That sounds bad but it looks like the shareholder, Croft Properties, a successful New York real estate investor, really wanted to take Mainstreet private on the cheap and was irked when the board gave CEO Bob Dhillon a whack of stock options, apparently to thwart a bid, which understandably rankled shareholders.

That said, Mr. Dhillon, unlike the heads of so many other real estate companies, is relatively modestly paid and owns a lot of stock.

So to get back to the thesis: Mainstreet has healthy inside ownership, tangible evidence that the stock is cheap, lots of cash when cash is king and might be poised to crank out cash flow, especially if commodity prices stay strong. If this makes sense to you, the stock sells on the Toronto exchange.

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