COMMENT

On the sunny side of Mainstreet

Calgary-based investor sees profit in rental properties

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Inside Finance

Frank Mayer, an analyst with Desjardins Securities, has been covering real estate companies since 1973. And naturally enough over that period he has seen lots of good ideas, ideas that have made his clients piles of cash.

Mayer's latest idea is Calgary-based **Mainstreet Equity Corp.**, an apartment-owning company that started in April, 1998, as a junior capital pool.

"It is one of the more interesting ideas we have run across in the last 33 years," Mayer says. "It's a good idea, no question. It has a great operating system known as the 'mainstreet value chain,' that's effectively implemented with significant exposure to Alberta."

In May, Mayer had a one-year target of $11.40. Later he upped it to $12.50 a share. A few months later — after Mainstreet reported strong third-quarter results — he hiked the target to $15.25.

Jimmy Khing Shan, an analyst at National Bank Financial, has also published research on Mainstreet. In July, he initiated coverage, assigned an "outperform" rating and attached a one year target of $11.75. (Mainstreet, which was listed on the TSX in May, 2000, closed on Friday at $10.35.

"Mainstreet could well be at a historic turning point, being in the right place at the right time," Shan says.

Mainstreet is unique in another way: it has never raised common equity via a public issue. At the end of 2004, Desjardins raised $33-million for Mainstreet via an offering of 7.25% convertible debentures. (The conversion price is $6.50 a share.)

Back in 1998, Mainstreet — started by Bob Dhillon and Darrell Cook — owned fewer than 300 apartment units in Calgary and Edmonton. It now has 4,200 units and has spread its reach to Vancouver and Toronto, though Alberta is home to about two-thirds of its holdings. As of the last reporting date, Dhillon owned 40.6% of the company; Cook had 25.6%.

Desjardins' Mayer says Mainstreet fills a niche by consolidating a slew of "mom and pop" operations and bringing a mainstreet look to the buildings it acquires. "The company looks at mid-sized units where there isn't that much competition. And typically it buys when the building is in trouble," meaning one characterized by an increase in vacancies, a reduction in rents and a collection of less desirable tenants. "It becomes a downward vicious cycle," Mayer says.

Once the building is acquired, Mainstreet goes to work. "It applies modern business systems to deal with the problems that each of the properties has. And there are economies of scale. It applies the mainstreet standard to each building so that they have a certain look," Mayer says.

That process of converting the buildings takes about 12 to 18 months. About 60% of Mainstreet's portfolio has been converted — or "stabilized" in the vernacular used by the company.

For his part, Dhillon, a veritable whirlwind, defines the company's strategy as "buying B-class buildings for a C-class price."

His company can do that because it buys units that are typically in need of a major refurbishment. So after spending about $6,000 per unit, it rents them out. (In some cases, it will sell them.) This time it charges a higher rent. In Calgary it has recently upped the rent by 37% — or $260 per unit per month.

And given the dominance of fixed costs, the increase in revenue falls straight to the bottom line. For instance, it expects to keep most of the additional $3.8-million that will flow from the rent hikes in Calgary.

Dhillon likes the business because of two major drivers:

- There is a shortage of supply, in part because building rental accommodation hasn't been a major priority for the country. (In other cases, supply has shrunk because buildings have been converted to condos.) Those supply shortage will continue because the buildings trade for less than replacement cost. "New supply won't come on stream until rents go up considerably," Dhillon says. "Meantime costs of construction, including land, are rising, as are the bottlenecks to get permits."
- There is continued growth in demand. "There is the echo generation, there is the growth in immigration to Canada and there is migration to Alberta," says Dhillon, an immigrant himself. A Sikh who was born in Japan, he came to Canada 30 years ago.

Mayer likes Mainstreet as a stock because it is well managed and well financed, and operates in a "good fundamental environment."

Add in a gap between the current share price and its potential value and we have another reason. "Mainstreet is a classic micro-cap and micro-caps tend to be inefficiently priced," Mayer says. Finally, Mayer likes the jockey. "Dhillon is a driven guy," he says.

So what can go wrong?

Mayer doesn't see that many difficulties. The company is in markets "that are basically strong and cash flows are growing." When pressed Mayer says the biggest difficulty would be if Dhillon were hit by the proverbial bus. "At this stage, he is very much the man," he says.

Another potential negative is that Mainstreet's portfolio in Edmonton doesn't turn out as well as its Calgary apartment holdings. Thanks to some recent acquisitions, Edmonton is now a larger part of Mainstreet's holdings. At the end of June, it owned 1,567 units in Edmonton, up from 1,053 a year ago. And it is committed to buy another 87 units there.

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