

# Income Trusts:

## Old Wine in New Bottles?

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### INTRODUCTION

Following the hi-tech market meltdown and highly publicized accounting and insider trading 'indiscretions,' Canadian investors are considering income trusts in ever-increasing numbers. That is because they appear to favour current cash distributions over what could be the unrealized growth potential financed by primarily retaining cash flows. While some conventional debt and equity investment vehicles can meet the demand for cash distributions, they do have some drawbacks for investors. For example, to obtain a high yield in debt, investors need to purchase riskier bonds. When it comes to equities, high payout companies and preferred shares do not provide the same cash flow and are difficult to find in sufficient quantity. Income trusts, on the other hand, are structured to meet investors' desires for large and stable cash distributions. As such, they have become a major segment of the initial public offering (IPO) and secondary issue market. In fact, during 2002, income trusts accounted for 94% of the value of all Canadian IPOs and, in the first six months of 2003, they represented 80%<sup>4</sup>.

Despite their growing presence in the Canadian investment landscape, pension funds and other institutional investors have remained on the sidelines when it comes to income trust investing. In this paper, we outline the key reasons why income trusts should be part of a pension portfolio, as well as some of the benefits and risk characteristics of different forms of income trusts. We start by reviewing the types of income trusts and how their structure is beneficial to investors. We also look at the structure of trusts, their sensitivity to economic variables and the key benefits of holding them in a portfolio. In addition, while income trusts can be thought of as higher-yield, low-duration equities, they do have unique elements requiring specialized analysis

within an equity mandate. This paper illustrates important income trust elements requiring more detailed scrutiny on the part of analysts, in particular the business model, the role and quality of management, governance and debt factors. While some of our discussion is focused on business trusts since they are the newest form and are expected to have the greatest future growth, many issues are also applicable to the other trust forms.

### TYPES OF TRUSTS

To start, it's important to distinguish between different types of income trusts. The three trust forms have a similar purpose and are structured to take advantage of specific income tax provisions that eliminate double taxation of corporate profits. This single-entity taxation is an important benefit of income trusts, but there are other advantages, too. The different trust forms are, in essence, equity securities whose operating cash flows are affected by underlying economic factors, which ultimately can impact distributions to unitholders of the trust. These factors range from oil and natural gas prices for energy-based royalty trusts through to overall business conditions that affect both real estate investment trusts (REITs) and business trusts. There are, however, important differences. For example, while business trusts and REITs are ongoing business entities that must finance capital expenditures from cash flows to maintain distributions to unitholders, energy-based royalty trusts are a 'wasting' asset where cash distributions have a significant return-of-capital element as the underlying asset is depleted. In the latter case, growth is obtained through acquisitions of new properties by issuing new trust units.

We begin by making two assumptions about the environment in which income trusts exist. First, unlimited liability, currently perceived as an impediment to institutional investment in trusts and to their inclusion in S&P/TSX 60 indexes, will be removed by legislation. While apparently imminent in Ontario, legislation was not introduced before the summer recess. There are legal opinions, however, stating that unitholders in a trust have the same liability as shareholders in standard equities. Moreover, from the institutional investor perspective, it is simple and inexpensive for a pension fund to establish a limited liability subsidiary into which income trust investments can be situated. It can, however, be

administratively complex to shelter individual investments from each other within the subsidiary. Second, we assume the federal government will not change tax provisions facilitating income trusts. As income trusts—especially business trusts—increase in size, the federal government may become concerned about perceived losses in tax revenues. While there has been little research on estimating net impact on tax revenues, we would expect that, given market size, tax authorities are unlikely to take decisions that would destroy a viable market and important source of funds.

### WHY INCOME TRUSTS?

Pension funds should be interested in investing in the income trust market for a number of reasons. First, large and relatively stable cash distributions are important elements in meeting ongoing pension liabilities. Second, statistical properties of income trust returns are useful for diversification purposes. For example, in the table (on page 3), we present a portfolio composed of all income trusts as well as portfolios of individual income trust types for the period 1996 to 2002 and show how their rates of return correlate with the returns of both the TSX300 index and the Scotia Capital Markets Mid Term Government Bond index.

Whereas the overall trust index correlation with the TSX300 is 0.498, there is substantial variability across trust types with business trusts having the lowest correlation and REITs the highest. Similarly, REITs and business trusts have higher correlations with Government bond returns than energy-based royalty trusts and slightly higher correlations than the overall portfolio (with a value of 0.431). Low correlations with both interest rates and the overall stock index for the period suggest there is scope for diversification.

Third, the income trust market is maturing. This maturation, observed in the increasing size of the overall market<sup>5</sup> and recently larger issue sizes, has been assisted by both retail and institutional fund managers' actions, as they search for high-quality income trust investments and put pressure on issuers and underwriters to introduce improved governance provisions in income trust IPOs. Any increase in issue size will ultimately translate into greater liquidity, which could enhance the outlook for investments in this area.

Probably the best indication of market maturity is investors' reaction (as revealed in income trust units price changes) to reductions in cash distributions by some trusts. For the six months ended June 30, 2003, eight trusts reduced distributions. In the case of two trusts, Halterm and Legacy, distributions were eliminated, whereas for the others reductions were less dramatic. As expected in a mature market, some companies' market prices reacted in anticipation of the reduction, resulting in higher cash distribution yields. Further, investors evaluated the severity of economic impact generating a reduction in distributable cash and priced shares accordingly. Finally, and most important, distribution reductions did not cast a pall over the whole income trust market

### HOW ARE TRUSTS STRUCTURED?

To start, it is important to understand the complexities of the income trust structure. Of course, that can be challenging, especially when the typical income trust structure diagram resembles a set of exit ramps on a major highway. One point to keep in mind, however, is that the structure is established for one simple reason: to generate single-entity taxation at the unitholder level.

At the IPO stage, investors purchase trust units and the funds are used by the trust to purchase both subordinated debt and equity issued by the operating company. The trust unitholder, through ownership of trust units, is now both a shareholder and lender to the underlying operating company. Debt owned by the trust is typically large relative to equity and consequently has a yield reflecting this 'leverage.' Some commentators have likened this debt to junk (high yield) bonds in terms of leverage and associated yield. Note that debt purchased by the trust is not the same as debt issued to third parties such as a bank. We place the term leverage in parentheses

since the unitholder owns both debt and equity. In effect, debt and equity are stapled together and the unitholder has a claim to underlying cash flow of the operating entity. This 'internal' debt is used to eliminate operating company tax through interest deductibility. The internal debt level and interest rates on this debt are deliberately set, within reason, so as to generate this result. Both interest generated from debt ownership and dividends as a result of equity ownership are paid to the trust which, in turn, redistributes cash to the unitholder.

Real leverage enters through the use of outside, or third party, debt. This debt is senior to internal debt and can be either bank debt or privately placed debt with terms of five to ten years. This debt increases unitholders' risk. Generally, this debt is small in relation to the trust's free cash flow.

The operating company generates distributable cash flow that is equal to cash flow from operations (CFO) less sustaining capital expenditures. Any proceeds from net debt increase distributable cash flow as do net proceeds from the sale of assets. The actual cash flow distribution to the trust is a combination of interest, dividends, capital gains and a return of capital. The operating company need not pay out all distributable cash, thus leaving a reserve. In effect, the trust receives EBITDA less the sum of capital expenditures and external interest. The trust then distributes the cash flow to unitholders who are taxed on distributions based on the form of income received by the trust. The return of capital element reduces investors' tax base who then pay a capital gain tax when units are sold. Return of capital distributions are more prevalent in the energy-based royalty trust area.

In Table 1 column 1 (see page 4), we show actual distributions as a proportion of cash flow from operations. For the full sample the median value is

### CORRELATIONS OF VALUE-WEIGHTED PORTFOLIOS WITH TSX AND MEDIUM-TERM BOND RETURNS

1996-2002

	All income trusts	Business trusts	REITs	Energy-based royalty trusts
TSX 300	0.498	0.381	0.490	0.432
Bond return	0.431	0.472	0.446	0.309

0.87 with a range of 0.25 to 3.18. For business trusts the median distribution is 1.0 with a range from 0.43 to 1.52. Median values for energy and REITs are about 0.85. These payouts appear very high. In column 2, we present distributions for corporations that are in comparable industries to income trusts. Payouts are higher in all income trust categories relative to non-trust corporations because little discretionary cash flow is retained/reinvested in the business. For non-business trusts corporations, for example, the median distribution is dramatically smaller at 0.28.

In columns 3 and 4 we identify the breakdown of the distribution between return of capital (ROC) and a taxable return. For the full sample, the median value is 48 per cent as a return of capital and 52 per cent as a taxable distribution. Proportions are different for subsamples. For business trusts, the ROC pro-

portion is 13 per cent, reflecting need to retain funds to maintain the firm or the smaller amount of tangible assets within these types of businesses.<sup>6</sup> Energy and REITs have much higher ROC proportions. For energy trusts, the high return of capital element reflects the finite lifetime of their wasting assets.

Under current tax law and average tax rates, tax saving in a business trust is \$0.12 per dollar of distributable cash. The effective tax rate to an investor is 46% for an income trust in which all cash is in the form of interest and 58% under normal taxation and payment of dividends. Actual tax savings will depend upon how unitholders are ultimately taxed since some unitholders will hold investments in tax-deferred vehicles.<sup>7</sup> Other trust forms generate tax-efficient results although not necessarily through use of internal debt.

**TABLE 1: LEVERAGE AND DISTRIBUTION CHARACTERISTICS FOR INCOME TRUSTS**

	Distribution as proportion of CFO (trusts)	Distribution as proportion of CFO (comparable corporates)	Distribution breakdown proportion	
			ROC 3	Taxable 4
<b>Full Sample</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Mean	0.94	0.18	0.44	0.56
Median	0.87	0.07	0.48	0.52
Standard Deviation	0.45	0.19	0.28	0.28
Minimum	0.25	0.00	0	0
Maximum	3.18	0.58	1	1
Number of Values	37	26	34	34
<b>Business Trusts</b>				
Mean	0.99	0.30	0.31	0.69
Median	1.00	0.28	0.13	0.87
Standard Deviation	0.28	0.20	0.35	0.35
Minimum	0.43	0.00	0	0
Maximum	1.52	0.58	1	1
Number of Values	15	14	14	14
<b>Energy Index</b>				
Mean	0.95	0.04	0.52	0.48
Median	0.86	0.04	0.48	0.52
Standard Deviation	0.68	0.01	0.21	0.21
Minimum	0.25	0.04	0.19	0.00
Maximum	3.18	0.06	1	0.81
Number of Values	14	12	13	13
<b>REITs</b>				
Mean	0.84	n.a.	0.54	0.46
Median	0.85	n.a.	0.54	0.46
Standard Deviation	0.13	n.a.	0.10	0.10
Minimum	0.59	n.a.	0.38	0.30
Maximum	0.98	n.a.	0.70	0.62
Number of Values	8		7	7

## SENSITIVITY OF TRUSTS TO ECONOMIC VARIABLES

Given the similarity of trusts to equity, it is useful to examine factors that influence rates of return on units. We do this in two ways. First, we obtain the measure of beta for income trusts in various industry classifications and for companies in the same industry but with a conventional structure. Results are presented in Table 2. For each industry classification where both trust and non-trust firms exist, the beta for the former is lower, in many cases by a substantial amount. Lower betas reflect a combination of factors: companies using the trust structure are less risky on average than the industry, managements of income trusts are successful in reducing operating risk, trusts have lower leverage.

Another way to look at risk elements in income trusts is to identify the sensitivity of rates of return for trust units to rates of return on a market index and the change in Government of Canada bond yields (an interest rate factor). To do this, we constructed separate portfolios of business trusts, REITs and energy-based royalty trusts and an overall income trust portfolio. Individual trusts are value-weighted within each portfolio. For all income trusts, rates of return are sensitive to both the overall market and interest rates. Business trusts are most sensitive to interest rates and least sensitive to the TSX300 compared to REITs and energy-based royalty trusts. The overall portfolio displays positive sen-

sitivity to the TSX300 and negative sensitivity to changes in interest rates.

## BENEFITS OF INCOME TRUSTS

There are three major benefits to an income trust structure, which should be reflected in the trust unit market price. First is the tax benefit. As noted previously, the structure provides single-entity taxation thereby increasing investors' after-tax cash flows. The second benefit is removal of agency cost of free cash flow. To the extent that non-trust companies have large and stable cash flows, funds in excess of the company's investment needs can be held in (unprofitable) cash or invested in projects that do not increase shareholder value. This 'gold-plating' behaviour is diminished drastically with the necessity to pay large and stable distributions under the trust structure.<sup>8</sup> Removal of agency costs will result in a value increase as cash is paid to investors instead of invested in poor projects or held in cash.

Third, there is a reduction in financial distress costs for business trusts. In a normal corporation, distress costs can arise in the event the firm has trouble meeting debt servicing obligations due to a cash flow reduction. Further, attempts to resolve distress also have negative impacts on the firm's ongoing cash flow. In the business trust structure, since the debt (other than external debt) and equity are owned by the same investors, an unexpected cash flow reduction will not necessarily trigger

**TABLE 2: COMPARISON OF BETAS BY INDUSTRY SECTOR**

Sector	Number of Firms			Raw Beta		
	Income Trusts	Others	Total	Income Trusts	Others	Total
Electric Generation	6	1	7	0.18	2.84	0.56
Storage Warehousing	3	1	4	0.24	0.28	0.25
Gas Distribution	1	3	4	0.09	0.20	0.17
Pipelines	3	4	7	0.16	0.28	0.23
Food Retail	1	3	4	0.21	0.44	0.38
Forestry	1	6	7	0.15	0.89	0.78
Oil-Exploration and Production	13	126	139	0.38	0.73	0.70
Oil and Gas Drilling	4	8	12	0.18	0.88	0.65
REITs- Hotels	3	0	3	0.71	n.a.	0.71
REITs - Diversified	4	0	4	0.20	n.a.	0.20
REITs - Healthcare	1	0	1	0.17	n.a.	0.17
REITs - Apartments	2	0	2	0.12	n.a.	0.12

*source: Bloomberg*

financial distress since the debt holder/shareholder will immediately agree to a reduction in interest payments in line with lowered cash flow. Under this scenario, the company can handle larger amounts of internal debt in order to generate the tax benefit of eliminating corporate tax using interest deductions. Of course the amount of third-party debt has to be considered since this debt is senior and the company can be in default if these debt obligations are not met.

Benefits from income trusts should be observed in changes in stock prices of publicly traded companies when they announce a reorganization to an income trust structure. A number of companies have announced and undertaken this restructuring. For example, Dundee Realty Corp. had an increase in share price of approximately 40% upon announcement of its restructuring. This increase in value is not out of line with increases experienced by other companies making similar announcements and is probably too large to be explained by tax benefits alone.<sup>9</sup>

#### **UNIQUE ISSUES FACING INCOME TRUSTS**

Regardless of type, income trusts are, in effect, equity securities. If trusts are equities, however, and a pension fund wants active management, why not leave investment decisions to an equity manager? We believe it is necessary to engage a manager with specific knowledge in income trusts to manage an income trust portfolio. The reasons are similar for utilizing a specialized manager for small capitalization stocks or corporate bonds—there are unique factors that require specific investigation and understanding. We do not suggest that these factors are unimportant in other equity investments, only that they take on greater importance in the income trust area.

To appreciate need for specialized analysis, remember the *raison d'être* for income trusts—the instrument is all about distributable cash flow: its size and how much is paid to the unitholder. While due diligence is important in any investment, it takes on increased importance in the income trust market. For income trusts, stability and (to a lesser extent) growth of distributions are crucial. Since distributions are typically a large part of distributable cash flow, there is little room for management error or for large fluctuations in cash flow. Managerial decisions must be made with this fact in mind. The analyst must

understand the unique factors affecting cash flows and, hence, potential values and be able to assess the risks and expected returns of income trusts.<sup>10</sup>

Another factor is the level of disclosure for an income trust. An income trust is an indirect offering and, while it meets the same disclosure requirements as normal equity, there are some disclosure problems, primarily associated with external management contracts, which are considered in a subsequent section. Problems include lack of disclosure of compensation apart from aggregate levels and, in some situations, of trading in public units.

#### **I. BUSINESS MODEL**

In evaluating an income trust, an understanding of the underlying business model is crucial. Each income trust form has operating risk based on its underlying business and an associated expected return based on analysts' forecasts. Even within each trust form, operating risk can be different. For example, the risk associated with cash flow variability for commercial, residential and hotel REITs are different and depend upon many factors such as terms of leases associated with properties. Of all income trusts, power trusts have the lowest operating risk due to use of long-term contracts.

Business trusts are the most difficult to analyze since companies using the trust structure can have different business characteristics. Companies that best fit the income trust model have stable cash flows, low growth, good predictability on the timing and amount of future capital expenditures to maintain cash flows, large barriers to entry, little chance of technological change and a large customer base with strong loyalty. It is clear from this description that some business models are not a 'good fit' and would be expected to have higher risks and hence higher cash distribution yields.

With increasing demand for trusts and potentially larger issue sizes,<sup>11</sup> it is possible that more companies, be they based on Canadian or U.S. assets, will use the trust structure. Since a business trust is a good exit vehicle for venture capital or sale of a division, companies with inappropriate assets could attempt to use the structure. Analysts must be aware of companies' risks, provide realistic valuations and decide not to participate in some IPOs. In fact, in 2002 some vendors tried but failed to use the structure for these reasons.

## II. ROLE AND QUALITY OF MANAGEMENT

Management must focus on making decisions that maintain cash flow levels, their stability and, where appropriate, growth. The analyst needs to determine management's dedication to these factors. For example, does management constrain costs and use hedging techniques to remove cash flow variability (for example, hedging U.S.-denominated cash flows or floating interest rates on debt to reduce cash flow variability)? Does management ensure that growth, generally financed through issuance of new units, contributes to value of the units?

Another significant issue for the analyst is management's decisions on capital expenditures and the size of cash reserves. It is important to identify the amount and uncertainty of capital expenditures needed for both maintenance and growth purposes and the size of reserve required to maintain distributions in the event of a transitory reduction in distributable cash flow. Too few capital expenditures may result in short-term large distributions but will ultimately lead to poor long-term results. On the other hand, holding too large a cash reserve leads to the possibility of gold-plating. In some companies, existing assets may be old and in need of a major modernization with associated capital expenditures. Is management making necessary expenditures to remain competitive or will there be a large impact on future cash distributions when needed asset renewal is required?

An additional managerial element is the strategy used to fund distributions. Many trusts make monthly distributions. If the trust is in a cyclical business, however, there could be a need to borrow from the bank to 'bridge' the distribution until cash flows materialize. While cyclicity could add risk to a trust, it is not serious if cash flows are easily predicted. There may be situations, however, in which cash flow reductions are not transitory and debt turns out to be more permanent. Using debt to fund distributions when cash flows are insufficient can increase leverage and unitholder risk without any change in underlying cash flows. This will have a negative impact on value.

Instead of using debt to maintain distributions, management may use asset sales. Clearly, this is not a long-term strategy since the firm ultimately runs out of redundant assets. In the extreme, assets may not be redundant and cash flows will ultimately

be affected. The analyst needs to understand the business to ensure that cash flows can be maintained without reliance on asset sales or issues of new debt.<sup>12</sup>

## III. GOVERNANCE

A more controversial issue in the income trust area is use of external as opposed to internal managers for operating companies. For the latter, management is no different than in a normal corporation with compensation based on salaries and bonuses, generally related to distributable cash flow and reported in the normal manner. Some trusts are small, however, and it may be more efficient to use external management with the needed expertise to manage the corporation. But even for larger income trusts, external management contracts should offer effective management, provided incentives built into the contract align managers' and unitholders' interests. While incentive issues are important for internal contracts as well, they are generally structured differently and are less open to abuse than external management contracts. Since external management contracts generate fees to external managers that reduce distributable cash flow, it is essential that analysts understand management contract specifics and determine if the contract is structured in the best interests of unitholders and not managers. There may even be situations where the analyst will decide not to purchase the trust because of the external management structure or, in an IPO, refuse to participate unless the contract structure is revised.

In some situations, external contracts are structured poorly. Such problems have generally been found in deals done in the past and are less of an issue in current transactions. For example, fees can be an increasing proportion of pre-determined levels of operating cash flows. This structure may have made sense when the company was small, but there may be no provision for cash flow growth over time. A better structured external management contract would have a ratchet on cash flows such that fees would be based on increases in cash flows over base levels and the base level would rise with cash flows. Also, it would be useful to have fees based on the impact of management decisions on cash flows and not on economy-wide improvements in cash flows generally unrelated to management decisions.

This structuring can be difficult to implement and may argue for simpler fee structures that can be obtained through internal management.

Problems associated with external management contracts have not gone unnoticed and there has been a movement to internalize these contracts. In fact, the *Globe and Mail* reported that, based on their research of 113 funds, only 28 still had external managers.<sup>13</sup> The cost of internalizing the management function can be high and will depend upon termination provisions in the contract. Remember, high internalization prices can also reflect success of the management team in increasing cash flows for the trust.

#### IV: DEBT FACTORS

Although internal debt (used for business trusts and some royalty trusts) is not a major issue, and third-party debt is not very large, there are issues with third-party debt that the analyst must identify. First, covenants on the debt may be structured such that the ability to pay distributions may be impaired even if the firm is able to make its interest payments. For example, a covenant on interest coverage or fixed charge coverage can be breached even though ability to pay interest is unaffected. Unless the bank waives the shortfall, the company can have trouble meeting its distributions.<sup>14</sup> Second, the trust may have guaranteed some third-party debt. In this case, the trust can be responsible for payment of operating company debt.<sup>15</sup> The analyst must understand terms in the debt contract and be aware of any possible impacts on the trust's cash distributions.

#### CONCLUSIONS

Income trusts have become important financial instruments in Canadian capital markets and are expected to increase in number and issue size in the future. While they may have had an air of suspicion in the past, when analyzed objectively, they are no more suspicious than other equity investments. Income trust cash distribution properties are useful to pension funds. However, there are enough unique elements in income trusts such that, even though they have equity attributes, investment mandates should give consideration to managers who specialize in these financial instruments. Traditional equity valuation metrics may be insufficient in this specialized 'asset' class. ●

#### ENDNOTES:

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2. Professor of Finance and David Y. Timbrell Junior Professor, Rotman School of Management, University of Toronto.
3. The authors thank Gauri Aniruddha Bhat for collecting the data and Alan Wicks, Duncan Anderson, Michael Walsh and Steve Rotz for helpful comments.
4. PricewaterhouseCoopers LLP study as reported in the *Globe and Mail, Report on Business*, July 8, 2003.
5. As of June, 2003 there were 111 trusts with a market capitalization of approximately \$55 billion. This amount was about 5% of the TSX market capitalization.
6. The taxable distribution for business trusts was primarily interest payments (about 75% on average).
7. There is some evidence that RSP investors are the marginal shareholders. When Provident fund announced that it was in jeopardy of losing its eligibility for RSP, the unit price fell.
8. The levered buyout has a more intense incentive since debt payments must be made or the company is bankrupt. In the trust structure, although a major part of the distribution is an interest payment, the bankruptcy element is missing.
9. There may be some element of market euphoria associated with the conversion, which could account for part of the large price increase. Not all announcements lead to a price increase—see Enterra Energy Corp. announcement.
10. In addition, interest rates are currently low and this has had a major impact on the market value of trusts. It is important to understand the sensitivity of cash flows to interest rates so that the appropriate trust can be purchased if the analyst expects interest rates to increase.
11. Yellow Pages IPO had an issue size of \$950 million.
12. Transforce Income Fund is an example of a trust that has used both debt and asset sales as noted in their First Quarter report for 2003.
13. *Report on Business*, June 25, 2003.
14. This is not a hypothetical issue. General Donlee Income Fund reported a shortfall in their fixed coverage ratio on July 17, 2003. The bank waived the shortfall.
15. The recourse is generally limited to the trust's investment in the operating company. Note that non-trust corporations often have guarantees on secured credit facilities.