

The ins and outs of income trusts

By Bill Maclean

Ownership in an income trust brings added risk and returns. Investing wisely can certainly pay off.

It's a challenge to find good investment opportunities these days. Canadian money market funds currently yield just above 3%. Meanwhile, corporate fraud, geopolitical risk and a struggling U.S. economy haven't helped matters. Employers have witnessed a dramatic reversal in the funding status of their pension plans over the past year, and continued volatility and lowered return expectations have them taking a new look at their investment options.

Over this same period, income trusts have grown to represent more than \$50 billion in market capitalization—up from \$19 billion in 1999. This growth has been supported by strong relative returns.

ORIGINS OF INCOME TRUSTS

Income trusts are operating businesses that have been put into a trust. They pay out the bulk of their free cash flow to unit holders. The businesses that are sold into these trusts are usually mature and stable income-producing companies that lend themselves to fixed (monthly or quarterly) distributions.

These trusts are regarded as equity investments with fixed-income attributes or high-yield debt with no fixed maturity date. Pension plan sponsors—who have become cautious in the face of poor equity returns—are becoming attracted to income trusts that offer regular income payments and a significant premium yield compared to fixed-income investments.

Trusts were introduced in the mid 1980s. Oil and gas trusts paid out royalties to investors from stable income-producing fields. The 1990s saw the emergence of real estate investment trusts, which became popular in light of declining interest rates and increasing real estate values.

The constant demand for yield fueled the creation of other income trusts—based on assets such as coal, synthetic oil, iron ore and pipelines—throughout the remainder of the 1990s. With limited supply of product to put into trusts, investment bankers then created the business trust.

VALUATION METHODS

So why does a company sell itself or a division into a trust? Perhaps because it doesn't see tremendous growth prospects (often true of mature companies) and this is the best way to get the highest valuation while senior management continues to run the company. Alternatively, an owner of a relatively illiquid company may want to monetize ownership and income trusts provide the highest valuation.

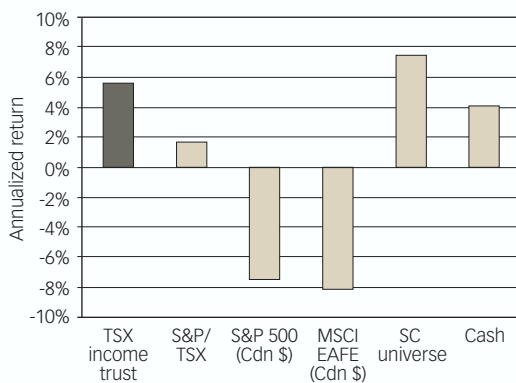
If an investor wants to sell his or her equity ownership, there are a number of valuation methods to consider. Traditional methods emphasize the earnings multiple. The multiple is derived from where the stocks of similar companies in the same industry trade. With three years of depressed equity markets and corporate financial underperformance, this method appears less attractive today.

On the other hand, income trusts focus the valuation

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It's all relative

Income trusts provided returns like fixed-income products from an equity investment. (Four-year annualized return at May 31, 2003.)



on a method that discounts promised future cash distributions. Because the discount rate (interest rate) assumption used to come up with a valuation has declined considerably over the past few years, this method has become a more attractive way to value the business.

TAX ISSUES

Trusts effectively eliminate double taxation of dividends. The cash distributions are taxed in the hands of the individual investor, not as earnings at the corporate level. This allows companies in trusts to maximize their payouts.

Concerns have been raised in respect to the unit holder's potential unlimited liability. Ontario Finance Minister Janet Ecker recently moved to address this risk with a budget proposal to change the law so that investors in income trusts will not be responsible for damages beyond their investment. Other provincial jurisdictions are expected to follow suit.

Ontario's legislation was expected to be passed into law prior to summer recess. But it was not. Now, with a provincial election on the horizon, there may be further delays.

Many income trusts are illiquid with large differences between the buyer's and seller's price. At the federal level, the Canada Customs and Revenue Agency is reviewing the potential loss of tax revenue from these trusts. Many businesses sold into the trust have paid little tax, due in

part to the use of debt in the business. The unit holder continues to defer tax until the distributions are received from the fund.

Although there is a possibility of legislative changes, they are not likely to affect existing trusts. Sponsors should still be aware of this debate, though, as significant changes to tax legislation could impact pricing, demand, supply and liquidity.

Pension fund investors need to consider several factors when they look to invest in income trusts. Here are a few of the issues that arise from the ownership of an income trust:

- **Credit.** Evaluate the ability of the underlying business to sustain the level of cash flow promised.
- **Equity.** Examine the prospects for the business to survive indefinitely as the trust has no maturity date.
- **Interest rates.** The decline in rates has played a significant role in creating a demand for this product and any sustained rise in the level of interest rates will have a negative impact.
- **Inherent risks.** Specific company/business risks can affect a trust's ability to pay its distribution to investors. The health of the economy, the ability of the company to manage profitability, consumer sentiment, competition and key personnel are but a few important factors. Sponsors must conduct research in the same manner as they would for any equity investment.
- **Debt.** Most trusts will have some degree of debt imbedded in them. The key is determining what level is appropriate for the underlying business, whether the cost of it will undermine the continued cash flow distributions and if there any refinancing risks.
- **Capital expenses.** In order to maintain the company's ongoing business, will unexpected capital expenditures be required that could endanger the income distribution?
- **Liquidity.** What is the level of liquidity of the investment?
- **Management.** If management has a minor ownership stake in the trust, what is their incentive to maintain the trust's health? Who does management work for, and how do they get paid? What is the cost of the management contract? Do they have any conflicts with the unit holders?
- **Valuation/pricing.** What is the valuation/pricing of the investment relative to other income trust offerings?

Most business trusts today are being priced in the 9% to 12% pre-tax range. The yield is quoted as a current yield based on past or expected distribution, and the

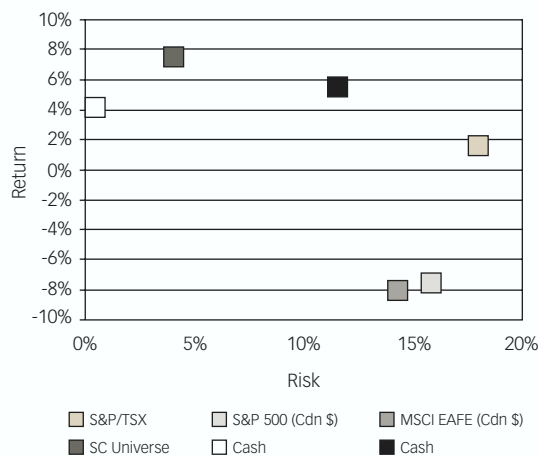
Correlation analysis

The returns of business trusts are not closely related to those of other asset classes.

Correlation	TSX income trusts	S&P/TSX	S&P 500 (Cdn \$)	MSCI EAFE (Cdn \$)	SC Universe	SC Universe BBB	SC 91-day T-Bill
TSX income trust	1.00	0.24	0.25	0.24	0.14	0.11	0.13
S&P/TSX	0.24	1.00	0.68	0.68	-0.07	0.12	0.00
S&P 500 (Cdn \$)	0.25	0.68	1.00	0.77	-0.23	-0.07	0.06
MSCI EAFE (Cdn \$)	0.24	0.68	0.77	1.00	-0.06	0.11	0.04
SC Universe	0.14	-0.07	-0.23	-0.06	1.00	0.81	0.23
SC Universe BBB	0.11	0.12	-0.07	0.11	0.81	1.00	0.16
SC 91-day T-Bill	0.13	0.00	0.06	0.04	0.23	0.16	1.00

Risks and rewards

Income trusts offer a premium return, but pension plans must be willing to take on extra risk. (Four-year analysis at May 31, 2003.)



underlying initial investment or current value of its principal. One appropriate method used to value a business income trust is to compare its yield to that of a similar corporate bond with a long maturity date.

The credit level of the average business income trust is below investment grade (less than BBB). A comparison of the average yield on income trusts to the yield on the Scotia Capital Universe Corporate Index at the end of May, reveals an excess yield of 5% to 7% in favour of income trusts (see "It's all relative," page 49). This is in line with the past four years of pricing history, suggesting that while trusts have appreciated, they remain consistently priced.

Income trusts do offer a return premium in recognition of the higher credit and related risks. Investors must decide whether it is sufficient compensation for the risk exposure (see "Risks and rewards," above).

Going forward, a key risk to the business trust market is

a rise in interest rates. If rates go up, two pricing events will affect these trusts. The first will be an increase in the yield of other competing fixed-income investments. The second will be a higher discount rate used to value cash distributions. These events will decrease the relative value of the trust and, as a result, its pricing.

The most efficient way for sponsors to take advantage of income trusts is to invest through a diversified fund. As with all major asset classes, investors should examine the investment manager's experience, track record and depth of expertise in this particular field. A thorough manager search will identify the fund and manager that best meets the investor's objectives.

Income trusts can offer value to a pension plan over time through a premium return, but with a measured increase in risk. Income trusts do have a relatively short history, though. As well, the returns of business trusts are not closely related to that of other asset classes (see "Correlation analysis," page 53). As an operating business, trust returns are impacted by economic and specific business conditions, and by the status and direction of interest rates.

Income trusts offer value to sponsors through their premium returns. They also offer risk diversification relative to both stocks and bonds. To minimize specific security risk and to diversify, sponsors should invest with a professionally managed fund that has experience and a solid track record.

Business income trusts are consistently priced relative to historic levels, but they are sensitive to changes in interest rates as well as the credit of the trust itself. It is also important to remember that these trusts have not been around for a long time, so the analysis of their performance is limited. As a result, investors should be prepared for potentially dramatic changes in value in alternative business and economic environments.

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