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Income Trusts and Growth: Empirical Evidence

Chengye Sun

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Abstract
This paper provides empirical evidence on the growth, financing activity, and operating performance of Canadian business income trusts. We find that business income trusts are growing in terms of total assets and sales revenues. They frequently acquire other businesses in post-IPO period. We also find that income trusts are likely to issue third-party debt to finance acquisitions. Median operating return on total assets decreases after an business income trust IPO, indicating an operating performance inferior to that in pre-IPO years.

About the author
Chengye Sun is a Ph.D. Candidate at the Sprott School of Business, Carleton University, in Ottawa, Ontario, Canada.

Carleton University
Sprott School of Business

710 Dunton Tower
1125 Colonel By Drive
Ottawa, ON K1S 5B6 Canada
Tel: (613) 520-2388
Fax: (613) 520-4427
www.business.carleton.ca

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Chengye Sun
Sprott School of Business, Carleton University

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Author contact: Chengye Sun, Sprott School of Business, Carleton University, 1125 Colonel By Drive, Ottawa, Ontario, Canada K1S 5B6, Tel: (613) 265-5096, Email: csun@connect.carleton.ca

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The Strategic Dimensions of Information Systems Capability: An Evolutionary and Resource-based View

1. Introduction

Studies reported that the Canadian income trusts IPO market became hot after year 2002. King (2003) estimated that the capitalization of income trust market jumped from $30 billion to $50 billion in 2002. Tax advantage is also among the reasons that make income trusts become popular. An income trust generally passes through overwhelming portion of its incomes to unit holders in forms of interest income, dividend, and return of capital, so that the incomes are taxed only on unit holders' side. Aggarwal and Mintz (2004) estimated that income trusts have $400 to $600 million tax benefit in 2004. Hayward (2002) estimated a total benefit of $1 billion. However, Shenfeld (2003) pointed that investors would not enjoy a significantly large tax benefit because personal tax incurred on received income would offset the benefit. Investors' tax benefit results in the Canadian government's tax revenue loss. Although the exact amount is difficult to estimate, the Canadian federal government concerned that booming income trust market would result in more and more tax revenue loss. In October 2006, Canadian Finance Minister, Mr. Jim Flaherty, announced that the income trusts will be taxed as corporations: existing income trusts will be taxed starting from 2011, and new income trusts will be taxed immediately.

Jog and Wang (2004) found 94 income trust IPO transactions in the Toronto Stock Exchange with gross proceeds of $7,780 millions in 2002 and 2003; in the same period, 12 common stock IPOs were transacted with gross proceeds of 765 millions. Based on the characteristics of their operating assets, income trusts can be categorized as: resource trusts, real estate trusts, investment trusts, utility trusts, and business income trusts. Jog and Wang (2004) found that business income trusts have come to dominate the income trust market since 2002. Business income trusts are generally mature businesses that have stable and predictable cash flows and do not stand opportunities of growth in productivity. These mature businesses aim to distribute all pre-tax income to unit holders. Efficient capital allocation theory states that capital is a rare resource; it should flow to the fastest-growing businesses that represent the highest-

returning investment opportunities. If capital flows to business income trusts, high-growth investment opportunities would be short-funded. In this way, investment in business income trusts would negatively affect the growth potential in Canada. On the other hand, Jog and Wang (2004) found business income trusts frequently went to the equity market for subsequent issuing and more than 50% of the raised capital was used for capital expenditure and acquisitions, indicating that business income trusts may not be an impediment to investment growth. The question of whether business income trusts keep growing in post-IPO period remains unanswered.

Jain and Kini (1994) found that common equity IPOs have inferior operating performance in post-IPO period than in pre-IPO period. They argued that the management of IPO companies might not be able to manage the new large firms, resulting in the poor operating performance. Business income trust IPOs generally have mature operating businesses and acquire other mature businesses. This raises an issue similar with common equity IPOs that the management of business income trusts may not be able to manage the new trusts. In addition, the newly acquired businesses may not be able to generate sufficient cash flow to sustain a business income trust's promised cash distribution. We expect that business income trusts have inferior operating performance in post-IPO period. However, there is no study investigating business income trusts' operating performance yet.

In this paper, due to the similar characteristics of the operating assets of resources trusts, utility trusts, and business trusts, we include resources trusts and utility trusts into our business trusts sample. We found that more than half of the income trusts have larger-than-zero growth rates in total assets and revenues in post-IPO period, suggesting that income trusts keep growing after going public. In addition, business income trusts acquire new businesses and finance the acquisitions by frequently issuing debt. Operating performance of income trusts in post-IPO years is inferior to the performance in pre-IPO years

The structure of this paper is as follows: in the next section, we describe our data sources and income trusts IPO sample. In section 3, we document empirical evidence and discuss issues associated with income trust structures. In the last section, we draw our conclusions

2. Data Sources and Sample Description

We build up our sample by selecting newly listed income trusts[1] from the Toronto Stock Exchange *Monthly Review*, recording their names, and finding their prospectuses in SEDAR (http://www.sedar.com). Since prospectuses issued prior 1997 are not available, our sample only includes income trust IPOs after 1997. Table 1 shows compositions of our final sample. In total, there are 59 income trust IPOs in the sample. 43 are business income trusts IPOs and 16 are resource and utility income trusts IPOs. This sample covers all the Canadian income trusts IPOs in the business, resource, and utility sectors issued from 1997 to 2003. Based on this universe, we expect to provide unbiased results and objective conclusions on Canadian income trusts.

Table 1

Final Income Trust IPO Sample of This Paper

		Issuance Year						
		1997	1999	2000	2001	2002	2003	Total
category	Business	8	1	0	4	22	8	43
	Resource	0	0	1	3	3	2	9
	Utility	2	0	0	1	2	2	7
	Total	10	1	1	8	27	12	59

		Post-IPO Year			
		t	t+1	t+2[2]	t+3[3]
category	Business	43	43	35	13
	Resource	9	9	7	4
	Utility	7	7	5	3
	Total	59	59	47	20

[1] Income trusts under "Newly Listed Companies" section in *TSE Monthly Review* are considered as income trust IPOs.

[2] Second post-IPO-year financial data are not available for 12 IPOs in 2003.

[3] Third post-IPO-year financial data are not available for the 27 IPOs in 2002 and the 12 IPOs in 2003.

3. Empirical Results

3.1. Evidence of Growth

Table 2 shows income trusts' annual total assets growth rate. In Panel A, median growth rate in year t, or IPO year, is 44%; this is because income trusts use gross proceeds raised from unit holders to acquire businesses and therefore significantly increase the total asset base. Median total assets growth rates in year t+2 and t+3 are 2% and 4%, respectively. In general, income trusts total assets grew in post-IPO years. In Panel B, 28, or 60%, of income trusts have total assets growth rate larger than 0% in year t+2; this percentage is slightly lower than the percentage in year t-1, which is 61%. We also test the percentage of income trusts with total assets growth rate larger than 5%, 10%, or 20% respectively, and we do not find a significant drop in percentage of income trusts at any level of total assets growth rate.

Table 3 shows the ratios of capital expenditure over depreciation and amortization. The median ratio decreases from 1.15 in year t-3 to 1 in year t-1, and from 0.71 in year t+1to 0.69 in year t+2, indicating that operating companies invest less and less to expand existing producing capacity in pre-IPO period. Because the businesses are already mature, income trusts just maintain rather than expand their existing businesses. 28, or 50%, of income trusts have capital expenditure greater than depreciation and amortization in year t-1, however, the percentage drops to 30% in year t+1. It shows that 70% of income trusts do not expand their existing businesses after IPO. The lowest ratio is in year t when capital expenditure takes 52% of depreciation and amortization. This is because income trusts spend a large amount of free cash in acquiring businesses and reducing the cash in capital expenditure.

Table 2 Economic Growth of Income Trusts

Panel A Total Assets Growth Rate

	Year					
	t-2	t-1	t	t+1	t+2	t+3
Number of Income Trusts[4]	21	57	58	59	47	18
Median	0.05	0.02	0.44	0.01	0.02	0.04
Mean	0.13	0.26	1.34	0.23	0.1	0.19
Std. Deviation	0.25	0.65	2.99	0.68	0.23	0.32
Minimum	-0.26	-0.46	-0.46	-0.48	-0.37	-0.09
Maximum	0.81	3.55	19.06	3.71	0.77	0.86
t (comparing to 0)	2.38	3.04	3.41	2.59	3.01	2.5
p value	0.03	0	0	0.01	0	0.02
Number of IPOs with this multiply >0	15	35	47	33	28	11
Percentage	71%	61%	81%	56%	60%	61%

Panel B Counts and Percentages

	Year					
	t-2	t-1	t	t+1	t+2	t+3
Total Sample	21	57	58	59	47	18
growth rate >0%						
Number of income trusts	15	35	47	33	28	11
percentage	71%	61%	81%	56%	60%	61%
growth rate >5%						
Number of income trusts	10	27	42	20	21	9
percentage	48%	47%	72%	34%	45%	50%
growth rate >10%						
Number of income trusts	9	22	39	17	18	6
percentage	43%	39%	67%	29%	38%	33%
growth rate >20%						
Number of income trusts	5	15	36	16	13	5
percentage	24%	26%	62%	27%	28%	28%

While income trusts do not expand their existing businesses, they achieve growth by frequently acquiring other businesses. In Table 4, 34% of income trusts have more than two acquisition transactions in a total of three post-IPO years; the corresponding percentage in pre-IPO period is 27%. We find 4 out of 51[5] income trusts acquire businesses in all the pre-IPO years[6], representing 8% in our sample; on the other hand, 5 out of 20 income trusts acquire businesses in all the post-IPO years, representing 25% of our sample.

[4] The following numbers of income trusts do not have financial data on total assets: 38 income trusts in year t-3; 2 income trusts in year t-2; 1 income trust in year t-1; 2 income trusts in year t+2.

[5] 8 income trusts do not have available data on acquisitions in year t-3.

[6] We collect income trusts' financial data up to three pre-IPO years and three post-IPO years.

Table 3

Capital Expenditure in proportion of Depreciation & Amortization
(Capital Expenditure / Depreciation & Amortization)

	Year						
	t-3	t-2	t-1	t	t+1	t+2	t+3
Number of Income Trusts[7]	48	56	56	56	57	46	20
Median	1.15	1.04	1	0.52	0.71	0.69	0.8
Mean	4.97	2.27	2.46	1.6	1.06	0.91	1.01
Std. Deviation	21.02	4.4	4.24	3.29	1.29	0.92	1.03
Minimum	0	0	0	0	0	0	0.08
Maximum	146.74	28.2	23.55	17.43	6.3	4.86	4
t (comparing to 1)	1.31	2.16	2.57	1.36	0.34	-0.70	0.04
P value	0.20	0.04	0.01	0.18	0.74	0.49	0.97
Number of IPOs with this multiply >1	25	29	28	15	17	12	7
Percentage	52%	52%	50%	27%	30%	26%	35%

Table 4

Number of Income Trusts With Acquisitions in Pre-and Post-IPO Period

Panel A In Pre-IPO Years

	Number of Acquisitions			
	0	>=1	>=2	=3
Number of income trusts with acquisition transaction	27	32	16	4
percentage	46%	54%	27%	8%
number of income trusts with available financial data	59	59	59	51

Panel B In Post-IPO Years

	0	>=1	>=2	=3
Number of income trusts with acquisition transaction	29	30	16	5
percentage	49%	51%	34%	25%
number of income trusts with available financial data	59	59	47	20

3.2. Financing sources

In Table 5, of the 21 income trusts that acquire businesses in year t+1, 12 or 57% use debt[8] and debt related financing instruments to raise money, and 6 or 29% use subsequent offerings and related financing. In year t+2, 63% income trusts use debt and related financing for acquisitions, and only 10% use subsequent offering and related financing. In year t+3,

[7] The following number of income trusts do not have financial data on capital expenditure or depreciation and amortization: 12 income trusts in year t-3; 3 in year t-2; 3 in year t-1; 2 in year t; 2 in year t+1; 1 in year t.

[8] Third-party debt is listed under "liability" in balance sheet. Though income trust units are considered as quasi-equity because they include both equity and subordinated debt, income trust units are listed under "unitholders equity" in balance sheet. In our study, we consider third-party debt as income trusts long-term liability, and we consider income trust units as equity.

percentages of income trusts using debt, and subsequent offering and related financing are 73% and 18%, respectively. This evidence shows that income trusts are more likely to issue third-party debt for the acquisition of businesses.

Table 6 shows long-term debt to total assets ratios of the whole sample. The median ratio is 0.14 in year t, and reaches 0.19 in year t+2. In general, income trusts keep raising debt in the post-IPO period, and have a higher leverage in year t+2 than in year t . A higher leveraged capital structure than before may pose a potential problem in cash distribution. During a period of economic downturn, an income trust would not be able to sustain cash distributions to unit holders because the majority of operating cash inflow would be used for paying interest expense. Third-party debt holders may also ask to suspend cash distributions to unit holders through bond covenants when income trusts have cash problems. Therefore, the higher leveraged capital structure an income trust has, the higher relative risk the income trust involves.

Table 5 Financing Manners

Year t+1		
Debt and Debt Related Financing	12	57%
Debt	6	29%
Debt + Eternal Available Cash	3	14%
Debt + Subsequent Offering	3	14%
Sequent Offering	2	9%
Subsequent Offering + Eternal Available Cash	1	5%
Eternal Available Cash	6	29%
Total	21	100%
Year t+2		
Debt and Debt Related Financing	12	63%
Debt	10	53%
Debt + Eternal Available Cash	2	11%
Sequent Offering	1	5%
Subsequent Offering + Eternal Available Cash	1	5%
Eternal Available Cash	5	26%
Total	19	100%
Year t+3		
Debt and Debt Related Financing	8	73%
Debt	5	45%
Debt + Eternal Available Cash	2	18%
Debt + Subsequent Offering	1	9%
Subsequent Offering + Eternal Available Cash	1	9%
Eternal Available Cash	2	18%
Total	11	100%

Table 6 Long-Term Debt to Total Assets Ratio of Income Trusts

	t-3	t-2	t-1	t	t+1	t+2	t+3
Number of Income Trusts	21	58	58	58	58	46	20
Median	0.20	0.33	0.32	0.14	0.15	0.19	0.18
Mean	0.21	0.30	0.31	0.15	0.15	0.18	0.19
Std. Deviation	0.18	0.25	0.25	0.16	0.16	0.16	0.22
Minimum	0	0	0	0	0	0	0
Maximum	0.59	0.75	0.85	0.86	0.87	0.78	0.96

3.3. Operating Performance

Operating return on total assets is calculated by EBITDA over total assets. It indicates cash generating ability of an operating company, and therefore can be used to measure the sustainability of cash distribution to unit holders as well. In Table 7, Panel A, for income trusts with acquisitions in post-IPO period, median operating return on total assets drops from 18% in year t-1 to 12% in year t+1. The median operating returns on total assets are 13% and 12% in year t+2 and t+3, respectively. Income trusts display worse operating performance in the post-IPO period than in the pre-IPO period. The acquired businesses may not have operating returns on total assets that are as high as income trusts' existing businesses. Therefore, sustainability of cash distributions are negatively affected by income trusts' acquisition transactions. In Table 7, Panel B, for income trusts without acquisitions in the post-IPO period, we also find inferior operating performance in the post-IPO years. Median operating return on total assets drops from 18% in year t-1 to 10% in year t+2, indicating that management does not perform as well as before, after re-organizing their businesses into an income trust structure. Based on our whole income trust sample, Table 7, Panel C shows the number and corresponding percentage of income trusts that have worse performance in the post-IPO years than in year t-1. 37, or 65% of income trusts in year t+1 have inferior performance than in year t-1; 27, or 59% income trusts have inferior performance in year t+2; and 13, or 68% of income trusts in year t+3. In general, more than half of income trusts perform worse in post-IPO period.

4. Conclusions

In this paper, based on a sample that includes business income trust IPOs in the period from 1997 to 2003, we provide evidence that business income trusts show increases in total assets and sales revenues in post-IPO period; this evidence suggests income trusts may not necessarily be an impediment to investment. Business income trusts expand by frequently acquiring other businesses, divisions and income trusts. The income trust management is more likely to raise money from the debt market to finance these acquisition transactions. On average, business income trusts have a lower operating return on total assets.

Table 7 Operating Return on Total Assets

Panel A Sub Sample of Income Trusts With Acquisition

	t-3	t-2	t-1	t	t+1	t+2	t+3
Number of Income Trusts	10	28	29	29	30	27	13
Median	0.12	0.17	0.18	0.12	0.12	0.13	0.12
Mean	0.14	0.19	0.19	0.13	0.13	0.13	0.14
Std. Deviation	0.08	0.13	0.10	0.08	0.05	0.05	0.06
Minimum	0.03	0.03	0.04	0.04	0.01	0.05	0.05
Maximum	0.27	0.72	0.44	0.41	0.22	0.24	0.28

Panel B Sub Sample of Income Trusts Without Acquisition

	t-3	t-2	t-1	t	t+1	t+2	t+3
Number of Income Trusts	10	28	28	29	29	20	7
Median	0.25	0.19	0.18	0.11	0.12	0.10	0.14
Mean	0.25	0.23	0.21	0.12	0.14	0.15	0.15
Std. Deviation	0.13	0.17	0.14	0.10	0.09	0.12	0.10
Minimum	0.08	0.06	0.03	0.00	0.00	0.03	0.05
Maximum	0.46	0.86	0.54	0.45	0.44	0.53	0.35

Panel C Full Income Trust Sample

	Comparison Relative to Year t-1			
	t to t-1	t+1 to t-1	t+2 to t-1	t+3 to t-1
Number of Income Trusts	56	57	46	19
Median	-0.05	-0.02	-0.01	-0.04
Mean	-0.07	-0.07	-0.06	-0.07
Std. Deviation	0.12	0.13	0.12	0.13
Minimum	-0.5	-0.46	-0.48	-0.45
Maximum	0.21	0.19	0.15	0.08
t (comparing to 0)	-4.11	-3.9	-3.13	-2.41
P value	0	0	0	0.03
Number of income truss with this multiply >0	39	37	27	13
Percentage	70%	65%	59%	68%

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