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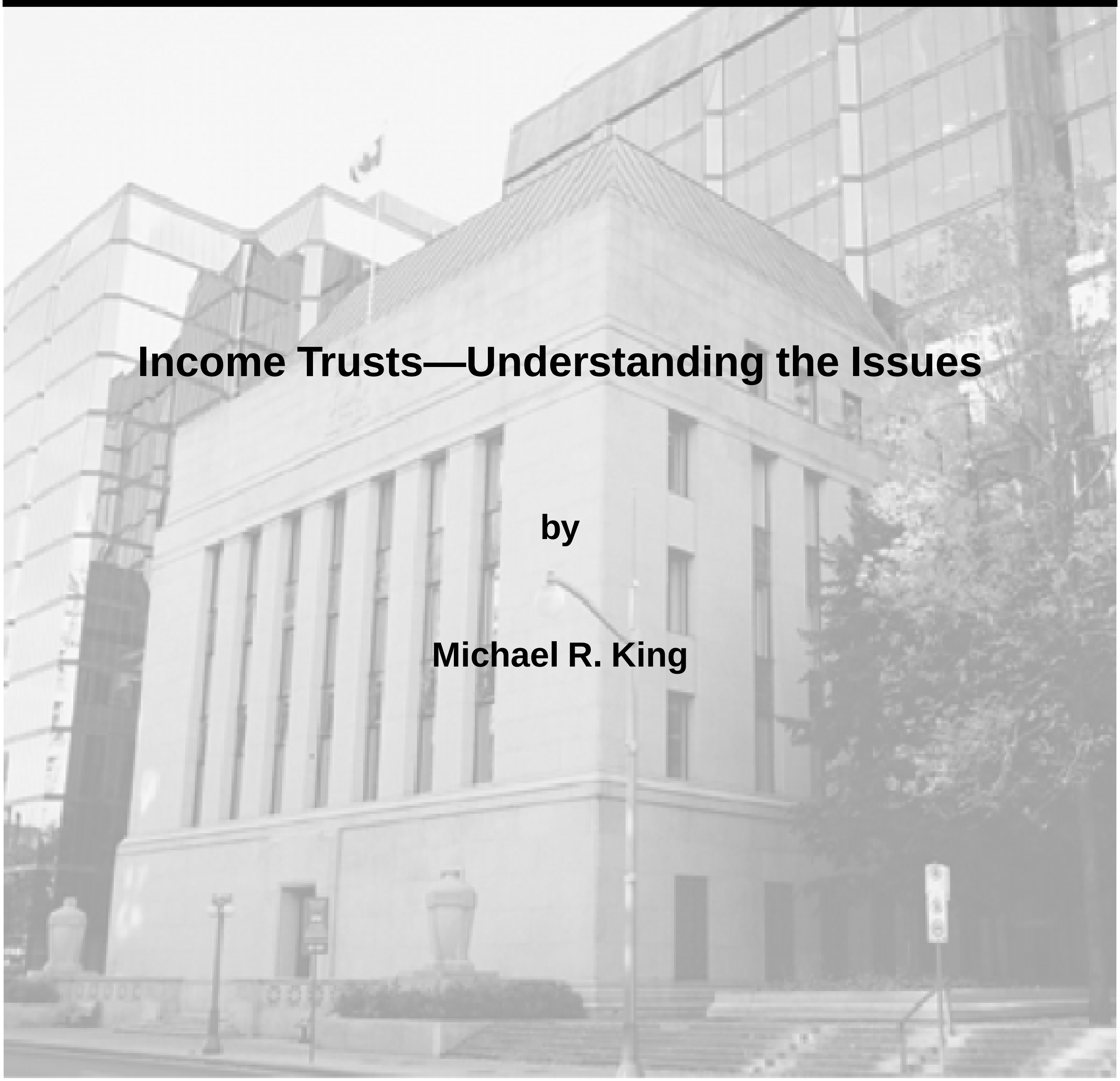

Income Trusts—Understanding the Issues

by

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Abstract

An income trust is an investment vehicle that distributes cash generated by a set of operating assets in a tax-efficient manner. The market capitalization of income trusts has grown rapidly over the past two years, reaching $45 billion at year-end 2002. The sharp rise of income trust valuations, the large supply of new issues, and the complexity of their legal structure have increased scrutiny of this asset class. Because retail investors are the principal owners of income trusts, the author explores whether the cash returns from income trusts are in line with the risks. The structure and valuation of a typical income trust are outlined. The benefits of income trusts and the issues related to investment are elaborated, focusing on legal and regulatory issues, corporate governance, operational issues, and market issues.

JEL classification: G12, G3
Bank classification: Financial markets

Résumé

Les fiducies de revenu sont des instruments de placement qui versent les gains produits par un portefeuille d'actifs d'exploitation, et ce, en réduisant l'incidence de l'impôt des sociétés. La capitalisation boursière de ces fiducies s'est accrue rapidement au cours des deux dernières années, atteignant 45 milliards de dollars à la fin de 2002. La forte hausse de leur valeur, l'abondance des nouvelles émissions et la complexité de leur structure juridique ont eu pour effet de diriger davantage l'attention sur cette catégorie d'actif. Dans son étude, l'auteur cherche à déterminer si les montants versés aux détenteurs de parts, dont la majorité sont des particuliers, sont proportionnels aux risques. Il donne également un aperçu de la structure et du mode d'évaluation d'une fiducie de revenu type. Enfin, il décrit les avantages qu'offrent ces instruments de même que les questions qu'ils soulèvent sur les plans juridique et réglementaire et sur ceux de la gouvernance, des opérations et du marché.

Classification JEL : G12, G3
Classification de la Banque : Marchés financiers

1. Introduction

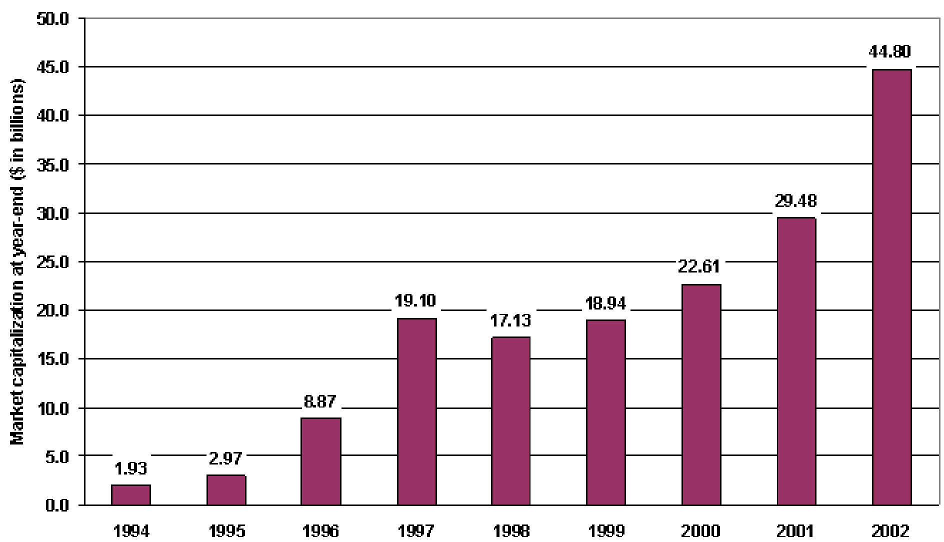
Income trusts had a market capitalization of $45 billion at year-end 2002, a dramatic increase from the $29.5 billion at year-end 2001 and the $2 billion at year-end 1994 (Figure 1). The sharp rise of income trust valuations and the large supply of new issues have increased scrutiny of the valuation of this asset class. Given the complexity of income trust structures, analysts speculate that retail investors may not understand all the issues raised by this type of investment. This paper reviews the key characteristics of income trusts, and outlines a number of issues related to their legal structure, management, and valuation.

An income trust is an investment vehicle that pays out substantially all of the cash flows generated from relatively mature, revenue-producing assets in a tax-efficient manner. This structure allows the owners of a business to sell off assets at a higher valuation than when the assets are held in a corporate structure. This higher valuation is driven by the high demand for income trust units and the tax savings generated by this structure, which reduces or eliminates corporate tax for the operating company. Investors in an income trust therefore receive a higher level of cash distribution than is possible when the same assets are held by a corporation. Investors have earned high total returns over the past year from income trusts, which are eligible for a registered retirement savings plan (RRSP), pension accounts, and other non-taxable accounts. The growth of this asset class has also benefited the Canadian securities industry by bolstering earnings during a period of weakness in other investment-banking businesses.

The Bank of Canada's principal interest in the income trust sector concerns the efficient functioning and health of Canada's financial system. Capital markets form a key part of Canada's financial system, and make an important contribution to the welfare of Canadians. This paper provides background information on an important sector of Canadian capital markets, to foster an informed discussion about income trusts both within the Bank and with other interested parties.

Section 2 highlights the phenomenal growth of this asset class over the past two years. Section 3 describes how an income trust is structured. Section 4 discusses the valuation of income trusts. Section 5 reviews the benefits and the issues to consider when investing in income trusts. Section 6 concludes with a discussion of the implications of income trusts for the efficiency and health of Canada's financial system.

Figure 1: IncomeTrust Market Capitalization
(Source: CIBC World Markets 2003)



2. Growth of the Income Trust Sector

An income trust is a special-purpose entity that sells equity to the public ("unitholders") in the form of units and uses the proceeds to purchase an operating company that holds a set of income-generating assets. Legally, income trusts are a subset of the broader category of "mutual fund trusts" within the meaning of the Income Tax Act (Canada).[1] The term income trust can be used broadly to cover a variety of businesses and models, or used narrowly to refer to a segment of this asset class. In this paper, income trusts refer to royalty trusts, real estate investment trusts ("REITs"), and trusts based on a variety of businesses (also called hybrid trusts or business income trusts), but they exclude limited partnerships.[2] In principle, an income trust owns mature assets that require little ongoing capital expenditure, face little competition, and provide a long-term stream of cash flows. Examples of such assets are natural gas processing and distribution, electrical power generation, mining, and warehouse facilities. In practice, a wide variety of businesses have been securitized through income trusts, such as restaurants, consumer product companies, manufacturing businesses, and telecommunications assets.[3] Table 1 gives a breakdown of income trusts by business sector.

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1. Subsection 132(6) of the Income Tax Act (Canada) sets out the criteria for qualifying as a mutual fund trust. Mutual fund trusts may be open-ended or closed-ended. For more details, see CIBC (2003), Hayward (2002), and TD Newcrest (2002).
2. Surprisingly, there is no consensus on the number of income trusts outstanding, with figures reported from 100 to 200. This confusion may result from a lack of consistency in the use of the term income trust, with some figures including oil and royalty trusts and REITs. See BMO Nesbitt Burns (2003), CIBC (2003), TD Newcrest (2002), and National Bank Financial (2003).
3. Income trusts have been created for bleach processing, cheque printing, coffee decaffeination, gas stations, heating oil, ice, newspapers, peat moss, pet food, pulp, and waste disposal.

Table 1: Income Trusts by Business Sector

Business sector	Number of trusts	Per cent share by market capitalization
Consumer and manufacturing businesses	44	31
Real Estate/REITs	16	22
Oil and gas	15	27
Power generation	8	11
Other resource-based	4	9
Total	87	100

Source: Scotia Capital (2002)

Income trusts, having a total market capitalization of $45 billion by year-end 2002, represented about 6 per cent of the stock market capitalization of the Toronto Stock Exchange (CIBC 2003). Income trusts are not included in the Standard and Poor’s/Toronto Stock Exchange (S&P/TSX) Composite Index, but would rank eighth among the subindexes based on their market capitalization (Scotia Capital 2002). In comparison, the Canadian corporate bond market had a market capitalization of approximately $837 billion at year-end 2002, of which the high-yield market was around $5 billion.

The phenomenal growth of income trusts has been driven by the appreciation of outstanding income trust values, and the issuance of units through initial public offerings (IPOs) and subsequent sales by existing income trusts. First, income trusts outperformed both equity and government bonds in 2002, with the BMO Nesbitt Burns Trust Composite posting a total return of 13.7 per cent in 2002. This return compares with -12.4 per cent for the S&P/TSX Composite Index and 10.8 per cent for 10-year Canada bonds (Table 2). Note that the total return of the BMO Nesbitt Burns Trust Composite hides a considerable amount of volatility in this asset class, as income trusts underperformed the overall equity market in the fourth quarter of 2002.

Table 2: Total Return in 2002

Index	Per cent
BMO Nesbitt Burns Trust Composite	13.7
S&P/TSX Composite	-12.4
10-year Canada bonds	10.8

Source: BMO Nesbitt Burns (2003)

Second, sales of units by income trusts totalled $9.4 billion in 2002. IPOs of income trust units dominated the market for new equity issues, with 36 income trusts totalling $5.1 billion being offered to the public, representing 86 per cent of the value of Canadian IPOs last year. Existing income trusts sold an additional $4.3 billion of units in 56 offerings.[4] Figure 2 shows total income trust issuance by quarter, including the sharp rise in the number of offerings beginning in the fourth quarter of 2001. Income trusts have represented a rising share of equity issuance over the past two years, accounting for approximately 40 per cent of issuance on the TSX and the TSX Venture Exchange (Table 3 and Figure 3). According to data collected by the Investment Dealers Association of Canada (IDA), the average size of an equity offering by an income trust in 2002 was $100 million, significantly larger than the average equity offering of $6.8 million (Table 3).[5] The major investors in this asset class are retail investors, who represent, on average, two-thirds of the purchases of income trust IPOs in 2002 (Scotia Capital 2002).

4. An existing income trust is one that had previously gone public through an IPO. Because most income trusts are open-ended, an existing income trust can sell additional units to the public to raise new capital. This new capital can be used to purchase new assets, or to replenish equity capital that has been paid out by the income trust.
5. This size difference may be due to the development of this sector, with the creation of new income trusts driving growth. Once the income trust sector matures, the average size can be expected to decline.

Table 3: Annual Canadian Equity Issuance, 1996–2002

Year	Income trust issuance			Common equity issuance			Income trust as % of total issuance
	Value ($bn)	No. of issues	Avg. size ($mn)	Value ($bn)	No. of issues	Avg. size ($mn)	
1996	4.3	30	142.1	21.2	2,774	7.6	17
1997	10.3	70	147.2	25.6	1,723	14.9	29
1998	2.5	28	87.6	18.3	1,493	12.3	12
1999	1.6	34	46.0	17.6	1,923	9.2	8
2000	2.9	31	92.8	20.7	2,155	9.6	12
2001	7.0	77	90.9	12.1	1,796	6.8	37
2002	11.0	108	101.7	15.8	2,315	6.8	41

Source: IDA (2002a,b, 2003)

Figure 2: Quarterly Issuance of Income Trusts
(Source: IDA 2002 a, b, 2003)

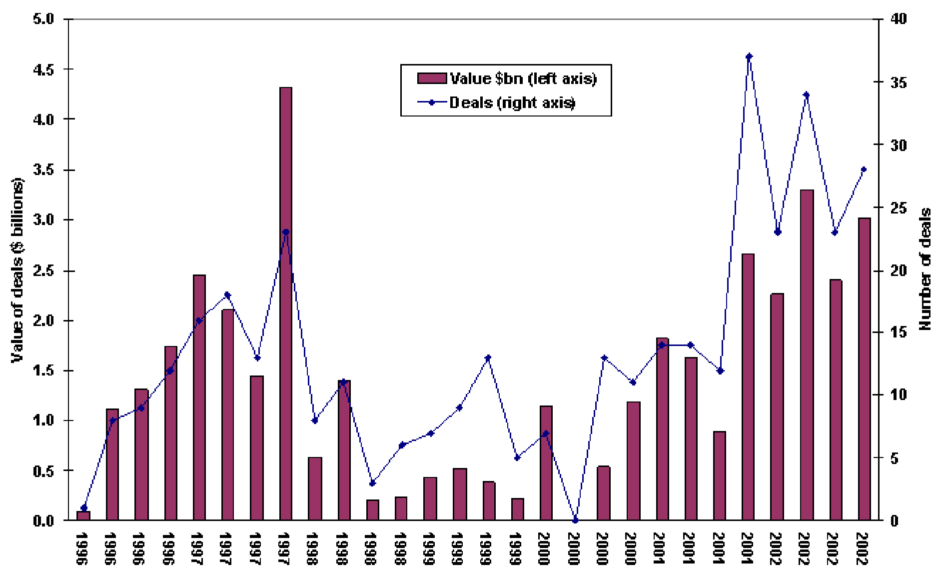
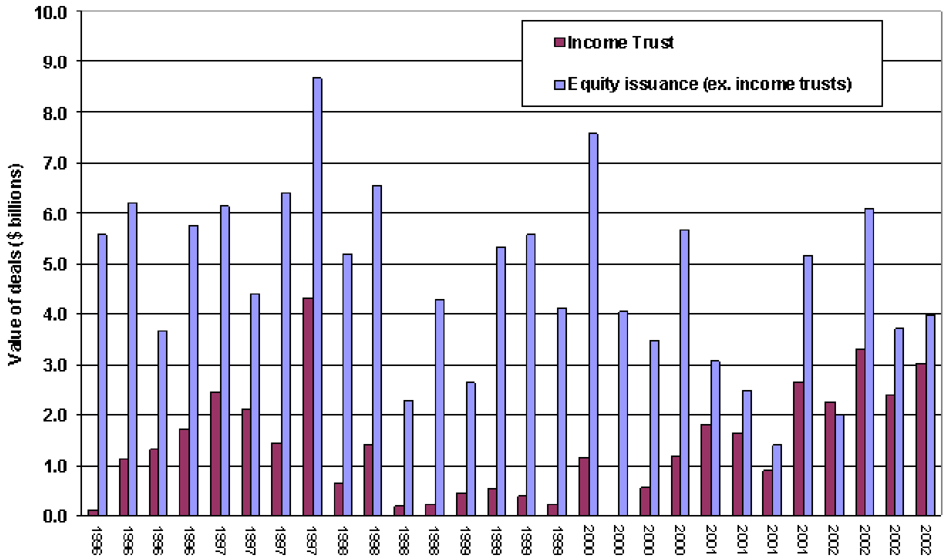


Figure 3: Quarterly Total Equity Issuance
(Source: IDA 2002 a, b, 2003)



In 2002, IPOs by income trusts represented four of the five largest Canadian IPOs in 2002 (Table 4).[6] Although the income trust market was very hot in 2002, the market showed signs of slowing towards the end of that year, with a number of IPOs being pulled or postponed due to a lack of demand and a general repricing of the sector. The new supply of income trusts, which exceeded $2 billion per quarter from late 2001, appears to have exceeded demand. Investors— particularly institutional buyers of income trusts—backed away from the IPO market, and only three income trust IPOs were completed in December. Over the fourth quarter of 2002, the BMO Nesbitt Burns Trust Composite actually suffered a loss of -0.2 per cent, whereas the S&P/TSX Composite posted a total return of 7.5 per cent.

Table 4: Largest Initial Public Offerings of 2002

Offerings	Value $mn	Gross underwriters' fees
SFK Pulp Fund	414.8	$22.8 mn / 5.50%
TSX Group Inc.	341.6	$17.1 mn / 5.00%
Bell Nordiq Income Fund	324.4	$17.0 mn / 5.25%
InnVest Real Estate Investment Trust	300.0	$16.5 mn / 5.50%
Boralex Power Income Fund	250.0	$13.1 mn / 5.25%

Source: PricewaterhouseCoopers, SEDAR filings

6. "Income Trusts Power Canadian IPO Market to Record Levels in 2002," press release by Pricewaterhouse Coopers, 7 January 2003.

A significant development in the income trust market in 2002 was the sale of U.S.-based assets through a Canadian income trust. Heating Oil Partners Income Fund was the first Canadian income trust to be created using U.S. operating assets, but six other U.S. businesses had filed prospectuses for similar transactions by the end of 2002. In March 2003, Specialty Foods Income Fund became the second income trust based on U.S. assets to be issued in Canada. The issuance of a Canadian income trust by a U.S. company has led the financial media to question the valuation of the income trust market.[7] If American companies find it more attractive to sell their businesses in Canada than in the larger U.S. capital markets, observers are led to conclude that the income trust market in Canada must present a unique financing opportunity for businesses.

Commissions from income trust IPOs in 2002 were a principal source of income for investment dealers in a year when industry profits across all major business lines fell (IDA 2002b). While full-year totals are not yet available, as of the third quarter 2002 income trust IPOs were sustaining investment banking revenues, which were the main driver of investment dealer profits. The gross underwriters fee on an income trust IPO is 5 to 6 per cent, which suggests that gross revenues from underwriting $5.1 billion in IPOs were up to $300 million (Table 4). The gross fees on offerings by existing income trusts are likely to have added another $150 million. In comparison, the total net profits for the securities industry in 2001 were $1.01 billion (IDA 2002b). Table 5 shows the lead underwriters of income trust issues in 2002. Income trust IPOs were also a major source of income for corporate law firms. Legal fees for issuers' counsel on a trust commonly range from $500,000 to $1 million or more, with fees for underwriter's counsel generally being about one-half to two-thirds of that amount.[8]

Table 5: Lead Underwriter of Income Trusts in 2002[1]

Rank	Underwriter	Deals	Gross proceeds ($ mn)
1	CIBC World Markets	31	2,967.9
2	Scotia Capital	20	2,011.2
3	RBC Capital Markets	19	1,987.0
4	BMO Nesbitt Burns	13	1,082.4
5	National Bank Financial	6	610.7
6	TD Securities	6	294.1

1. Full credit to lead underwriter.
Source: *National Post*, 27 January 2003

7. U.S. laws restrict the businesses that may qualify for special tax treatment to a few specific industries, such as real estate and natural resources. Apart from REITs and master limited partnerships, the United States does not have a security comparable to an income trust unit.
8. S. Rubin, "Income Trust Offerings Keep Lawyers Hopping," *National Post*, 4 February 2003, p. DM2.

3. Structure of an Income Trust

The structure of an income trust is designed to maximize the cash distributions from a set of revenue-generating assets, with these distributions made on a periodic basis either monthly or quarterly. Cash distributions are maximized because income trusts distribute all available earnings to investors, whereas corporations distribute dividends on a discretionary basis. The cash distributions from an income trust are maximized by minimizing or eliminating the corporate tax paid by the operating company that holds these assets. Under the Income Tax Act, trusts are taxed as individuals and are generally subject to the maximum personal income tax rate. In most circumstances, however, income trusts can claim a deduction for the income distributed to the unit holders, who are then liable to tax on that income according to their individual circumstances. In other words, an income trust is a "flow-through" vehicle that allows income to flow through it and be taxed at the investor level.

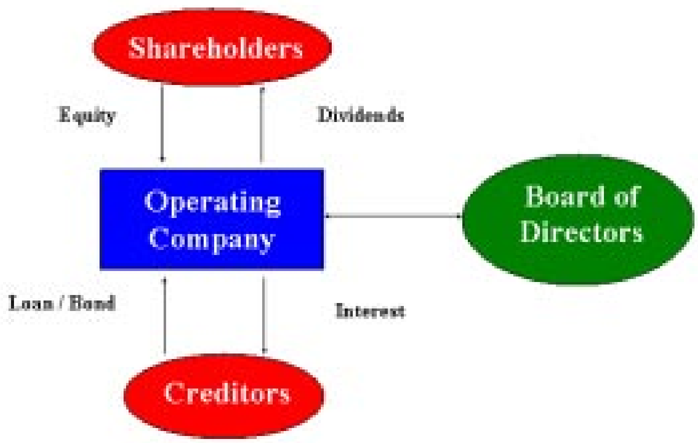
An income trust is typically established to hold all of the shares and a substantial amount of interest-bearing debt of a particular corporation that, in turn, holds assets that have a reasonably predictable revenue stream. The principal objective of the income trust structure is to reduce the incidence of corporate taxation by creating a flow of interest that is deductible by the corporation, and which then "flows through" the trust to be taxed as received by investors. The primary tax advantage of this structure is the elimination of unintegrated corporate-level income tax.[9] The precise structure of any given income trust is determined by the nature of the assets, the tax position of the company that sells the assets to the income trust, and an assessment of the most tax-efficient way to transfer the cash flows to investors.

3.1 Corporate structure

Figure 4 shows a typical corporate structure. The corporation is capitalized with equity and debt, which represent the two principal claims on the income of the corporation. Shareholders invest equity in the company in return for dividends and the potential for capital appreciation of the shares. Dividends are paid out of after-tax income. Shareholders must pay tax on this dividend income in the tax year in which it is received, unless this investment is held in a tax-deferred investment vehicle, such as an RRSP. Likewise, shareholders pay capital gains tax on the price

9. The Canadian tax system recognizes that dividends are distributed from after-tax income. Individuals receive a dividend tax credit to take into account tax paid by the corporation under a mechanism referred to as tax integration. The integration mechanism is based on the small-business income tax rate; thus, credits may be smaller than the tax paid by the corporation. This situation is described as under-integration, and commonly referred to as double taxation.

Figure 4: Corporate Structure



appreciation of their shares over their cost base only when the shares are sold, allowing investors to defer this tax for the future. Creditors provide debt financing to the corporation in the form of bank loans, trade credit, or fixed-income securities issued through the capital markets. This interest is paid out of pre-tax income. This debt can be secured against the assets of the corporation, or the debt can represent an unsecured claim.

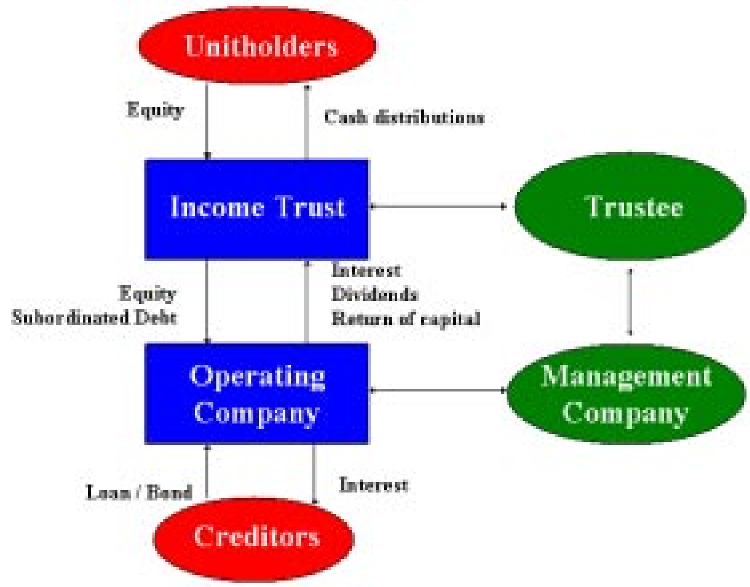
In a corporate structure, a group of full-time, professional managers run the company. These managers are supervised by a board of directors, staffed by some combination of independent directors and members of the management team, who supervise the management of the company on behalf of shareholders. If the company is a reporting issuer or equivalent under applicable securities legislation, it must file with the relevant securities regulatory authorities. These filings outline the financial statements, business, and corporate governance structure of the corporation.[10]

3.2 Income trust structure

Figure 5 shows a typical income trust structure. The first key difference is the introduction of one or more legal entities between equity investors and the operating company. In this example, there is one legal entity—the income trust—between equity investors and the operating company. Equity investors in an income trust structure are called unitholders, because they buy units in the income trust. The income trust, in turn, can own up to 100 per cent of the equity of the operating company that holds the revenue-generating assets.

10. Documents filed by reporting issuers on Canadian securities exchanges are available at http://www.sedar.com.

Figure 5: Structure of an Income Trust



Almost all of the cash flow generated by the operating company is distributed to unitholders in the form of interest income, dividend payments, and a return of equity. These cash distributions are made on a monthly or a quarterly basis. Interest payments are paid out of pre-tax income, and dividends are paid out of after-tax income. The income trust uses a mix of debt and equity to minimize the taxable income of the operating company. As Hayward (2002, 1531) states,

> By interposing a mutual fund trust between the public investors and the operating corporation, the corporation may substantially reduce or eliminate corporate tax at the operating entity level and pass on those savings in the form of higher distributions to investors.

The equity that is treated as debt by the income trust is non-arm's-length, private-market debt that pays a coupon determined by the operating company's management. Although this debt is covered by a debt indenture, the debt generally does not carry the covenants or protection of a public market debt issue (Fournier 2002). It is subordinated to other claims on the operating company and should be viewed as equity for all purposes except for tax purposes.

The debt held by the income trust is distinct from the third-party, arm's-length debt issued by the operating company. Third-party creditors that lend to an operating company owned by an income trust are in the same position as creditors to a corporation. Interest payments on bank loans or fixed-income debt are paid out of pre-tax income. This debt pays a market rate of interest, and has the same covenants as other bank loans and public market issues. Most importantly, the third-party debt issued by the operating company has a superior claim on the assets of the operating company. When calculating the leverage of the operating company, however, only the third-party debt is considered, because the debt held by the income trust is treated as equity.

A second key difference between an income trust structure and a corporation is the structure of corporate governance. The board of directors is replaced by a trustee (or board of trustees), who supervises the operating company on behalf of unitholders. The management of the operating company may be outsourced to a management company, or may be run internally by full-time, professional management. Some income trusts also have a board of directors. The trustee is appointed when the trust is created to act as a fiduciary on behalf of the unitholders of the trust, and this relationship is governed by a trust indenture. The trustee oversees cash distributions to unitholders in the income trust, and makes decisions related to the operating company on behalf of unitholders. In practice, the trustee delegates many of these responsibilities to the management of the operating company.

4. Valuation of an Income Trust

The valuation of an income trust is similar to the valuation of any other security. Investors discount the future stream of cash flows that are expected to accrue to unitholders using a discount rate that reflects the uncertainty of the business and the capital structure. Three steps are fundamental to the valuation of an income trust: an analysis of the distributable cash, an understanding of the capital structure, and a comparison of the income trust against other income trusts in the same industry sector or business. Existing income trusts should be valued relative to their peers in the same industry using multiples of cash flow that take into account the leverage in the capital structure, the uncertainty of the business, and the type of cash distributed from a tax perspective.

4.1 Distributable cash

The first step in valuing an income trust is to understand how much cash will be distributed to unitholders. Similar to the valuation of equity, cash distributions to unitholders are estimated using earnings before interest, taxes, depreciation, and amortization (EBITDA) as a starting point.[11] EBITDA is used widely in valuation because it represents the cash from the operation of the business, excluding cash raised through financing and investment. EBITDA is also the cash flow available to pay creditors and equity-holders of a firm, without taking into account the capital structure of the firm. An investor interested in a given income trust will analyze the business and

11. Investment texts outline many definitions of cash flow, with different measures used, depending on the objectives of the analysis; free cash flow or economic value added (EVA) are two definitions among many. Distributable cash is the benchmark for valuing an income trust.

scrutinize the cash-flow projections of management to determine whether the amounts are reasonable and sustainable.

When forecasting distributable cash, EBITDA is adjusted for a number of cash expenses. The most important are capital expenditures, actual interest expense, overhead and fixed costs, and actual taxes payable. Given that an income trust is expected to generate a steady stream of cash flows into the future, the assets must be maintained or replaced in the case of depleting assets, such as oil reserves. Capital expenditures are expected to be modest for a mature business. Actual interest expense is the amount of interest paid on third-party debt, which depends on the term and amount of this debt. While actual taxes payable are expected to be small, some tax leakage may occur. A number of income trusts in more volatile businesses incorporate a cash reserve, where cash from one period is saved to smooth the flow of cash distributions for the future. This practice can provide comfort to unitholders, suggesting that management is conservative in its assumptions. It can also send the opposite signal, however, by suggesting that future business conditions are unpredictable and cash flow may be volatile. Assumptions about the size of these amounts will determine how much cash is left over to be distributed to unitholders.

Cash return is a popular measure of the attractiveness of an income trust, owing to its simplicity. Cash return represents the amount of cash distributed to unitholders in the current period, divided by the current price of one income trust unit. Cash return is comparable with dividend yield, which measures the dividends paid out to common shareholders divided by the current price of a common share. This ratio is simple but it can also be misleading. Like a dividend yield, cash return is a backward-looking measure that considers one period of cash flow relative to the unit price at one point in time. Both dividends paid to common shareholders and distributable cash paid to unitholders are expected to be stable over time, with management resisting a reduction in payouts due to the negative signal such a decision would send to investors. However, the amount of cash distributed per unit in the past may not be a good predictor of future distributions, if the revenues of the operating company decline or assumptions about cash expenses are too optimistic. In some cases, income trusts have overdistributed cash to maintain cash returns from a falling income stream. This practice may prevent a fall in cash distributions in the short run, but will surely lead to a fall in distributions in the future, because the operating entity is not sustainable when run in this manner. Cash return should therefore not be equated with a bond yield, since the coupon payment on a bond is generally fixed, whereas cash distributions to unitholders are not.

A second point to consider is that the distributable cash paid to unitholders can take the form of interest, dividends, or a return of equity. *Return of equity* should not be confused with *return on equity*, a ratio that measures the profitability of a business. With a return of equity, the operating company repays unitholders part of their initial investment. In other words, unitholders get back some of their own money. This *return of equity* to unitholders reduces the cost base of their units, with capital gains tax paid on any capital appreciation only when the units are sold. Two income trusts may be generating the same cash returns; one of these, however, may be simply paying out part of the investor's equity, rather than generating cash distributions through operation of the business. Investors should be sure they understand the source of cash distributions, rather than rely simply on cash returns.

Individual investors need to consider after-tax returns when comparing investments, not pre-tax returns. Apart from allowing investors to delay the payment of capital gains on part of their cash distributions, income trusts do not offer more tax benefits to investors than equities. Dividend and interest income is subject to personal income tax, although unitholders may hold their investment in a tax-sheltered savings plan, such as an RRSP. For investors who are subject to taxes, however, it is important to understand what portion of the cash distribution in a given year is sheltered from tax.

4.2 Capital structure

The second step in valuing an income trust is to understand the capital structure of the operating company. Enterprise value refers to the market value of the debt and equity in a company. It is a measure of the market value of the total assets of the business. When an income trust is being established, enterprise value represents the total amount paid to the company that sells the operating assets (the vendor) to the income trusts. The vendor of the assets is paid the proceeds of the equity offering by the income trust and the proceeds of any debt that is assumed by the operating company.[12] The amount of equity raised through the IPO of the income trust depends on the distributable cash generated by the assets and the cash return investors require to invest in the income trust. The operating company generally assumes third-party debt as part of the sale. Typically, this third-party debt is bank debt that is secured against the operating assets.

The amount of third-party debt in the capital structure of the operating company affects the leverage of the operating company and the uncertainty of cash-flow projections. Unitholders are paid out of cash flow after interest expense on third-party debt has been deducted. The actual interest expense will therefore vary over time, and will directly affect the amount of distributable cash. One multiple to use when comparing the leverage across income trusts is the dollar amount of debt divided by the EBITDA generated by the assets. A typical income trust holds debt equal to

12. Although, in theory, the enterprise value is based on market value, in practice it is difficult to establish the market value of debt, so the book value is used instead. Note that the value of total assets recorded on a balance sheet is the book value of the debt and equity.

0.5 to 1.5 times EBITDA (Scotia Capital 2002). Given that EBITDA is not the cash flow that is paid out to unitholders, it makes sense to consider the level of debt relative to distributable cash.

4.3 Industry

When considering an investment in an income trust, investors should not simply compare the cash returns available across all categories of income trusts. To identify relative value, income trusts should be compared with their peers in the same sector on the basis of a range of valuation measures. Cash returns will vary across sectors in line with the relative risk of each business model, the competitive environment, the characteristics of the assets being securitized, and the capital structure decisions of management. Riskier business models should offer higher cash returns within a given industry and across industries. A preferred measure would be to compare the risk-adjusted returns of income trusts both within and across industries, although this measure is not made available in research reports issued by the securities industry.

Table 6 shows typical valuation statistics for three distinct categories of income trusts. At one end of the scale, power generation and pipeline trusts offer cash returns of 9 to 11 per cent, with these businesses commanding a premium valuation based on multiples of cash flow due to their stability. In contrast, the average oil and gas royalty trust offers a cash return of 20 per cent or more, in line with the uncertainty of a business that is based on a depleting asset with volatile market prices for its products. Diversified businesses lie between these two extremes, offering cash returns of 8 to 12 per cent that reflect the uncertainty of their business models and the relatively higher leverage in their capital structure.

Table 6: Income Trust Relative Value, Year-end 2002

Multiple	Power generation & pipeline	Conventional oil & gas trusts	Diversified business
Pre-tax cash return	9.5%	21.4%	11.1%
Per cent tax deferred	61%	45%	19%
Price-to-cash flow	11.9x	4.6x	8.3x
Debt-to-cash flow	1.5x	1.1x	2.6x
Enterprise value-to-EBITDA	12.6x	5.8x	9.7x

Source: BMO Nesbitt Burns (2003)

In summary, income trusts should be valued relative to other income trusts in the same industrial sector, using multiples of cash flow adjusted for leverage to determine relative value. Various multiples should be used in this comparison, to capture the impact of capital structure decisions among other factors.

4.4 Valuation example

Table 7 shows an example of how cash return and leverage interact in the valuation of an operating company. In this example, assets generating $30 million in EBITDA are sold to an operating company. The deductions from EBITDA to arrive at distributable cash are minimal, with capital expenditure equivalent to 10 per cent of EBITDA estimated to maintain the operating assets in perpetuity. Investors in this income trust expect to earn a cash return ranging from 11 per cent in column A to 14 per cent in columns C, D, and E.

Table 7: Illustrative Pricing of $30 million EBITDA Company ($ millions)

	A	B	C	D	E
1. Distributable cash					
EBITDA	30.0	30.0	30.0	30.0	30.0
Less:					
Capital expenditure (10% of EBITDA)	3.0	3.0	3.0	3.0	3.0
Interest expense (6% coupon)	2.7	2.7	2.7	0.0	4.2
Estimated fixed costs	1.0	1.0	1.0	1.0	1.0
Estimated capital tax	0.6	0.6	0.6	0.6	0.6
Distributable cash	22.7	22.7	22.7	25.4	21.2
2. Enterprise value					
Cash return (distributable cash/equity)	11.0%	12.5%	14.0%	14.0%	14.0%
Equity (size of income trust IPO)	206.4	181.6	162.1	181.4	151.4
Debt (third-party)	45.0	45.0	45.0	0	70
Enterprise value (sale price of assets)	251.4	226.6	207.1	181.4	221.4
3. Leverage					
Enterprise value/ EBITDA	8.4 x	7.6 x	6.9 x	6.0 x	10.4
Debt/EBITDA	1.5 x	1.5 x	1.5 x	0.0 x	2.3 x
Debt/distributable cash	2.0 x	2.0 x	2.0 x	0.0 x	3.3 x

Source: Based on Scotia Capital (2002)

The cash return demanded by unitholders determines the size of the income trust. Investors have an incentive to buy the income trust that has the relatively highest cash return for a given level of risk. The cash return determines how much equity will be raised through the income trust IPO. The IPO size is determined by dividing the distributable cash by the cash return required by investors. For example, operating company A has distributable cash of $22.7 million and offers a cash return of 11 per cent, leading to an IPO size of $206 million. This approach treats the cash flow generated by the assets as a perpetuity, where the cash return is the discount rate used to capitalize future expected cash distributions. If investors demand a higher cash return for a given level of distributable cash, the proceeds from the IPO will fall, as column B of Table 7 shows, where $22.7 million of distributable cash that generates a return of 12.5 per cent leads to equity of $181.6 million.

The enterprise value of the operating company varies, based on the amount of third-party debt in its capital structure. If it is assumed that the operating company issues debt equal to two times EBITDA, then the level of debt is $45 million and the enterprise value of operating company A is $251 million (or 8.4 times EBITDA). A higher cash return for a given level of debt leads to a smaller amount of equity raised in an IPO and a smaller enterprise value. The same assets may be sold to generate cash returns of 12.5 per cent in column B or 14 per cent in column C, which reduces the amount of equity raised to $181 million and $162 million, respectively. With $45 million of debt in the capital structure, the enterprise value is reduced to $227 million (or 7.6 times EBITDA) in column B or $207 million (or 6.9 times EBITDA) in column C.

A higher level of debt for a given cash return leads to a smaller amount of equity raised in an IPO, but a higher enterprise value. The operating companies in columns C, D, and E all provide the same cash return of 14 per cent. However, the degree of leverage varies, from column D having no leverage to column E having the highest. As leverage increases for a given cash return, the distributable cash drops as the interest expense rises, leading to a smaller amount of equity. Column E has the highest leverage but the least amount of equity; however, it provides a relatively higher enterprise value, at $221 million, than columns C and D, and the highest multiple of enterprise value to distributable cash flow. The incentive of the vendor of the assets is to increase the leverage for any given cash return demanded by investors, because leverage increases the total proceeds received for the sale of the assets; namely, the enterprise value.

Table 7 shows how the incentives of the vendor and the underwriter can vary, with both parties constrained by the demands of investors. The underwriter has an incentive to maximize the size of the income trust IPO for a given cash return by minimizing the amount of debt held by the operating company. The vendor, however, has an incentive to maximize the enterprise value of the operating company by increasing the leverage, making the cash return more volatile. Clearly, unitholders are best off in the column that has the highest cash return and the lowest leverage, aligning their incentives with the underwriters of the IPO. Investors should therefore consider the risk-adjusted cash return when comparing income trusts with different amounts of leverage, to ensure that they are being paid for the greater volatility inherent in the capital structure. For the diversified-business income trusts followed by BMO Nesbitt Burns, the levels of debt for 2001 ranged from a low of 1.7 times distributable cash to a high of 4.4 times, with a mean of 2.6 times.

This valuation analysis has raised three pitfalls that investors should be aware of when comparing the cash return on income trusts. First, income trust investors need to scrutinize the assumptions about cash flow, to ensure that the amount of distributable cash generated from a given level of EBITDA is realistic and sustainable. Second, investors should understand what they are receiving when they are paid a cash distribution. Because cash distributions represent a combination of interest, dividends, and return of capital, identical cash distributions may reflect different combinations of these returns. Part of the distribution may be a return of equity that allows tax to be deferred but represents a return of the unitholder's investment in the income trust, not earnings generated by the operating company. This problem is particularly serious if the operating company is overdistributing cash flow and allowing the earning power of assets to decline. Third, the cash return should be compared on a risk-adjusted basis, to incorporate differences in capital structure across income trusts. Multiples of debt should be compared to understand the impact of capital structure choices on the uncertainty of cash flows. In particular, debt levels should be compared with distributable cash and not with EBITDA.

5. Issues Related to Income Trusts

Income trusts can be considered from two perspectives. From that of a company, income trusts present an opportunity to both raise capital and sell off assets, but they also represent a risk, due to the presence of a potential tax-advantaged competitor in a given market sector. From an investor's perspective, the attractiveness of an income trust depends on a judgment of whether the cash returns are appropriate given the risks of the investment. This section addresses a number of issues related to the analysis of income trusts—both the benefits and risks—to provide a perspective on the role played by this asset class in Canada's capital markets. This discussion raises a number of issues that investors should be aware of when analyzing an income trust for investment.

5.1 Benefits of income trusts

The income trust market has delivered a number of benefits. Firms have been able to realize significant gains on the sale of assets through this market. Companies have therefore been able to raise significant amounts of capital by selling off mature assets and either returning the proceeds to shareholders or investing them in potentially more profitable growth opportunities. This means of raising capital has particularly benefited small firms or firms that did not have access to Canadian equity markets on attractive terms. A number of companies, such as Big Rock Breweries of Alberta, chose to delist from stock exchanges, because it was more attractive for investors to operate the business through an income trust structure, owing to the reduction of corporate tax.

Investors have earned high cash returns from income trusts over the past few years, a period when Canadian stock markets suffered significant losses and interest rates declined to historically low levels. Apart from the immediate appeal of high cash returns, this type of investment suits investors who prefer to have management distribute cash from the business, rather than leave the cash in the hands of managers who may reinvest the funds unwisely. Higher cash payouts reduce the need to monitor management. This benefit took on special meaning in the wake of the corporate governance scandals of the past few years.

The income trust sector has also been an important source of revenues for the securities industry. It has replaced the earnings lost by the fall in mergers and acquisitions activity and the drop in traditional equity offerings (IDA 2002b).

5.2 Issues raised by income trusts

Although the growth of this market sector has numerous benefits, it also has a number of potential issues that investors should consider when valuing an income trust. Table 8 classifies these issues into four broad categories: legal and regulatory, corporate governance, operational, and market. Legal and regulatory issues include the potential personal liability of unitholders, the possibility of a change in tax treatment, and the treatment of unitholders in the event of bankruptcy. Corporate governance issues focus on the role and appointment of trustees and the management company, potential conflicts of interest, unclear incentives, and the limited legal rights of unitholders. Operational issues are related to the subordination of the unitholder’s claim on the operating assets, the sustainability of expected cash flows from these assets, and the degree of leverage in the operating company’s capital structure. Market issues concern the sensitivity of income trust valuations to changes in the level of interest rates, the level of risk premiums premiums, secondary market liquidity, and future access by an income trust to the capital markets. Each issue is addressed in turn.

Table 8: Summary of Issues in Income Trusts

Category	Issues
Legal and regulatory issues	Personal liability of unitholders Tax treatment Bankruptcy
Corporate governance issues	Related to trustees Related to management company Rights of unitholders
Operational issues	Subordination of claim by unitholders Cash-flow sustainability Financial leverage
Market issues	Level of interest rates Risk premiums Future access to financing Secondary-market liquidity

5.3 Legal and regulatory issues

5.3.1 Potential liability of income trust unitholders[13]

Unitholders may be personally liable for the debts or actions of the operating company. Unlike corporate law, trust law may not provide unitholders with limited liability. Although this is legally feasible, a number of Canadian securities firms have given legal opinions that there is little probability of this type of event occurring. Even if this possibility is seen as remote, a large group of institutional investors are unwilling to purchase income trusts until the limited liability issue is resolved. On 12 November 2002, it was reported that income trusts would not be included in the S&P/TSX Composite Index any time soon, the view being that the major concern was the unresolved issue of possible unlimited liability of unitholders of trusts.[14] The chief executive officer of Canada's largest real estate investment trust was quoted as saying that various U.S. institutions will continue to refuse to purchase units of Canadian real estate investment trusts until the limited liability issue is resolved. In October 2002, it was also reported that the Government of

13. Most of the detail in this section comes from Erlichman (2002), Senior Partner of Fasken Martineau DuMoulin LLP.
14. Pension funds argued that the S&P/TSX Composite must be an investable index. Pension funds, however, are unable to purchase income trusts, owing to the potential liability. See T. Slee, "TSX Committee Ignores the Real World," 12 December 2002, available at http://www.gordonpape.com.

Alberta had been approached by interested parties to have legislation adopted in that jurisdiction to put the liability issue to rest for business trusts formed under Alberta law.[15] The Ontario Teachers Pension Plan Board launched a new subsidiary in early 2003, called Golden Apple, to invest in income trusts, to shelter the pension fund from potential liabilities.[16]

Erlichman (2002) states that:

> By statute and common law, a corporation is a legal entity and the shareholders (in their capacity as shareholders) have the benefit of limited liability subject to certain exceptions. . . . Under the law relating to trusts, if a creditor has not agreed pursuant to an exculpatory clause in a contract that the creditor's claims will be satisfied out of the trust property only, the trustee may be personally liable to the creditor. If there are insufficient trust assets from which the trustee can be indemnified, the question then becomes whether the trustee in turn has the right to be indemnified by the unitholders. It has been held in cases involving private trusts that competent beneficiaries may be obligated to indemnify a trustee against liabilities properly incurred by the trustee. That principle also may apply to public income trusts, although there have been no reported cases to my knowledge, which deal with this issue in a public trust context. An important caveat, however, is that the private trust cases also indicate that any right of indemnity against beneficiaries that a trustee would otherwise have may be excluded by the terms of the instrument creating the trust. Accordingly, if properly drafted, a trust instrument can insulate beneficiaries from personal liability based upon the rationale of this line of cases.

Erlichman concludes that "most Canadian lawyers who have thought about this issue believe there is but a remote chance that liability would accrue to unitholders of a Canadian mutual fund trust (which for the purposes of this legal issue is no different from an income trust) if there were insufficient assets in the trust itself from which the trustee could satisfy a liability to creditors of the trust."

The issue of unitholder liability is being addressed in Ontario. Finance Minister Janet Ecker announced in the Ontario Budget Speech on 27 March that the Government of Ontario would limit the liability on trusts governed by the laws of Ontario under a proposed Trust Beneficiaries' Liability Act 2003.[17] The Act states that (Ontario 2003):

> The beneficiaries of a trust are not, as beneficiaries, liable for any act, default, obligation or liability of the trust or any of its trustees if, when the act or default occurs or the obligation or liability arises,
>
> (a) the trust is a reporting issuer under the Securities Act; and
>
> (b) the trust is governed by the laws of Ontario.

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15. Arc Energy is lobbying the Government of Alberta to enact laws that would provide trust unitholders with limited liability. See "Trusts Shut Out of TSX Benchmark," *National Post*, 11 November 2002, p. FP1.
16. A. Willis, "Teachers' Golden Apple Move Lends Polish to Income Trusts," *The Globe and Mail*, 24 January 2003, p. B10.
17. E. Roseman, "Income Trust Holders to Get Liability Shield," *The Toronto Star*, p. C3.

The passage of this Act is expected to lead to the introduction of similar legislation in Alberta, where similar lobbying efforts have been underway for some time. Given that most income trusts are located in Ontario and Alberta, these efforts are likely to reduce the potential risk of unitholder liability. CIBC reports, however, that the S&P/TSX will likely reconsider the inclusion of income trusts into the general composite index once the liability risk is eliminated from all income trusts established in all provinces.[18]

5.3.2 Tax treatment

Several industry analysts suggest that the Canada Customs and Revenue Agency (CCRA) could change the current tax structure to eliminate the favourable tax treatment given to income trusts (CIBC World Markets 2003; TD Newcrest 2002). Although the growth of the income trust sector has likely affected corporate tax revenues, it is hard to estimate how much the tax burden has changed.[19]

Hayward (2002) provides a comprehensive review of the tax issues. Essentially, the operating company reduces its taxable income by making interest payments to unitholders on a high-yield note that is issued by the operating company and held by the income trust. Although the interest rate on this note is set to reduce taxable income to near-zero, it must nonetheless meet the criteria of reasonableness under paragraph 20(1)(c) of the Income Tax Act (Canada). The coupon on this debt and the degree of leverage in the capital structure are chosen to minimize corporate tax at the operating company level. As a result, the income that is distributed to unitholders is effectively taxed only once, either when it is received by unitholders in the form of dividends or interest payments, or when they sell their units in the case of returns of capital. Hayward (2002, 1560) argues that an income trust structure "highlights a serious flaw in the system—namely, the failure to apply a coherent and consistent treatment to legal entities, economic claims, and cash flows that may differ in form but that are equivalent in substance." The courts are unlikely to interfere in this area, however, because past precedents show that the courts respect the legal form of the transaction without regard to the underlying economic purpose.

5.3.3 Bankruptcy

Insofar as income trusts are not accumulating retained earnings, they are financially dependent on the capital markets to provide capital. This dependence renders income trusts vulnerable, particularly in the event of an economic downturn in their respective sectors (Erlichman 2002). The question arises as to how a financially distressed income trust would achieve financial

18. A.S. Dunning, "Income Trust Inclusion into the S&P/TSX Composite Index," CIBC World Markets, 10 April 2003.
19. S. Rubin, "Ottawa Faces $1B in Lost Tax," *National Post*, 15 August 2002, pp. FP1, FP8.

restructuring, given the existing state of Canadian insolvency legislation. Because of the legal status of an income trust, Erlichman (2002) argues that existing bankruptcy law would not apply. Instead, existing trust law would have to be modified for this event, complicating this process and increasing the costs.

5.4 Corporate governance issues

The Trust Indenture and the Management Agreement outline the duties of trustees and the management company, respectively, but leave most of the decisions to the managers. This situation raises questions about the corporate governance of an income trust, particularly related to the staffing of these positions, their incentives, and the level of disclosure of any conflicts of interest. By extension, these documents and the powers that they confer on Trustees and the management company impact the rights of unitholders. This situation appears to be the inevitable outcome of adopting a legal form that was not intended for this purpose. The attractive valuation of income trusts explains why owners of businesses have adopted income trusts as a substitute for a corporate form. While income trusts resemble corporate entities, they fall under a different code of law with different requirements for corporate governance. Trusts were not designed to accommodate active shareholder input, leading to a deficiency in the disclosure and transparency of income trusts relative to corporate entities (Erlichman 2002). These issues are explored below.

5.4.1 Trustees

According to Erlichman (2002), there is no legislation enforced in Canada that requires trustees of an income trust to be independent, or that requires a majority of the trustees to be independent. Both the Ontario Securities Commission and the B.C. Securities Commission have made proposals that describe a framework for regulating mutual funds and their managers. In many cases, the trustees may be appointed without the approval of unitholders, are responsible for drafting disclosure and insider trading policies, and are responsible for auditing the management of the operating company. More importantly, in the case of many income trusts, some or all of the trustees of the income trust are the managers of the operating company. This situation creates a number of potential conflicts of interest that investors must take into account when they evaluate an income trust. In addition, the trustees may be individually indemnified by the income trust in respect to the discharge of their duties, or they may delegate many of their responsibilities to management to avoid potential liability (Fournier 2002).

5.4.2 *Management of the operating company*

Although the corporate trustee makes the actual distributions of cash to unitholders of the income trust, the trustee typically delegates most, if not all, of his or her responsibilities and powers to the management company. This management company manages the operating company and its assets, and the administrative functions of the income trust itself. The management company is also generally responsible for pursuing investments or acquisitions to maintain or increase the levels of cash flow generated by the operating company. These cash-generating assets need to be preserved to maintain a steady distribution of cash to unitholders in the income trust.

Historically, the management company appointed to run the operating company has consisted of the promoters or organizers (i.e., past management) of the income trust. Investors need to be aware of a possible conflict of interest, where the management fees and incentives may not align the interests of the managing company with the interests of the unitholders. For example, a shareholder of the management company who is not an officer or board member of the trust does not technically have to disclose trading in the units of the trust (TD Newcrest 2002). Also, although the total dollar amount of compensation of the management company is disclosed, the trust does not have to disclose individual compensation. The management company usually has the right to appoint a certain proportion of board members without input from unitholders (TD Newcrest 2002). In addition, the management company does not necessarily have to devote all of its time to running the trust, but may be engaged in other business activities that are not disclosed. These examples highlight only a few of the potential areas of conflict that can exist between unitholders and the management company.

5.4.3 *Rights of unitholders*

Unlike a shareholder in a company, a unitholder in an income trust does not have the right to bring “oppressive or derivative actions” against the trustees or the management company (TD Newcrest 2002). This type of action is used by minority equity shareholders to argue against actions by management that may be against the interests of minority shareholders. While the courts can intercede to remedy the situation on behalf of a shareholder, they would not have the same ability in the case of a trust.

5.5 Operational issues

5.5.1 *Cash-flow sustainability*

Not every business model is viable as an income trust. This structure is most suitable for businesses that generate a steady stream of cash distributions, require minimal capital expenditure and face limited competition. It is not suitable for growth businesses, businesses requiring individual expertise, businesses with intangible assets, or businesses that require large ongoing capital expenditures. Given the proliferation of income trusts in different business sectors, commentators question whether the cash-flow assumptions that support IPO valuations are sustainable in the long run.

There are two main issues regarding cash-flow sustainability. First, the capital expenditure assumed in valuing the income trust may not be sufficient to sustain the cash flow that is to be distributed to unitholders. If the assets held by the operating company depreciate or amortize more quickly than anticipated, the operating company may need to make capital expenditures to maintain the stock, or must acquire new assets to maintain the viability of the income trust. This activity would reduce distributable cash flow, thereby reducing the cash return of the units. Such a case occurred in 1999, when Luscar Coal cut its distribution.[20] In other cases, income trusts have been found to be overdistributing cash flow to investors. In effect, the income trust distributes more than 100 per cent of earnings to unitholders, in an effort to avoid cutting the cash distribution. This type of activity would only delay the inevitable decline in cash distributions.

A second issue, highlighted in section 4.4, is the degree of leverage in the capital structure of the operating company. Higher leverage may increase the cash return to the unitholders, but it reduces the risk-adjusted return. If the coupon on the third-party debt is variable, or if the term to maturity of this debt is short, investors need to be aware that the actual interest expense may rise when the coupon resets or the debt is refinanced. An increase in this interest expense will directly reduce the distributable cash. This interest expense should not be confused with the interest expense on the subordinated debt held by the income trust, which is not subject to market fluctuations and is controlled to some extent by the operating company.

These issues led Standard & Poor’s to introduce a new product in 1999 called stability ratings. These ratings are intended to reflect the “sustainability and variability in distributable cash flow generation in the medium to long term” (S&P 2002).[21] An S&P stability rating is relative to other income funds, and ranges from a high rating of SR-1 to a low of SR-7. An income fund rated SR-1 has the highest level of cash distribution stability and the lowest level of expected variability relative to other rated Canadian income funds. The stability rating is based on an assessment of four factors: an analysis of the fund’s structure and governance, an evaluation of the fund’s

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20. “Forget Bubble Talk about Income Trusts,” *The Globe and Mail*, 14 December 2002, p. C1.
21. Income-fund stability ratings are distinct from bond credit ratings. The stability rating addresses the variability and sustainability of the cash flows that remain after all debt obligations have been serviced. A credit rating reflects the ability and willingness of a borrower to make interest and principal payments on a specific debt issue.

business profile (broken down into operational stability, market position, and asset quality), an analysis of the fund’s financial profile (broken down into capital structure, cash-flow analysis, and other factors), and an analysis of the fund’s distribution analysis. A stability rating is voluntary, and income trusts must pay Standard & Poor’s to receive one. As of year-end 2002, only 25 income trusts were rated. Standard & Poor’s suggests that a large number of income trusts may have chosen not to seek a stability rating because it could have reflected negatively on their valuation (S&P 2002). The extent to which stability ratings are factored into the valuation of an income trust is unclear. Presumably, if this product is valued by the marketplace, unrated income trusts will eventually be forced to seek a stability rating in response to market pressure, or be penalized for a lack of disclosure relative to rated income trusts.

5.5.2 Financial leverage

Income trusts are like corporate entities. The management of the operating company chooses the amount of debt to include in the capital structure based on the underlying business and its capital intensity. However, section 4.4 has highlighted the fact that the incentives for the vendor of the assets are to increase the amount of debt at the operating-company level, leading to varying levels of leverage for competing income trusts in the same industry (Tables 6 and 7). The amount of leverage, measured as the third-party debt-to-cash flow, affects the uncertainty of the business. Higher leverage leads to greater subordination of the unitholder’s claim on the operating assets, greater sensitivity to changes in interest rates, and more variable cash flow. These effects are implicit in the use of debt-to-cash flow multiples, and are taken into account by Standard & Poor’s stability ratings. A simple measure, such as price-to-cash flow, does not reveal anything about leverage directly, in much the same way that the price-to-earnings multiple for a corporation does not reveal the capital structure of an investment in a common share. Investors need, therefore, to consider a range of valuation measures that explicitly take leverage into account. The discount rate used to capitalize future cash flows should be higher for a leveraged income trust, leading to a lower price for the same stream of cash distributions.

5.5.3 Subordination of claim by unitholders

One of the defining features of an income trust structure is for the trust to hold a significant amount of unsecured, subordinated debt issued by the operating company. This subordinated debt carries a high interest rate that reduces the taxable income of the operating company. Typically, this subordinated debt has a long maturity to defer repayment of the principal on this debt to unitholders.

Lenders to the income trust sector are in the same position as lenders to other businesses. A bank loan or third-party debt issued at the operating-company level is secured by the assets of the operating company. These assets provide collateral in the event of bankruptcy. Thus, bank or third-party debt held at the operating-company level has a superior claim to the assets of the operating company than the subordinated debt held by unitholders in the income trust. Any losses that exceed the value of these debts would represent a writedown of the income trust's equity in the business, reducing the value of the units held by income trust unitholders. For this reason, analysts view this subordinated debt as quasi-equity.

Standard & Poor's has compared the risk on income trust units to high-yield bonds, stating "in terms of relative risk, [an income trust unit is] subordinate to, and therefore riskier than, its high-yield cousin."[22] According to Fournier (2002), the subordinated debt cannot be guaranteed by the operating company or a third party, because any guarantee on debt owned by the income trust may impair the ability of the income trust to qualify as a "mutual fund trust" under the Income Tax Act (Canada). If the operating company runs into cash-flow difficulties, creditors may have the power through bond covenants to suspend cash distributions to the unitholders of the income trust.

5.6 Financial market issues

5.6.1 Level of interest rates

The principal factor impacting the unit values of these income trusts is the level of long-term interest rates. Income trusts are attractive because they offer a high cash return relative to other asset classes. Their growth throughout 2001 and 2002, therefore, is partly due to the historically low level of interest rates, the underperformance of the overall equity markets over that period, and the subsequent low cash returns on other asset classes. Income trusts, like other asset classes that compete on the basis of yield, are sensitive to the level of interest rates because they promise a steady cash payment into the future that is discounted to the present, similar to a perpetuity.

The high cash flows paid to unitholders and generated by the operating assets are expected to be maintained in perpetuity, as discussed in section 5.5.1. Given the projected stability of cash flows, income trust units are often compared erroneously with fixed-income instruments. Unlike a bond, an income trust does not pay back principal at a fixed point in the future, although unitholders may get back some of their investment in the form of a return of capital. One similarity, however, is the sensitivity to the level of interest rates, particularly long-term interest rates. Like a fixed-income instrument, the rate at which future cash flows are capitalized is central to the valuation of this security. A rise in the overall level of interest rates may therefore cause income trust valuations to fall, because the future cash flows are discounted at a higher rate.

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22. Standard & Poor's, "Report: Spotlight Shines on Canadian Income Trusts in 2002," 7 January 2003, and "Income Trusts: Canada's High-Yield Market?" 7 January 2003.

A rise in the level of interest rates may also have an indirect negative impact on income trust valuations. If the third-party debt held by the operating company pays a variable rate of interest, a rise in short-term interest rates would increase the interest expense and decrease the cash available for distribution to investors. If cash distributions drop, income trust values must fall accordingly.

5.6.2 Risk premiums

In finance, the discount rate used to capitalize future cash flows reflects the latter's riskiness. The uncertainty for a bondholder is measured by a credit rating and is reflected in the credit spread over some risk-free benchmark with the same maturity. For equity holders, the riskiness of a company depends on firm-level and industry characteristics and is captured by the covariance of the firm's stock returns with the market portfolio—the beta—which forms part of the cost of equity.

Studies show that risk premiums are time-varying and reflect market conditions. If market conditions change, investors may demand a higher return for a given level of risk. Unitholders in an income trust are exposed to the same potential change in risk premiums. When market conditions deteriorate, because of too much supply, higher volatility, lower liquidity, or an increase in risk aversion, the risk premium charged on income trusts may rise. A reassessment of the valuation of an income trust can have the same effect. A negative shock to the income trust sector could cause a fall in income trust prices, as investors reassess the valuation of different income trust business models and legal structures. In all of these cases, a rise in risk premiums would cause future cash flows to be discounted more heavily, leading to a fall in the valuation of this security.

5.6.3 Future access to financing

Income trusts may need to roll over third-party debt held at the operating-company level, or they may wish to raise additional financing to replace depleting or depreciating assets. If the assets of the operating company are not maintained or replaced as needed, the cash flow generated by them will decline and with it the cash distributions to unitholders. Because income trusts do not retain earnings, the only options for raising new capital are to issue more units or to borrow against existing assets. Future access to financing is therefore crucial for the income trust to remain economically viable in the long run. However, future access to financing is not guaranteed.

The operating companies owned by an income trust may secure funds through the bank-loan market. This source of funds is limited, however, by the amount of existing debt relative to the value of the assets held by the operating company. At some level of leverage, creditors will no longer be willing to lend to the operating company, at which time access to financing through equity markets becomes crucial. Alternatively, a downturn in the business of the operating company that happens when the third-party debt is due to be rolled over may lead the creditors not to roll over their loans, or to charge a significantly higher rate of interest. In this case, the income trust would have to turn to the equity markets for additional financing at a time when the business looks least attractive.

The equity capital markets represent an alternative source of funds. Over the past two years, equity issuance by income trusts picked up rapidly, with an average of $2.7 billion of equity issuance per quarter from the fourth quarter of 2001 to the third quarter of 2002 (Figure 3). This supply proved to be too much for the market to absorb. Income trust prices fell in the fourth quarter of 2002, and a number of income trust transactions were delayed or pulled. Only three income trust offerings were completed in December. Thus, future access to funds through the equity markets may be restricted, as in the fourth quarter of 2002. If both the loan markets and the equity markets are unwilling to finance the roll-over of debt, or to fund the acquisition of new cash-generating assets, this could force the liquidation of the business.

5.6.4 Secondary-market liquidity

The relatively small market capitalization of the average income trust introduces liquidity risk, since a small float makes it difficult to acquire or sell units without impacting the price. A large number of income trusts have a market capitalization of below $100 million, which is considered to be relatively small. This issue has been partially addressed by creating funds of income trusts that invest in a diversified portfolio of income funds. However, smaller-cap income trusts may suffer more during volatile periods in the markets because of this reduced liquidity.

6. Closing Observations

This paper has provided an overview of the income trust market, its growth, and the total return of this sector over the past two years. Companies have received attractive valuations for assets sold through this vehicle, and investors have received a high total return in 2002 relative to the overall stock market. This paper, however, highlights a number of issues related to income trusts that investors should consider when making an investment. A better understanding of the issues raised by income trusts will alleviate concerns about the valuation and rapid growth of this asset class.

The development of the income trust sector shows that Canadian capital markets are evolving to meet the needs of companies and investors. Companies have successfully sold a wide variety of assets by transferring them into an income trust structure. This activity has encouraged the flow of investment capital to projects that have solid rates of return (Shenfeld 2003). Investors have been offered a new investment vehicle that pays high cash returns. By returning cash flows to investors, income trusts allow investors to decide how best to allocate those funds, rather than leave them in the hands of management. The financial media have expressed concern about the rapid growth and the valuation of this asset class, claiming that the high multiples paid for the assets by unitholders are a sign of overvaluation. This concern is being addressed by the marketplace, as investors become more knowledgeable about the benefits and the uncertainty of different business models and allocate their funds appropriately. The decline in this market over the fourth quarter of 2002 and the slow start to 2003 may suggest that this market is evolving and has reached a new phase of consolidation with slower growth. The performance of this asset class over the coming year will put this perception to the test.

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