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OLD WINE IN A NEW BOTTLE?

Four factors for pension funds to consider in an analysis of income trusts.

INCOME TRUSTS ARE, IN EFFECT, HIGHER-YIELD, LOW-DURATION EQUITIES.

Despite their growing presence on Canadian capital markets, institutional and pension investors have been slow to accept income trust investing.

Yet income trusts, which include oil and gas trusts, real estate investment trusts and business trusts, are legitimate instruments that pension funds should consider for the following reasons:

- the large and relatively stable cash distributions they offer are important elements in meeting ongoing liabilities;
- the statistical properties of income trust returns suggest they are useful for diversification purposes, and;
- the income trust market is maturing.

The trust structure has as its sole purpose the elimination of tax at the corporate level through the use of relevant income tax provisions. The cash flow from the operating company after payment of interest on third-party debt, capital expenditures and an allotment for a reserve is then passed on to unitholders, who are taxed. Given the importance of the size and stability of distributions, it is critical that the underlying cash flows are not highly variable. Companies that are viable candidates for income trusts generally have stable cash flows and strong competitive positions.

Income trusts are, in effect, higher-yield, low-duration equities. They have unique elements, however, which take on a greater importance in an income trust structure, and thus require specialized analysis within an equity mandate. Stability and, to a lesser extent, growth of distributions are crucial. With distributions typically a large part of distributable cash flow, there is little room for management error or large cash flow fluctuations. Analysts must understand the unique factors affecting cash flows (and, hence, potential values) and be able to assess the risks. Four factors are: the viability of the business model, the

role and quality of management, governance issues, and the external debt contract.

Considering the business model, characteristics of the assets and stability of resulting cash flows is crucial. Assessing the operating risk and, in the case of business trusts, company characteristics is important in evaluating an income trust.

Management must make decisions that maintain the level of cash flows, their stability and, where appropriate, growth through reinvestment of retentions. The analyst needs to determine management's dedication to these factors. Does management constrain costs? Do they use hedging techniques to remove cash flow variability? Management's decisions on capital expenditures and the size of cash reserves are crucial. Finally, is management's strategy to fund distributions viable? Do they use debt, sell assets or use only cash flow from operations?

An element in governance is the compensation contract. While incentive issues are just as significant for internal contracts as external, they are generally structured differently and are less open to abuse than external management contracts. Assessing whether the contract has been structured to align interests of managers and unitholders is key to the evaluation.

Internal debt is not a major issue, and third-party debt is not large, yet debt covenants may be structured such that the ability to pay distributions may be impaired even if the firm is able to make its interest payments. Analysts must have meticulous knowledge of the terms of the debt contract and any possible impacts on the trust's cash distributions to unitholders.

Although income trusts are, in effect, equities, these unique characteristics recommend a manager with specific knowledge and experience in income trust investing when incorporating these vehicles within an active mandate. ■