INCOME TRUSTS: A Growing Asset Class

Investors and issuers alike have been drawn to income trusts lately. There are three key areas to examine when valuing an income trust.

BY MICHAEL R. KING

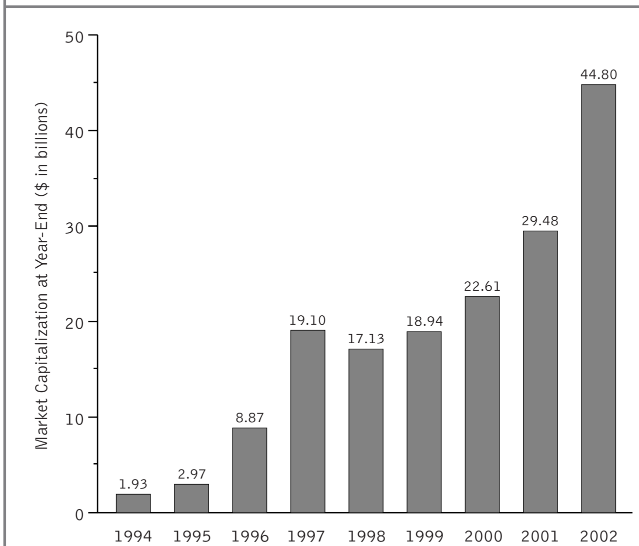
Income trusts in Canada had a market capitalization of $45 billion at year-end 2002, and made up approximately 6% of the stock market capitalization of the Toronto Stock Exchange (CIBC, 2002). This is a dramatic rate of growth when compared to the $29.5 billion of total market capitalization at year-end 2001 and $2 billion at year-end 1994 (Figure 1). Income trusts are an investment vehicle that pays out substantially all of the cash flows generated from relatively mature, revenue-producing assets in a tax-efficient manner. 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 is used to refer to royalty trusts, real estate investment trusts (REITs) and trusts based on a variety of businesses, but excluding limited partnerships.[2]

An income trust purchases revenue-producing assets by selling units in the trust to the public ("unitholders"). In principle, an income trust owns mature assets that require little ongoing capital expenditure, face little competition, and will provide a long-term stream of cash flows. Examples of such assets are found in 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] A breakdown of income trusts by business sector is shown in Table 1.

An income trust structure is attractive because it allows the owners of a business to sell off assets at a higher valuation than the market is willing to pay when they are held in a corporate structure. This higher valuation is driven by the tax savings generated by the income trust structure, which minimizes or eliminates corporate tax at the operating company and thus avoids

FIGURE 1

TOTAL TRUST MARKET CAPITALIZATION



Source: CIBCWM

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the double taxation on earnings distributed to investors. Investors in an income trust therefore receive a higher level of cash distributions than is possible when the same assets are held by a corporation. Like equities, income trust units are eligible for registered retirement savings plans (RRSPs), pension accounts, and other non-taxable accounts.

Growth of this asset class

The phenomenal growth of this asset class has been driven by the appreciation of outstanding income trust values, and the issuance of units through initial public offerings and secondary offerings. 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% in 2002. This return compares with -12.4% for the S&P/TSX Composite and 10.8% for 10-year Canada bonds (Table 2).

Second, new issuance by income trust units totaled $9.4 billion in 2002, with quarterly issuance peaking above $3 billion (Figure 2). Initial public offerings (IPOs) of income trust units dominated the market for new equity issues, with 36 income trusts totaling $5.1 billion being offered to the public, representing 86% of the value of Canadian IPOs last year. There were also 56 secondary offerings of income trust units worth $4.3 billion.

Income trusts have represented a rising share of equity issuance over the past two years, accounting for approximately 40% of primary and secondary issuance on the Toronto Stock Exchange and the TSX Venture Exchange (Table 3). According to data collected by the IDA, the average size of an income trust equity offering in 2002 was $100 million, significantly larger than the average equity offering of $6.8 million (Table 3).[4] The major investors in this asset class are retail investors, representing, on average, two-thirds of the purchases of income trust IPOs in 2002 (Scotia Capital, 2002).

While the income trust market was active in 2002, the market showed signs of slowing towards the end of 2002 with a number of IPOs being pulled or postponed due to a lack of demand and a general re-pricing of the sector. Over the fourth quarter of 2002, the BMO Nesbitt Burns Trust composite index actually suffered a loss of -0.2%, while the S&P/TSX composite posted a total return of 7.5%.

TABLE 1

INCOME TRUSTS BY BUSINESS SECTOR

Business Sector	Number of Trusts	% Share by Market Capitalization
Consumer and manufacturing businesses	44	31%
Real estate/REITs	16	22%
Oil & gas	15	27%
Power generation	8	11%
Other resource-based	4	9%
Total	**87**	**100%**

Source: Scotia Capital

TABLE 2

TOTAL RETURN IN 2002

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

Source: BMO Nesbitt Burns

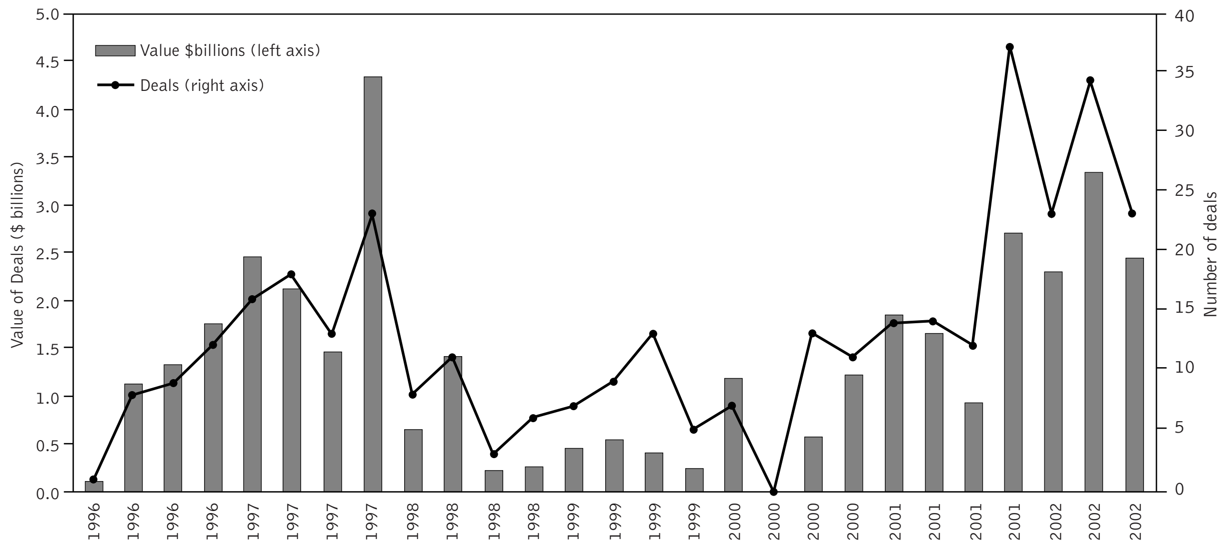
Structure of an income trust

The income trust structure maximizes the cash distributions from a set of income-generating assets by minimizing or eliminating the corporate tax paid by the operating company that holds these assets. This tax avoidance is possible because the Income Tax Act allows an income trust to treat part or all of its investment in the equity of the operating company as debt for tax purposes (Hayward, 2002). On this basis, the operating company classifies part of its cash distributions to unit holders as interest expense, which reduces or eliminates taxable income. 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.

Unlike a corporate structure, an income trust structure introduces a legal entity—the income trust—between equity investors and the operating company. Investors own units in an income trust that, in turn, owns all the equity of an operating company holding

FIGURE 2

QUARTERLY INCOME TRUST ISSUANCE IN CANADA



Source: Investment Dealers Association

the cash-generating assets.

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, while dividends are paid out of after-tax income. 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. While this debt is covered by a debt indenture, this debt generally does not carry the covenants or protection of a public-market debt issue (Fournier, 2002). This debt is generally subordinated to other creditor claims on the operating company and should be viewed as equity for all purposes except for taxation.

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 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 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.

Valuation of an income trust

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 others 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.

Distributable cash

The first element 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

TABLE 3

ANNUAL CANADIAN EQUITY ISSUANCE, 1996-2002

Year	Income Trust Issuance			Other Equity Issuance				
	Value ($bn)	# of Issues	Avg. size ($mn)	Value ($bn)	# of Issues	Avg. size ($mn)	Total equity issuance($bn)	Income trust as % of total
1996	4.3	30	142.1	21.2	2,774	7.6	25.5	17%
1997	10.3	70	147.2	25.6	1,723	14.9	35.9	29%
1998	2.5	28	87.6	18.3	1,493	12.3	20.8	12%
1999	1.6	34	46.0	17.6	1,923	9.2	19.2	8%
2000	2.9	31	92.8	20.7	2,155	9.6	23.6	12%
2001	7.0	77	90.9	12.1	1,796	6.8	19.1	37%
2002,Q1-Q3	8.0	80	99.5	11.8	1,727	6.8	19.8	40%
2002	9.4	92	102.2					

Source: Investment Dealers Association of Canada

before interest, taxes, depreciation, and amortization (EBITDA) as a starting point. EBITDA represents the cash flow available to pay creditors and equity-holders of a firm, without taking into account the firm's capital structure. An investor interested in a given income trust will analyze the business and scrutinize the cash flow projections of management to see if 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 future stream of cash flows, the assets must be maintained or, in the case of depleting assets such as oil reserves, replaced. 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. Assumptions about the size of these deductions from EBITDA will determine how much cash is left over to be distributed to unitholders.

Cash return is a popular measure for judging the attractiveness of an income trust. Cash return represents the amount of cash distributed to unitholders in the current period, divided by the current price of one unit. Cash return is comparable to dividend yield, which measures the dividends paid out to common shareholders divided by the current price of a common share. 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. While distributable cash paid to unitholders is expected to be stable over time, past distributions may not be a good predictor of future ones, particularly if the revenues of the operating company decline or assumptions about cash expenses are too optimistic. Cash return should therefore not be equated with a bond yield, as the coupon payment on a bond is generally fixed, while cash distributions to unitholders are not.

A second point to consider is that the distributable cash paid to unitholders may 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; however, one of these may be simply paying out part of the investor's equity, rather than generating cash distributions through operation of the business.

TABLE 4

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%
Percent 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

Finally, 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 offer the same tax benefits as equities. Dividend and interest income are subject to personal income tax, although unitholders may hold their investment in a tax-sheltered savings plan such as an RRSP. However, for investors that are subject to taxes, it is important to understand how much of the cash distribution in a given year is sheltered from tax.

Capital structure

The second element 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; in other words, the market value of the total assets of the business. 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. Leverage across income trusts may be compared using the multiple of debt-to-EBITDA, with a typical income trust holding debt equal to 1.5 times EBITDA (Scotia Capital 2002). Given that EBITDA is not the cash flow that is paid out to unitholders, it is more relevant for investors to compare the level of debt relative to distributable cash across income trusts when making an investment.

Industry Comparison

In order to identify relative value, income trusts should be compared with their peers in the same sector using a range of valuation measures. Cash returns will vary across industrial 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 securities industry research reports.

Table 4 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%, with these businesses commanding a premium valuation based on multiples of cash flow due to their stability. By contrast, the average oil and gas royalty trust offered a cash return of 20% 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 in between these two extremes, offering cash returns of 8% to 12% that reflect the uncertainty of their business models and the relatively higher leverage in their capital structure.

Conclusion

The income trust market has delivered a number of benefits. Companies have been able to realize significant gains on the sale of assets through this market, allowing companies to raise significant amounts of capital by selling off mature assets with the proceeds either returned to shareholders or invested in potentially more profitable growth opportunities. This avenue of raising capital has particularly benefited small firms and/or firms that did not have access to Canadian equity markets on attractive terms. A number of companies have chosen to de-list from stock exchanges, such as Big Rock Breweries of Alberta, as the income trust structure is more attractive for investors due to the reduction of corporate tax.

For their part, 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 leaving this cash in the hands of managers who may reinvest these funds poorly. Higher cash payouts reduce the need to monitor management, a benefit that has taken on special meaning in the wake of the corporate governance scandals of the past few years. ■

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Endnotes

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-end or closed-end.
2. There is no consensus on the number of income trusts outstanding, with figures from 100 to 200 reported. This confusion may be due to a lack of consistency in the use of the term 'income trust,' with some figures including oil and royalty trusts, and REITs.
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.
4. 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.