Income Trusts: Understanding the Issues

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An income trust is an investment vehicle that distributes cash generated by a set of operating assets in a tax-efficient manner. The sharp rise of income-trust valuations, the large supply of new issues, and the complexity of their legal structure have led to increased scrutiny of this asset class. To explore whether the cash returns from income trusts are in line with the risks, the structure of a typical income trust is compared with that of a typical corporate entity. The legal, regulatory, and governance issues introduced by these differences are then raised. Finally, business and market-related issues are discussed.

Structure and Valuation

An income trust is a special-purpose entity that sells equity to the public 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). The term "income trust" may be used broadly to cover a variety of businesses and models, or narrowly to refer to a segment of this asset class. Here, it refers to royalty trusts, real estate investment trusts, and trusts based on various businesses (also called hybrid trusts or business-income trusts).

As an asset class, income trusts have experienced phenomenal growth over the past two years. Income trusts had a total market capitalization of $45 billion at the end of 2002 and represented about 6 per cent of the stock market capitalization of the Toronto Stock Exchange. This total represents a dramatic rate of growth when compared with the $29.5 billion of total market capitalization at year-end 2001 and $2 billion at year-end 1994. The exceptional growth of this asset class has been driven by appreciation in the value of outstanding income trusts, the issuance of units through initial public offerings, and the subsequent sale of additional units by existing income trusts.

An income trust is designed to maximize the cash distributions from a set of revenue-generating assets, with these distributions typically paid to unitholders on a monthly 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. 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.

The valuation of an income trust is similar to the valuation of any other equity 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 one income trust with others in the same industry sector or business. To get an accurate picture of risks and returns, existing income trusts must be valued relative to others 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 tax treatment of different types of distributions.

Firms and investors have benefited from the development of income trusts. Firms have been able to realize significant gains on the sale of assets through this market. They 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

* This note summarizes a recently published Bank of Canada working paper (King 2003).

in potentially more profitable growth opportunities. This avenue of raising capital has particularly benefited small firms or firms that did not have access to Canadian equity markets on attractive terms. 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. Higher cash payouts reduce the need to monitor management, because investors make the decision on how to reinvest the earnings rather than leaving these funds in the hands of management.

Issues Raised by Income Trusts

Investors should consider several issues when valuing an income trust. These issues can be classified into four broad categories—legal and regulatory issues, corporate governance issues, operational issues, and market issues.

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. The issue of unitholder liability is being addressed in some provinces. For example, the Ontario government has introduced legislation that would limit the liability of Ontario-based unitholders under the Trust Beneficiaries' Liability Act 2003 (Government of Ontario 2003).[1] Hayward (2002) addresses the tax implications of this asset class.

While they resemble corporate entities, income trusts fall under a different code of law with different requirements for corporate governance. Unitholders in an income trust are represented by a trustee, whose responsibilities are laid out in a trust indenture. The assets owned by the income trust may be managed by full-time internal managers similar to a corporation, but this task may also be contracted to a management company under a management agreement. Investors need to scrutinize these documents in order to understand the staffing of these positions, the incentives for the trustee and managers, their compensation arrangements, and the level of disclosure required for factors such as potential conflicts of interest. Unitholders should also be aware that their legal rights are more limited than those of shareholders in a corporate entity.

Operational issues relate to the subordination of the unitholder's claim on the operating assets to secured bank loans or other debts, the sustainability of expected cash flows from these assets, and the degree of leverage in the operating company's capital structure. Not every business model is viable as an income trust. For example, this structure is suited to businesses that generate a steady stream of cash distributions and require minimal capital expenditure to maintain the productivity of the assets. Given the proliferation of income trusts in various business sectors, investors need to question the key assumptions regarding cash distributions to ensure that these distributions are sustainable in the long run.

Finally, market issues involve the sensitivity of income-trust valuations to changes in the level of interest rates, the level of risk premiums, and secondary market liquidity. While market conditions have been favourable for income trusts over the past two years, the change in the external environment in the fourth quarter of 2002 led to a decline in their valuation. In 2003, the wide variation in the performance of different income trusts reflects a greater differentiation by investors concerning their future prospects.

These investment 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" (Standard & Poor's 2002). A stability rating is voluntary, and income trusts must pay Standard & Poor's to receive one. As of year-end 2002, only 25 Canadian income trusts had been rated.

Conclusion

A better understanding of the issues raised by income trusts will allow investors to seek the appropriate return for a given level of risk. The mixed performance of this asset class over 2003 suggests that income trusts are evolving and have reached a new phase of consolidation with slower growth expected in the future.

1. Passage of this legislation was delayed by the Ontario election.

References

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