Textual Reference

Presentation on income trusts to the House of Commons Finance Committee

The TAMRIS Consultancy

30 January 2007

An income trust is a business entity that distributes all its cash flow after an allowance for maintenance capital expenditure and interest payments on debt.

It is therefore a business entity that needs access to the capital markets and credit if it wants to grow, expand or to invest in upgraded capital. And, most income trusts access the capital and debt markets to do just that.

Traditional business entities retain a percentage of earnings to fund all or a portion of capital growth, acquisitions and investment and use retained earnings to pay down debt used to fund acquisitions and capital investment and to support their dividends.

Entities that retain earnings to fund growth and acquisition will have a lower yield and a higher level of capital growth via the compounding of retained earnings. Entities that retain no earnings and/or distribute capital will have a lower level of capital growth or a higher rate of capital depletion.

The decision to buy an income trust is therefore primarily a decision between current and future consumption and a decision between the rate of depletion and/or accumulation of capital.

Many trusts have been distributing not just the return on their capital but a good portion of their capital itself. Many are also using debt and capital raised from new issuance to fund distributions in excess of cash flow let alone earnings.

Accepting capital depletion in favour of higher expenditure is not a problem if the investment decision and the price reflect the impact and the risks of this depletion.

It is a fact that the yield on cash, bonds and traditional equities are insufficient to meet the financial needs of all but the very wealthy. Individuals are forced to meet lifetime expenditure, to lesser or greater degree, by depleting investment capital. It is this problem of managing the rate of depletion over time that has drawn the individual investor towards the income trust sector.

Unfortunately, income trusts have not been valued as lower long term capital growth or capital depleting investments that are exposed to the economic and market cycle for their return and

The TAMRIS Consultancy
8 Algo Court, Willowdale, Ontario, Canada, M2M 3P1
Telephone 416 730 8103, E mail atamris@sympatico.ca
http://moneymanagedproperly.com

their access to capital. They have been valued as high growth, high yield investments impervious to risk, which of course they are not.

With most income trusts having been launched from the bottom of the last business cycle and up through the current commodity led boom, investors have been led to believe that they provide both high yield and high rates of capital growth over the long term, which they do not.

Given this belief it is no wonder that the average income trust investor is up in arms. It would appear to these investors that the government has indeed taken away the elixir of perpetual yield and capital return.

Are income trusts of value to the economy?

Canada does not have a consumption problem. It has a productivity, a growth and an investment problem.

An investment which leverages short term consumption at the expense of long term capital accumulation will exacerbate short term inflationary problems and impact long term economic growth.

Income trusts exacerbate the peaks and troughs of the economic cycle.

Income trusts are cash generative businesses that invest (with a few exceptions) in cash generative activities and acquire cash generative businesses. With few exceptions, income trusts are unlikely to invest capital in businesses that are not immediately accretive to cash flow. Their investment objective is therefore short term.

Capital is therefore being allocated to businesses leveraged to current consumption as opposed to long term investment and capital growth. This is raising the price of lower growth businesses relative to their long term return, something which is contrary to financial theory.

Some have pointed out that sales, revenue and capital invested by income trusts have increased at a far higher rate than the economy at large and use this to argue that income trusts have generally positive economic benefits.

These figures ignore the fact that this sector of the market has grown strongly through IPO issuance and post IPO acquisition and that much of this gain is due to the transfer of capital from other business structures, economic sectors and asset classes.

Acquiring existing capital via acquisition is not investment, neither is the application of resources to maintaining existing capital. Additionally excessive capital investment in any one sector, something that could result from the business income trust model would also have a negative impact on the efficient balance of economic growth.

At any one point in time resources are best allocated and managed by efficient, competitive and informed markets without distortions.

The efficient allocation of capital within the Canadian market place has been negatively impacted by tax distortions (for tax exempt investors) and by informational asymmetry; individuals are unaware that part of their yield is a return of their capital and that a good portion of their recent return is highly leveraged to the economic cycle and the demand for income trusts.

Tax distortions and the informational asymmetries have resulted in excessive demand for income trusts, raising the price of certain productive assets while reducing the total long term return on those same productive assets for income trust investors.

From the analysis I have conducted into this asset class income trusts focus on acquisitions that provide cash flow and tend not to operate in the necessary growth sectors of the future. Instead I see income trusts promoting amongst others Canada's strengths in Casinos, telephone directories and regional advertising, ice making, North America funeral homes, bleach and propane, seafood and no name brand foods, budget music, DVD distribution, cheques and chemicals' businesses that nobody else wants. While these businesses are necessary to the Canadian economy, t**hey do not warrant** the valuations attached and the capital being allocated.

Are they important to the Canadian resource sector?

As far as the resource sector is concerned, at a time when the world economy has been overweight commodities and when global capital has been aggressively seeking exposure to commodity investments it would seem absurd to state that the Canadian resource sector has been dependent on income hungry Canadian investors.

Instead I see many examples of corporate structures selling off assets to income trusts at valuations they would not be able to achieve elsewhere and could not afford to turn down.

The problem Canada has is in reallocating return from the resource sector to the rest of the economy, not in allocating more capital to this sector.

Are they important sources of capital for small to medium sized companies?

Over the last three months I have analysed the financial histories of 100 income trusts from pre IPO and conversion to the current point in time.

- The majority of the business trusts at IPO were not businesses seeking capital for expansion but private equity and institutional investors seeking exit strategies for business acquired.

- Another important source of income trusts were corporations spinning off non core businesses or minority stakes to raise capital.

- Many of the genuine corporate conversions were companies that were growing well enough prior to conversion, that were retaining earnings, acquiring businesses and investing and had access to debt and equity capital.

- Companies with significant cash flow are also companies that are best able to finance their own organic growth and are least likely to suffer from the end of the income trust model.

Is there a real, viable and valuable cost of capital benefit?

Many argue that income trusts provide a lower cost of capital. Unfortunately the lower cost of capital argument only works if capital raised is not transferred to institutional or private equity sellers but retained for organic growth or for an acquisition strategy that does not value its targets on similar distributable cash multiples.

There is ample evidence that income trusts are paying higher multiples for their acquisitions and that the benefit of higher unit prices is being felt by the sellers of assets and not the buyers of those assets.

The cost of capital argument appears to be confusing the benefit that a higher share price ordinarily bestows on a company, allowing it to raise capital for growth and acquisition. This argument ignores the fact that a growth company with a high share price only pays out a portion of current earnings as recompense for the capital issued. Clearly the cost of capital for an income trust in the market place is so high that it can often only meet this cost through a return of the investors' own capital, a return the individual has already paid for.

Does an income trust structure impose greater fiscal discipline?

Why does Canada need its small to medium sized companies to go on cash generative acquisition binges?

From my analysis it would appear that far too many income trusts have been raising capital far too easily. In the presence of significant demand from small Canadian investors it would appear that there is less financial discipline and constraint on income trust fund raising for acquisition purposes.

At the same time with valuations and the ability to raise cash dependent on the maintenance of high cash distributions many companies are forced to maintain their cash distributions at levels well beyond those the business is capable of maintaining.

Are income trusts a business and investment model that we want to see here in Canada?

An income trust model would only be a more efficient business and investment structure if investors were better able to make the capital allocation decision than the managers of the company and if investors were able to make similar judgements with regard to the issuance of and application of capital.

To do this investors would need to know the business better than the managers and to be able to model the long term impact of cash distributions on the ability of the business entity to grow its capital base and its distributable cash or at least manage its depletion.

Income trusts risk distributing far too much of their earnings and capital and are far too reliant on the whims of the market and the risks of the economic cycle. Examples of what happens to income trusts when they encounter difficult business and economic conditions already litter the financial landscape and examples of what happens to resource based income trusts are now being seen.

The income trust model is a short term leveraged consumption driven economic and investment model incompatible with long term investment/deferral of consumption. The impact of leveraging consumption towards the short term, amongst others, has significance for immediate investment, long term growth, short term inflation and interest rate policy. As the baby boomers retire such a structure could cause significant economic problems.

As stated, Canada has a productivity problem; its natural rate of economic growth (the growth rate that can be achieved without inflationary consequence) is low and sensitive to excess consumption. Canada does not need to leverage current consumption.

Why have income trusts been sold?

Income trusts have not been sold to help the retired individual meet their financial security in retirement. They were sold for the revenue they generated for the financial institutions and the often phenomenal financially engineered returns for private equity and institutional investors that used income trusts as exit routes.

Income trusts have been sold as stable mature cash generative businesses that require little or no capital to for business operations. This is not the case. Also, contrary to the belief of some, private investors have not been granted the same access to return as private equity and institutional investors.

I would like to point out that the income trust IPO has been an exit strategy that has allowed cash flows and leverage and hence valuations to be manipulated in favour of private equity, corporate and institutional sellers. Private equity returns on an income trust IPO can be between 3 and 7 times the initial equity investment.

In addition to the high and inappropriate cash valuations attached to these investments, many were further leveraged at their issue with additional debt designed to enhance the yield and attractiveness of the issue. Leverage has also been used to spin off partial holdings for a much greater initial capital return than could have been obtained via other routes. In short, the private investor has been used.

I believe that investor anger is genuine, but that it is misinformed and misguided with regard to its direction.