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The Outlook for Business Trusts

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Another week, another income trust that is converting into a corporation, usually accompanied by a substantial reduction in its distribution, which even the fact that the distribution will now be accounted for as dividend income from January 1st, 2011 does not offset. Gordon asked me when preparing for this month's column whether there would be any business trusts left when the new trust taxation regime is introduced in 2011, and at he present rate of takeover or conversion it is difficult to argue that there will be any remaining.

This argument applies specifically to business trusts, those businesses which were ordinary tax paying corporations before the trust conversion boom began earlier this decade. The original inhabitants of the trust universe, the oil and gas royalty trusts and the Real Estate Investment Trusts (REITs), are a different case and it appears extremely unlikely that many of the former will follow Crescent Point Energy Trust's decision this month to convert to a corporation. As for REITs, they were the one category of trusts specifically excluded from the government's SIFT legislation in November 2006, as even the Finance Minister recognized that a structure that was being introduced all over the world by other governments was a legitimate method of financing passive investments such as real estate.

Most oil and gas royalty trusts will probably not convert into corporations because, as noted in out discussions of Penn West Energy Trust, they have large "tax pools", expenditures on drilling wells and building pipelines, which, once they become taxable entities, they can use to offset some of the tax they will be subject to. Penn West's tax pools have increased from $5.5bn at the end of 2007 to $5.9bn at the end of last year, and Vermilion, another selection of the Income Investor, is already paying tax on its overseas operations, which will be able to be offset against some of its Canadian tax bill. Crescent Point did not reduce its payout when it announced its conversion, which may be why it remains one of the favourite energy trusts of the team at Guardian Capital.

The taxation change was focused on ordinary corporations whom the government felt were trying to game the tax legislation by transforming from taxable corporations to non-tax paying trusts, thus depriving the government of its revenue from this source, although, as numerous critics pointed out, this was merely a deferral of taxation, as the owners of the trusts paid tax when they received the distributions from the trusts, often at a higher rate than the corporation would have paid. The transformation of all income from flow through vehicles, whether income trusts, royalty trusts or limited partnerships, into dividend income was the basis for the Finance Ministry's claim that no taxable Canadian investor would be worse off due the legislation, which ignored the fact that non-taxable investors and foreigners had just seen their cash flow reduced at a stroke. It is notable that the decision by Telus to convert to a trust, followed, after the tax change, by confirmation that Encana was contemplating the same move, gives a good clue as to the reason for the timing of the government's move.

Where does this leave the investor in business trusts? As always when in investing in income trusts over the last dozen years or so, the corporate structure is far less important than the performance of the underlying business. Is management competent and honest, is the business in a sector with barriers to entry or good growth prospects, is it dependant upon inputs whose prices it cannot control and does it have pricing power for its own products are far more vital than whether it is paying tax at the corporate level and how high the distribution to unit-holders is. Often the best returns in the trust sector have come from those trusts with the lower or lowest yields, and as noted here before, a yield that is high is often a warning sign.

Having made this important proviso, the conclusion for most investors is that the business trust universe has shrunk substantially, is shrinking and will continue to shrink for the next twenty one months until the change in taxation actually arrives. The chief cause of this phenomenon is not conversions themselves, although RBC Dominion Securities trust team has a list of 15 closed conversions from trusts into corporations over the last eighteen months, with another half dozen announced so far this year. Rather it has been the wave of takeovers which has led to a steep fall in the number of trusts, with 41 business trusts, 11 oil and gas trusts, 8 REITs and 6 infrastructure trusts having been taken over since the fourth quarter of 2006. That means that nearly 90 income trusts have disappeared or transformed themselves, over one third of the total at their peak of popularity in mid 2006.

Of these, Income Investor recommendations Voxcom and Teranet were takeovers and Keystone North America and BFI Canada were conversions, with the attendant reductions in distributions. Recommendation Liquor Stores bought rival retailer Liquor Barn and the other listed water heater rental trust, UE Waterheater was taken over as opposed to recommendation Consumers' Waterheater. Even with the takeovers, the premium was not large, with Voxcom going at a 29% premium to its pre-offer price, and Teranet at 10% with the average premium for business trusts at 30%, inflated by the higher valuations in the first half of 2007, before the credit crisis began. The premiums for oil and gas trusts, REITs and infrastructure trusts averaged 14%.

Some well known names such as Aeroplan, CI Financial, Superior Plus, Mullen Group and Newalta, as well as Crescent Point and GMP Capital, have been amongst the trusts converting into corporations, or, in the case of CI and Mullen, back into the corporate form. It would be reasonable to assume that a number of the other business trusts will also follow that route, especially if they have a convincing argument that they have good prospects for growth which will be served best by distributing less of their cash flow. Some might follow the example of Keystone, which reduced its payout to a level which left Canadian investors' after tax income unchanged, or like Superior, which bought tax pools from a third party to shelter its income and we have already noted Crescent Point maintaining its payout when it converted. However, as noted when discussing the BFI Canada conversion, the majority of conversions have reduced their distributions, and, as

BFI has demonstrated with its recent successful $85m equity cash raising despite a 74% reduction in its payout, it appears investors are prepared to overlook cuts in distributions if they feel they management can demonstrate a good reason for retaining more of the company's cash flow. The provisions of the tax legislation also meant that trusts could only grow a certain amount during this period if they wished to retain their tax exemption, which some managements felt was unduly restrictive. It seems reasonable to assume that the majority of business trusts will have converted or will at least have reduced their payouts in anticipation of the introduction of the SIFT tax in January 2011 and the yields on a number of trusts are indicating that investors expect them to be cut. Income Investor readers should work on the assumption that distributions from the four remaining business trusts that I have recommended, Consumers' Waterheater, Davis + Henderson, the Keg and Liquor Stores, will likely see some reduction in their distribution yields, which range from just under 14% for Liquor Stores to 19.6% for Consumers', by the end of next year. This does not make them sells, but rather reflects the changed situation regarding both taxation and the valuation of equities over the last two and a half years.