

Effect of the Income Trust Taxation Changes on Western Canadian Business

Back to the Pre-Trust Era with Some Challenges Along the Way

Income trusts in Canada will return to a market that existed before the growth in income trusts occurred. The challenge will be the four year period before the tax changes come into full effect as opposed to the USA and Australia that followed the same process over a 10 year period.

The Trust Market

Over the last several years, the income trust market has offered a lucrative exit for companies that would not normally have been public company candidates. Although an expensive structure to maintain, becoming a trust also provided the company with an inflated currency with which to access capital and to make acquisitions.

Since the changes in trust taxation policy, income trust units have declined

15-20% with the worst hit being the smaller business trusts and oil and gas trusts with declining assets. This value should continue to fall as the value of the tax shield diminishes over time.

The trust market has, however, created a new market for high quality high yield investments. Over time, the trusts that lend themselves to a stable high distribution payout will need to grow 50% (compound annual growth rate over 10%) over the next four years to

maintain their distributions once they are fully taxed. Whether they maintain the trust structure or choose to become regular corporations with high dividend distributions is debatable, but their niche in the capital markets should remain intact.

Four Types of Trusts

There are four types of trusts (excluding Real Estate Investment Trusts "REIT"s" which were unaffected by the tax changes), and each will behave differently. The four types include trusts with declining assets, business trusts that make unsuitable regular public companies due to their size or business type, growth-oriented trusts and lastly trusts that can maintain a high level of distributions sustainably over time.

Declining Assets: Trusts with declining assets are comprised of aging oil and gas companies with diminishing reserve life. Consolidation of these companies will be the trend. In the trust era, declining assets were separated from growth assets. With limited access to capital, and potentially, restrictions on the number of

units that can be issued in an acquisition, these companies will need to consolidate. Predators of these trusts may well be the largest of the declining asset trusts or growth oriented public companies.

Orphans: The unsuitable public company trust includes smaller sized businesses and those that would not normally appeal to the public market. Consolidation is definitely a possibility, but it is anticipated that going private transactions will be popular. Another possibility includes the multi-business trust that starts selling off its pieces of which Superior Plus is a recent example.

Growth Oriented: Growth oriented trusts chose to be trusts as a result of favourable valuations and will most likely remain public companies but revert to the traditional public corporation model.

Sustainable Distributor: Lastly, there are companies that would not normally have been popular public company candidates that

have proven to be very popular with investors. These companies, of which the Yellow Pages trust is a good example, are well suited to high distributions to shareholders. While the changes in tax rules regarding trusts have yet to be finalized, these companies may well remain as trusts or revert to a standard corporation, but

will maintain their flavour of high distributions in dividend form. Recently, two of Canada's largest income trust funds (Renaissance Canadian Income Trust Fund, and Guardian Groups Monthly High Yield fund), have announced their inclusion of high dividend equities to their funds. High yield companies have created a new vehicle in the investment market with low correlation to traditional public companies that should retain their appeal to the yield driven investor.

Future Trends

Acquire or be Acquired: With the orphan trusts as takeover targets, Private equity groups ("PEG"s) and strategic buyers will have opportunities. Recently, a PEG bought out JW Aluminum from Superior Plus Income Trust and KCP Income fund put itself up for sale. Growth-oriented trusts will convert to regular public entities and consolidate compatible orphans, while solid high yielding trusts will stay the course by maintaining high distributions in a form acceptable to the market.

Bigger Sells Better: Private businesses will once again need a growth story with \$10-\$20MM in EBITDA to be considered public company candidates as opposed to the \$5-\$10MM EBITDA hurdle in the income trust era. Business owners will have to go back to more traditional succession planning and exit options. With the lack of the income trust exit option, smaller private company valuations will be reduced by 20%+ over 2006 valuations and liquidity events will be less frequent at the small end of the range.

Dividend Redirection: The management and former owners of the orphans may also find themselves as buyers of their own companies in going-private transactions by rolling their retained interest with a debt or equity financial sponsor. Trust going-private transactions will be popular and private companies will once again focus on growth, succession and value maximization strategies. Private businesses will have to focus on traditional value creation strategies to build a business with consistent growth in free cash flow. Reinvestment, expansion and acquisitions will be popular generators of corporate growth, while management and leverage buyouts will become more prevalent exit options.

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