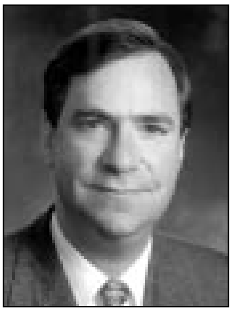
Canadian income fund sector comes of age



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Amid a prolonged downturn in initial public offerings of conventional equity securities in North American and global markets in recent years, Canadian income fund IPOs, as well as follow-on financings, have enjoyed spectacular growth. Not only have income funds IPOs become a viable alternative to conventional IPOs and other traditional exit and liquidity strategies, but they have also become – in appropriate circumstances – the method of choice for maximizing returns to existing stakeholders of a business and achieving optimal cost of capital structures for the newly created public entity.

In general terms, an income fund (also commonly called an income trust) is an equity vehicle created to acquire certain income-producing assets (such as an operating business, real property or resource royalties), typically financing this acquisition through a public offering of its securities (units). Although the nature of the businesses that have been taken public as, or converted from conventional corporate form to, income funds varies widely, the most viable and successful businesses for this structure share certain main characteristics: they are mature businesses with a history of stable, predictable cash generation capability and low continuing capital requirements. Within these broad parameters, almost any type of business can be a suitable candidate for an income fund.

Today, income funds listed on the Toronto Stock Exchange represent more than 50 different lines of business and have an aggregate market capitalization well in excess of C$50 billion. About 115 different income funds (including royalty and real estate investment trusts) are represented among those listings.

Growth in the number, diversity and market capitalization of income funds, which has been exponential in the past few years, has been fuelled primarily by IPOs of former private companies or divisions or subsidiaries of public companies. But there has also been growth in the sector attributable to conversion of existing public companies into income funds as a means of maximizing value to equity owners by taking advantage of the higher valuations available to income funds relative to corporations in appropriate circumstances. The growth and demand has been accelerated by an investor appetite for higher yielding securities (in an historically low interest rate environment), as well as by tax and capital efficiency.

The sector reached a milestone in August 2003 with the completion of the first C$1 billion IPO – the Yellow Pages Income Fund – which acquired and publicly distributed units in a business previously owned by an investor group led by Kohlberg Kravis and Roberts & Co and Ontario Teachers' Pension Plan Board. The scope and success of the transaction showed the attractiveness of the income fund exit mechanism for private investors as an alternative to conventional means of monetization. Less than four months after completion of the IPO, Yellow Pages and its principals were back to the Canadian public market with a follow-up distribution of units valued at a further C$1.5 billion.

From the perspective of investors, income funds are designed and intended to distribute cash flow from operations (typically monthly) on a pre-tax basis, thereby eliminating or lessening the double taxation of corporate profits. Properly structured, an income fund is able to take advantage of its status as a flow-through vehicle for Canadian tax purposes to effectively provide for pre-tax flow-through distributions of cash in a manner unavailable in conventional corporate form. Investors also benefit from any capital appreciation in the value of their units (which are listed and traded on the stock exchange exactly like conventional equities), although much of the overall return to investors is intended to derive from cash distributions.

Canada

Income fund governance is intended to replicate, to the extent legally possible, that applicable to Canadian publicly traded corporations. Because the funds are (for Canadian tax purposes) structured as unit trusts, the ultimate securities issuer has a board of trustees as opposed to a board of directors. Typically, the declaration of trust – which is the entity's "charter" – will provide for annual election of trustees, mechanisms for removal, and similar provisions analogous to those applicable to corporate directors. Day-to-day management, under the supervision and control of the trustees, is typically conducted through an affiliated corporate entity with officers and directors again replicating the process in the conventional corporate form.

From a capital markets regulatory perspective, income funds are not much different from other public issuers of securities. The Canadian registration and prospectus regime applicable to all IPOs and the timely and continuous disclosure system, requiring periodic financial and other timely disclosure of material information, annual reporting, proxy solicitation disclosure and the like, are as applicable to income funds as to conventional public corporations. In recognition of the explosive growth of the sector, the Canadian securities administrators recently published for comment a national policy that is the first regulatory instrument to focus directly on income funds. The policy is intended to provide guidance and clarification to market participants by expressing the view of the Canadian regulators on how the existing regulatory framework should apply to income funds and similar offerings.

One recent development has been the use of the structure by non-Canadian businesses. There have been several cases of US businesses completing IPOs in the Canadian capital markets through the use of income funds.

Another development, recognizing the sector as a legitimate and permanent capital markets category, has been the advent of several fund-of-funds products, both open and closed-ended, which invest exclusively in a diversified portfolio of income funds, as well as the creation of several income fund indices. Most of the major Canadian sell-side investment firms now have research analysts whose work is dedicated to research and analysis into income funds.

As the sector grows and matures through an entire business cycle, the expectation is that participants in the sector will engender the normal run of transactional activity traditionally associated with corporate issuers, including consolidations and other M&A, financial restructuring and going private transactions. It will be interesting to watch the development of this sector in the years to come.