Income Funds Come Of Age
“The tipping point... was the day that Standard & Poor’s bowed to reality, and made trusts part of the Canadian stock benchmark. Jot it down in your BlackBerry... the 26th of January, 2005. That was the day the sector really took off. That’s when trusts stopped being a novelty, and came to be viewed as a legitimate strategic alternative for every mature business.”

Income Funds Come Of Age: TSX Composite Inclusion Follows Banner 2004

On January 26, 2005, Standard & Poor’s announced that income funds will be included in the S&P/TSX Composite Index, the broad benchmark index for the Toronto Stock Exchange and Canada’s premier equity index, by mid-2005. With this long-awaited development, the income fund sector, the fastest growing segment of the Canadian capital markets, has come of age.

Inclusion in the Composite Index follows a year of significant activity in the sector. In 2004, the market capitalization of TSX-listed income funds increased almost 50% to $121 billion, representing a total of 175 income funds. The net increase of 40 income funds included 26 created by initial public offerings (IPOs). Publicly traded income funds now represent approximately 8% of the market capitalization of issuers traded on the Toronto Stock Exchange. The inclusion in the Composite Index of income funds, once viewed primarily as a retail investment, is expected to attract increasing numbers of institutional investors to the sector, thereby increasing liquidity and demand for income fund units.

The dramatic growth of the income fund sector – from a market capitalization of approximately $20 billion in 2000 – has been driven by a number of factors, including the attractiveness to investors of stable or increasing distributions in an economic environment characterized by low interest rates and a volatile equity market.

One of the hallmarks of 2004 was the development of cross-border income securities for Canadian investors, which have proved to be a popular addition to the income fund sector. Four Canadian IPOs of U.S. businesses have been successfully completed to date using this structure and investment bankers expect further such transactions to follow.

In response to the continued visibility and growth of the income fund sector, a number of important regulatory developments with respect to income funds took place during 2004. The passage of limited liability legislation in Alberta and Ontario was the prelude to income fund inclusion in the Composite Index. Canadian securities regulators finalized an important policy on income fund offerings. The federal government broadened the scope of Canadian withholding tax on distributions by REITs and resource trusts to non-resident investors. The federal government also introduced but then suspended proposals limiting pension fund investment in business income funds, as well as proposed amendments to the test for non-resident ownership of income funds.

In the following pages we describe some of the income fund highlights of 2004 and outline the key regulatory developments in the sector.

![Sector Growth Chart](goodmansincomefunds.com)
The Brick Group Income Fund, headquartered in Alberta, completed a $280 million IPO in July, 2004. Since its first store opening in 1971, the Brick Group’s growth has been driven by its long-term vision of innovation and value. Over the past 33 years, The Brick Group has strategically executed its expansion across Canada and now operates 167 retail stores (including its 14 franchise locations) in the provinces of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Quebec and the Yukon Territory. In addition, the Brick Group operates distribution centres in Vancouver, Edmonton, Winnipeg, Toronto, and Montreal. The Brick Group’s retail operations are unique in their ability to offer products in three different price segments under three distinct banners: The Brick, United Furniture Warehouse and HomeShow Canada.

Business and Power Income Funds

Over the last few years, income funds have been formed from a wide variety of operating businesses. These income funds have been one of the key areas of dramatic growth in the sector.

Investor appetite for specialty business income funds remained strong in 2004 with the completion of 53 offerings totalling $5.5 billion, including 21 IPOs. By the end of 2004, this sub-sector represented 36% of TSX-listed income funds by market capitalization.

The largest business income fund IPO during 2004 was a $280 million offering by The Brick Group Income Fund. The largest follow-on offering in this sub-sector was a $743 million bought deal for Yellow Pages Income Fund. Goodmans acted as issuer’s counsel on The Brick Group’s transaction and as underwriters’ counsel on the Yellow Pages transaction.

In 2004, the breadth of the income fund market accommodated both large and small business income fund transactions.

K-Bro Linen Income Fund, headquartered in Alberta, filed a preliminary prospectus on December 13, 2004 and completed a $43 million IPO on February 3, 2005. K-Bro is the largest owner and operator of laundry and linen processing facilities in Canada, providing a range of services to large healthcare institutions, hotels and other commercial accounts. These services include the processing, management and distribution of linen, including sheets, blankets, towels and operating room linen. K-Bro currently owns and operates laundry and linen processing facilities in Vancouver, Calgary, Edmonton and Toronto. The Goodmans team worked closely with management to successfully structure and execute the transaction.
2004 also witnessed the continued popularity of power income fund offerings with the completion of three IPOs (Atlantic Power Corporation, Macquarie Power Income Fund and Countryside Power Income Fund) and numerous follow-on offerings. Goodmans acted on each of the IPOs.

Activity in the power income fund sector may be further enhanced by government efforts across North America to update the energy supply. The Ontario government, for example, has said that Ontario faces an “energy crisis” and needs to refurbish, rebuild, replace or conserve 25,000 MW of generating capacity by the year 2020 to meet growing demand. That represents 80 per cent of Ontario’s current generating capacity and would require an investment of approximately $25 to $40 billion (or $1.6 to $2.6 billion per year over the next 15 years).

On April 8, 2004, Countryside Power Income Fund completed a $149 million IPO. Countryside used the proceeds to indirectly acquire two utility infrastructure investments located in Canada and make investments in 19 power projects and three gas pipeline projects located in the United States. The Canadian infrastructure investments are located in Charlottetown, Prince Edward Island and London, Ontario, and together have approximately 122 MW of thermal and electric generation capacity. The U.S. projects have approximately 51 MW of electric generation capacity and sold approximately 700,000 MMBtus of boiler fuel in 2003. Countryside owns the Canadian assets and has loans to, and a convertible royalty interest in, U.S. Energy Biogas Corporation which owns the U.S. power projects.

Big Deals – the ten largest income fund IPOs in 2004:

<table>
<thead>
<tr>
<th>Income Fund</th>
<th>Date</th>
<th>Amount</th>
<th>Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic Power Corporation</td>
<td>November 2004</td>
<td>$368 million</td>
<td>Power Generation</td>
</tr>
<tr>
<td>The Brick Group Income Fund</td>
<td>July 2004</td>
<td>$280 million</td>
<td>Furniture Retailer</td>
</tr>
<tr>
<td>Sunrise Senior Living REIT</td>
<td>December 2004</td>
<td>$271 million</td>
<td>Assisted Living Facilities</td>
</tr>
<tr>
<td>Medical Facilities Corporation</td>
<td>March 2004</td>
<td>$222 million</td>
<td>Specialty Hospitals</td>
</tr>
<tr>
<td>Macquarie Power Income Fund</td>
<td>April 2004</td>
<td>$212 million</td>
<td>Power Generation</td>
</tr>
<tr>
<td>Osprey Media Income Fund</td>
<td>April 2004</td>
<td>$204 million</td>
<td>Newspaper Publisher</td>
</tr>
<tr>
<td>Gienow Windows &amp; Doors Income Fund</td>
<td>October 2004</td>
<td>$165 million</td>
<td>Manufacturer</td>
</tr>
<tr>
<td>Otelco Inc.*</td>
<td>December 2004</td>
<td>$162 million</td>
<td>Rural Telecom</td>
</tr>
<tr>
<td>Countryside Power Income Fund</td>
<td>March 2004</td>
<td>$149 million</td>
<td>Power Generation</td>
</tr>
<tr>
<td>The Data Group Income Fund</td>
<td>December 2004</td>
<td>$148 million</td>
<td>Document Management</td>
</tr>
</tbody>
</table>

* Goodmans acted on this transaction.
1. Issuer’s Counsel  2. Underwriter’s Counsel  3. Seller’s Counsel  4. Lender’s Counsel
Cross-Border Income Securities

Since late 2001, the income fund vehicle has been used to take a number of U.S. businesses public in Canada. During 2004, Canadian income securities emerged as a tax-efficient alternative to cross-border income funds. U.S. income securities were originally designed by Canadian investment bankers for use by U.S. companies to raise capital primarily from U.S. investors. Goodmans played a key role in developing a parallel structure to enable U.S. companies to raise capital primarily from Canadian investors.

An income security is a separable unit comprising a dividend-paying common share and a specified principal amount of interest-bearing subordinated notes. These components trade together as a single unit but are separable at the option of a holder typically after 45 days following the IPO closing.

The first income securities offering marketed only to Canadian public investors was the $222 million IPO completed by Medical Facilities Corporation in March, 2004. Subsequently, Atlantic Power Corporation completed a $368 million IPO in November, 2004, Student Transportation of America completed a $128 million IPO in December, 2004 and Keystone North America completed a $171 million IPO in February, 2005. Goodmans acted as issuer's counsel on each of the IPOs.

In 2003, a group of doctors from South Dakota were looking to execute a partial sale of their holdings in limited partnerships that own and operate three of the largest specialty hospitals in South Dakota. Each hospital performs scheduled (as opposed to emergency) surgical, imaging and diagnostic procedures.

The doctors had been approached by many U.S. public corporations specializing in medical facilities but consistently rejected such offers due to price, the introduction of external management, and the potential loss of operating control. Representatives of the doctors were introduced to the Canadian income fund concept and quickly realized that the income fund structure could meet their demands.

Medical Facilities Corporation filed an amended and restated prospectus on March 1, 2004 and completed a $222 million IPO on March 29, 2004.
Atlantic Power Corporation completed a $368 million IPO in November, 2004. On closing, Atlantic acquired interests in a diversified portfolio of 15 power generation projects located primarily in the U.S. with 773 MW of net generating capacity. Fourteen of the projects are located across nine states in the U.S., representing most major U.S. power markets, and one project is located in Jamaica.

Atlantic acquired these projects from investment funds managed by ArcLight Capital Partners, LLC. The manager of Atlantic is owned by these funds. ArcLight is one of the leading private equity firms in North America focused exclusively on the electric power and energy sectors.

Student Transportation of America is the fifth largest provider of school bus transportation services in the United States, having more than 105 contracts with school districts in eleven states and a fleet of over 2,900 vehicles. In contrast to many of its large, national competitors, STA targets school districts located primarily in rural and suburban markets.

STA completed a $128 million IPO in December, 2004. This was the first income securities IPO to utilize a “dual-issuer” structure, in which investors subscribe for an IPS comprising a common share issued by an Ontario corporation and subordinated notes issued by a Nova Scotia unlimited liability company.

“They [income securities] are seen as heralding the rebirth of the cross-border IPO of U.S. firms in Canada...”

Keystone North America is a leading owner and operator of funeral homes across the United States, with 177 funeral homes and nine cemeteries. Keystone’s funeral homes are located in the Midwest, Northeast, Southeast and Northwest regions of the continental United States with individual service markets primarily made up of non-urban areas. Keystone’s funeral homes provide a full range of funeral services on both an at-need (at time of death) and pre-need (prior to death) basis.

On February 8, 2005, Keystone completed a $171 million IPO using the “dual-issuer” structure. The transaction involved the combination of two businesses, since Keystone acquired subsidiaries of Hamilton Federal Service Centers, another major owner and operator of funeral homes, concurrently with the IPO closing.

REITs

There were two REIT IPOs and numerous REIT follow-on offerings during 2004. Goodmans acted on the largest REIT offering, the $271 million IPO of Sunrise Senior Living REIT, as well as three unit offerings totalling $293 million by Calloway REIT, a $55 million offering of convertible debentures by Calloway REIT, a $165 million unit offering by Retirement Residences REIT, a $144 million offering of trust units by Riocan REIT, two unit offerings by IPC U.S. REIT totalling US $47 million, and a $40 million convertible debenture offering by IPC U.S. REIT, the first U.S. pay convertible debenture offering by an income fund.

The Canadian REIT Handbook


CIPPREC stated: “Interest in the burgeoning Canadian REIT sector has grown tremendously over the past few years and it is time for CIPPREC’s existing guide to REITs to be replaced by a comprehensive and definitive reference source... Goodmans has played a major role in the development of REITs in Canada, and we are delighted that the firm has agreed to take on this project... prominent REIT specialists, Goodmans LLP has a substantial REIT and income fund practice and is widely recognized as a leader in this sector. Lexpert Magazine has described Goodmans as ‘leading the pack’ of ‘Canadian law firms in REITs and other income funds’.”

Regulatory Developments

With the maturity and growth of the income fund sector has come increased attention from regulatory and governmental authorities. 2004 witnessed a number of significant regulatory and legislative developments.
**Limited Liability**

On December 16, 2004, Ontario passed legislation to provide certainty to unitholders of publicly traded trusts that their exposure to claims against the trust will be limited to their investment. The Trust Beneficiaries’ Liability Act applies to unitholders of any trust that is a “reporting issuer” under the Securities Act (Ontario) if its declaration of trust selects Ontario as its governing law. The Act provides to unitholders of publicly traded trusts statutory limitations of liability similar to those protecting shareholders of a corporation. This follows similar legislation, the Income Trusts Liability Act, enacted in Alberta in July, 2004.

**National Policy NP 41-201**

National Policy 41-201 – Income Trusts and Other Indirect Offerings was adopted by the Canadian Securities Administrators effective as of December 3, 2004. NP 41-201 is the first securities regulatory policy to focus directly on the income fund structure. The policy provides guidance and clarification to market participants by expressing the regulators’ views on how the existing securities framework should apply to income funds and other indirect offerings, both in the context of an initial public offering and on a continuing basis. The policy addresses vendor liability, stability ratings and a variety of issues related to prospectus disclosure.

The final policy contains significant changes from the earlier draft policy published for comment in October, 2003. In particular, having received many comments on the subject, the Canadian Securities Administrators removed the recommendation contained in the draft policy that an income fund that does not obtain a stability rating provide cover page disclosure explaining why it chose not to obtain a stability rating.

**Ownership Restrictions**

On March 23, 2004, the Minister of Finance proposed amendments to the Income Tax Act (Canada) (the “Budget Proposals”) to restrict direct and indirect holdings in business income funds by Canadian pension funds. On May 18, 2004, the Minister of Finance suspended the Budget Proposals pending consultation with representatives of the pension fund industry, the investment industry, provincial governments and other interested parties. The Department of Finance has indicated that it will continue to evaluate the development of the income fund market as part of its ongoing monitoring and assessment of Canadian financial markets and the Canadian tax system.
Non-Resident Ownership

In order to maintain its status as a “mutual fund trust” under Canadian income tax legislation, an income fund must not be established or maintained primarily for the benefit of non-residents of Canada (the “purpose test”) and accordingly, income funds generally provide for limits on non-resident ownership. Typically, non-residents are restricted from owning 50% or more of the units of the income fund, on either a basic or fully diluted basis. Recent legislative proposals replacing the purpose test with a blackline test (triggered where more than 50% of the units of the income fund – on a fair market value basis – are held by non-residents) have been suspended.

Distributions of income by a Canadian income fund to non-resident investors are subject to Canadian withholding tax. The Budget Proposals extended the scope of Canadian withholding tax to include distributions to non-resident investors of (i) gains realized in respect of the disposition of “taxable Canadian property”, and (ii) amounts not otherwise subject to Canadian tax (so-called “returns of capital”). However, this latter withholding tax is only applicable in respect of distributions made by a REIT or resource trust, and is not applicable in respect of most business income funds. Unlike the pension fund and non-resident ownership restrictions, the withholding tax proposals have not been suspended and are currently applicable in respect of distributions from Canadian income funds.
Industry Leaders Trust Goodmans

“Goodmans provided excellent service in all aspects of the transaction, from securities and banking matters to structuring and tax advice. We continue to rely significantly on Goodmans’ input and expertise as part of our effort to achieve the highest standards in all facets of our business, including corporate governance and securities compliance.”

– Paulina Hiebert, Vice President, Legal and Corporate Secretary, The Brick Group Income Fund

“We have worked with Goodmans from the time of the acquisition of K-Bro through to the IPO. The culture of experience, creativity, hard work and constant client support shared by Goodmans’ talented pool of lawyers greatly contributed to the success of our IPO process.”

– Linda McCurdy, CEO, K-Bro

“Goodmans displayed their expertise and creativity in guiding us to a successful closing of a complex transaction.”

– Göran Mörnhed, President and CEO, Countryside Power

“Goodmans’ experience and support was invaluable in resolving issues to execute the offering in record time.”

– Michael Salter, Chief Financial Officer, Medical Facilities Corporation

“Goodmans did an outstanding job at every step of the transaction, from the early days of analyzing structural alternatives through to a rather complex closing with many moving parts. We were extremely fortunate to have them representing us.”

– Barry Welch, President and CEO, Atlantic Power Corporation

“We were looking for a firm who had experience in cross-border income trust deals. I knew that our structure had to be unique for this deal to be completed. The team at Goodmans set out a process that was innovative and responsive and led to our recent successful IPO transaction.”

– Denis J. Gallagher, Chairman and CEO, Student Transportation of America

“As a U.S. company transitioning to a public company in Canada, we relied heavily on our advisors. Goodmans’ entire team was there with us every step of the way, guiding us through the intricacies of the income trust structure they know so well, establishing our board and corporate governance, coordinating with the regulatory agencies, structuring and orchestrating the transaction itself and making sure we stayed on track to make it happen. Their “can do” attitude and committed approach was refreshing from a professional service firm. We truly felt as if they were part of our management team making the transaction happen with us, not just for us. Every individual we had the pleasure of working with was a consummate professional with exceptional skills and commitment to us.”

– Steve Shaffer, CFO, Keystone Group