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REITs & Income Trusts

By Julius Melnitzer

Contrary to conventional wisdom, initial public offerings (IPOs) are thriving. It's a question of definition. The genre has expanded. The IPO designation, traditionally associated with first-time public offerings by private companies seeking stock exchange listings, is in fact broad enough to embrace any financial vehicle that represents a new source of equity for the issuing company. And, notwithstanding the stock market slump, these vehicles are generating lucrative legal fees for a handful of law firms. Enjoying unusually strong market positions are **Goodmans LLP** and Torys LLP in Toronto.

The strongest performer as far as new sources of equity go is undoubtedly the income trust, and its three sub-species: the real estate investment trust (REIT); the oil and gas royalty trust; and the business trust. Even as Toronto-based Crosbie & Co. reported that the value of Canadian mergers and acquisitions dropped more than 64 per cent in the second quarter of 2002 compared to the same period last year, a PricewaterhouseCoopers survey revealed that investment bankers raised \$4.2 billion in IPOs in the first half of 2002. Ninety-four per cent of that total, or about \$4 billion, came from income trusts. Indeed, the three largest IPOs in 2002 so far are all income trusts: Bell Nordiq Income Fund raised \$324 million; Boralex Power Income Fund collected \$250 million; and Noranda Income Fund brought in \$225 million.

The roots of income trusts are in the real estate and energy sectors, but the advent of the business trust has brought the vehicle to a wide range of commercial sectors. Current Canadian income funds include such diverse businesses as decaffeinated coffee producers (Swiss Water Decaffeinated Coffee Income Fund), fast-food chains (A&W), cheque printers (Davis + Henderson), customs brokers (Livingston International) and American-based heating-oil distributors (Heating Oil Partners Income Fund). Many of the funds involve public companies spinning off cash-producing segments of their business.

Income trusts have proven so popular that the Ontario Teachers' Pension Plan Board advised the provincial government that it would invest up to \$2 billion in the proposed Hydro One privatization if the province replaced its plan for a traditional \$5.5 billion IPO with an income trust model.

Business trusts, however, are a relatively recent phenomenon. REITs—mutual fund trusts that own, manage and maintain real property—and oil and gas trusts still dominate the Canadian income fund sector, which is

made up of 90 funds with a market capitalization of \$33.3 billion. The country's 16 REITs have a cap of \$8.6 billion, and combine with 21 oil and gas trusts having a cap of \$13.9 billion to make up almost two-thirds of the income trust market.

Otherwise, 36 specialty business trusts have a cap of \$7.2 billion, five power and pipeline business trusts are worth \$2 billion, and 12 "fund of fund" trusts—funds that invest in other income funds, whose very existence attests to the growing importance of the vehicle—have a cap of \$2 billion.

The bottom line is that the income trust sector is assuming dimensions that suggest it will be around for the long haul. Energy trusts have certainly demonstrated their staying power, and REITs—which have sparkled briefly in the past only to flame out rather quickly when real estate dynamics took a turn for the worse—are attaining a critical mass that will make them difficult to dislodge.

"The popularity of REITs is the latest in a huge series of changes in the real estate sector, which has moved from being entrepreneurially driven to public company and pension fund driven, and now to REITs, in which about 50 per cent of the investors are retail unitholders," says Stephen Pincus, a REIT specialist with **Goodmans** in Toronto.

John Ulmer, a tax lawyer with the Toronto office of Davies Ward Phillips & Vineberg LLP, who has an outstanding reputation among REIT and income trust players, puts it even more strongly. "The real estate players that are not REITs are finding that they have no access to capital markets," he says.

Nevertheless, the evolution to REITs is still embryonic, and the REIT sector in Canada is yet very small relative to the real estate sector as a whole. But with an eye to the future, Standard & Poor's has announced that it will launch an S&P/TSX Canadian REIT Index Fund on October 15, 2002. Investors have also taken note. The CIBC World Markets Canadian REIT closed out this year's second quarter at a 52-week high.

As for business trusts, they are closing the market cap gap on REITs and energy trusts rapidly, and the sheer range of businesses for which the vehicle has fundraising potential speaks volumes to its longevity prospects.

But whatever the future holds for income trusts, 2001 and 2002 have been buoyant. And that amounts to a wealth of legal fees for lawyers in what otherwise might be a sobering M&A and securities environment. "The fees for issuer's counsel on a REIT IPO most commonly range from

\$500,000 to \$1 million,” says one REIT expert who spoke on condition of anonymity. “Fees for underwriter’s counsel would be about half that.”

Interestingly, however, only a small number of the law firms with a high profile in the Toronto financial services market have benefitted significantly to date from the rise of income trusts. “There are no more than 30 lawyers who have experience in REIT work,” says Pincus.

The reasons for this market concentration are varied. Business trusts are a very recent phenomenon, barely beyond a few months old, and the fog hasn’t lifted yet on which firms will benefit most from their emergence. But REITs, by comparison, are a well-known financial vehicle, although their latest rebirth only began in early 2001. Because of the structural similarities in the various forms of income trusts, the firms that have historically led the REIT market are the ones poised to profit most from the overall boom.

Leading the pack is **Goodmans**. In 2001, the firm acted as either issuer’s or underwriter’s counsel on nine IPO REIT offerings that raised \$878 million out of a total of approximately \$1.6 billion in Canadian REIT IPO financing during the year. Torys followed, acting on six transactions that raised \$518 million. No other firm acted on more than two REITs, and the five firms that acted on that many were Davies Ward, Fasken Martineau DuMoulin LLP, Fraser Milner Casgrain LLP, McCarthy Tétrault LLP and Osler, Hoskin & Harcourt LLP, who together were involved in 10 transactions that raised \$842 million, some \$36 million less than the transactions in which **Goodmans** alone was involved. (These totals exceed \$1.6 billion because REIT deals usually require two law firms: one for the issuer and one for the underwriter, and the deal value for each transaction is included in the transactional value for each firm that was retained.)

At **Goodmans**, Pincus leads the team that acted as issuer’s counsel on CPL Long-Term Care REIT, Canada’s first healthcare REIT; on a number of hospitality REITs; as issuer’s counsel on Retirement Residences REIT in 2001, the first REIT IPO in three years and the first with a “captive” development arrangement; and as underwriters’ counsel on the IPC US Income Commercial REIT IPO, the first

Canadian REIT to own properties located exclusively in the United States while retaining its status as qualifying Canadian property for *Income Tax Act* (ITA) purposes.

At Torys, Patricia Koval heads up the REIT team that has acted for both issuers and underwriters in transactions involving Canadian Real Estate Investment Trust (CREIT), RioCan REIT, Avista REIT (subsequently acquired by Summit REIT), O&Y REIT and Northern Property REIT.

Overall, **Goodmans** has been involved in deals that raised 56 per cent of the funds derived from the Canadian IPO REIT market in 2001; Torys’s share was 32 per cent. While exact figures for 2002 are not available, anecdotal evidence suggests

that **Goodmans** and Torys have been at least as busy in this year’s active market, which by the end of June had racked up \$881 million in capital, exceeding the pace in 2001.

And from the perspective of the law firm, it’s not as if completion of the IPO depletes the income trust cash cow. “Once REITs are up and running, the industry style is to grow and then grow again,” Koval says. “The structure is not designed to retain earnings, so there’s a need to go back to market frequently to finance acquisitions, or else there’s legal work because growth is by consolidation.”

Indeed, Torys enjoyed a good run from the last consolidation wave, acting for RealFund when it merged with RioCan in 1999 and for Avista when it merged with Summit REIT in a hotly contested takeover that same year. In 2002 alone, Torys has represented underwriters on (non-IPO) REIT-related financing transactions in excess of \$700 million. Consolidation has also benefited **Goodmans**, which represented both Retirement Residences REIT and CPL Long-Term Care REIT when they merged earlier this year to create Canada’s third-largest REIT with a market capitalization of \$800 million and assets of \$1.9 billion.

The historical entry points of **Goodmans** and Torys are important. **Goodmans** is well-known for its high-profile real estate practice and for a strong client base of entrepreneurial developers. That base has evolved into a major real estate financing and leasing practice, as well as the associated specialties of development, construction, administrative and municipal law.

Stephen Pincus



Many **Goodmans** clients were caught in the early 1990s real estate market collapse. Some had become involved in real estate mutual funds, the predecessors of the modern REITs. These funds were open-ended, largely because the *ITA* did not permit closed-end mutual funds to hold real estate. The open-ended funds, however, allowed investors a right of redemption at a price based on the most recent appraisal of the fund's underlying portfolio. In a falling market, that was a recipe for disaster.

Still, developers liked the mutual fund trust structure because it was the most efficient tax mechanism available to investors. The structure was not subject to large corporations' tax and capital tax, it allowed income to flow through to investors on a pre-tax basis. It also provided tax deferrals because investors obtained the benefit of capital cost allowances, paying capital gains tax on the deferred amounts only when the trust disposed of the units.

Consequently, the real estate industry successfully lobbied the federal government for an *ITA* amendment, passed in 1995, which allowed closed-end funds to hold real estate. The four existing real estate funds converted themselves from open-end to closed-end, heralding the "new generation" of Canadian REITs. Patricia Koval, whose experience began with her representation of First City Trust in the early 1990s, was instrumental in effecting the conversions for RealFund (later acquired by RioCan) and CREIT.

In 1997, Stephen Pincus led the **Goodmans** team that structured CPL Long-Term Care REIT, the first REIT in Canada to own operating businesses. Pincus replicated the model in hospital REITs such as Legacy, CHIP and Canadian Hotel Income Property REITs. "Those REITs paved the way for what became known as commercial REITs," says Seymour Temkin, formerly national director of real estate, Canada's for Deloitte & Touche. Temkin, who joined **Goodmans** as a consultant in September 2002, is the accountant associated with virtually every modern REIT transaction in Canada. CPL also established the reputations of Pincus and **Goodmans** as REIT specialists.

As the commercial REITs, themselves the forerunners of the business trusts, grew in popularity, **Goodmans** could

boast of both its broad real estate expertise and its specialized experience with REITs to attract clients. Meanwhile, Torys leveraged its REIT know-how with the firm's traditional Bay Street institutional connections to attract underwriting retainers on income trust transactions. "We actively marketed REITs with our underwriting clients, even going with them when they went to make presentations to prospective issuers," Koval says.

But the REIT market disappeared when investors returned to equities in 1998. It was to be almost three years before Canada saw another REIT IPO. This hiatus, however, may have cemented the market positions of **Goodmans** and Torys.

"One tends to go with the teams that have experience," says Allan Kimberley, managing director of real estate investment banking at CIBC World Markets. "When REITs revived in 2001, nothing had happened for three years, and nobody had gained any experience in the interim. So the legal and accounting firms that did the work in 1997 and 1998 were the only ones we could turn to when REITs kick-started again."

For the most part, the lawyers with experience were the REIT specialists at **Goodmans** and Torys, frequently in association with tax counsel John Ulmer of Davies Ward. "We tend to feed off each other," says Koval. "I see a lot of Stephen Pincus, and quite often the structure of a brand-new REIT is a joint product of the law firms involved. In the REIT area, we have a very co-operative atmosphere because there are almost always two firms on a deal, and they're both trying to make the structure happen for clients that want it to happen. Remember, the impetus for the deal usually comes from the investment dealers going to the prospective issuers.

"For their part," Koval adds, "the lawyers from different firms tend to develop deep friendships and working relationships that come from the sense of working toward the same goal." That, according to Ulmer, means a lot of referral work amongst the group, which undoubtedly contributes to keeping the club closed.

Still, the burst of activity in income trusts in the last two years has meant that other firms have started knocking loudly on the door. Jonathan Levin and Joel Binder of Fasken Martineau in Toronto are an increasing presence, with recent mandates on the \$210 million Clearwater

John Ulmer



Income Trust, the PBB Global Logistics Income Fund and the Livingston International Income Fund. Industry insiders also mention teams from Blake, Cassels & Graydon LLP, Fraser Milner, McCarthys and Oslers as knowledgeable in the area.

Yet **Goodmans** and Torys remain the front-runners. Indeed, **Goodmans**'s historical association with the issuers and Torys's association with the underwriters is fast disappearing as both firms become known throughout the industry by virtue of their constant presence at the bargaining table on one side or the other.

Goodmans and Torys may have established their REIT market positions via different entry points, but their success is grounded in similar strengths: creative lawyers with broad corporate commercial backgrounds and a strong business sense teamed with an outstanding tax department and first-rate securities experience.

Both Pincus and Koval are corporate commercial lawyers. Pincus's practice embraces M&A, corporate finance, banking, restructuring and joint ventures in a broad range of industries. Koval lists corporate finance, securities regulation, managed assets and M&A as her specialties. Both firms have top-drawer tax and securities specialists on hand.

"What the clients want most is creative thinking that is clearly out of the box, because there's always a lot of structuring in response to a diverse blend of issues relating to tax, real estate, corporate law and commercial law," Pincus says. "No two REITs or income trusts are the same. So you can't be bureaucratic in the sense of having a fixed mindset from previous deals. You must find a way to adapt a particular business to a particular vehicle. Income trust work is mind work."

It is also a continuous balancing act. "REITs and business trusts happen only when the clients and the professionals are able to properly balance the interests of the vendors and the investors who are effectively represented by the underwriters and their counsel," Pincus says. "That balancing requires consideration of tax efficiency for the issuers and tax efficiency for the investors in the context of the myriad of restrictions and regulation that affect REITs."

There is also the constant trade-off between structuring to minimize the tax consequences to issuers and getting assets into REITs at favourable yields. Koval believes that

the structuring involved in REITs and income trusts makes them far more complicated for lawyers than an ordinary IPO or secondary financing for an existing company.

And even as the creative juices flow, lawyers must remain sensitive to the market and to the issues of the day, such as corporate governance. Fortunately, REITs and income trusts have tended to be more transparent than the Enrons of the world, partly because they are trading in cash flow. "Pre-booking sales won't give you cash for distribution," notes Pincus somewhat acerbically.

Many REITs and income trusts have long required that the majority of their directors be independent in accordance with Toronto Stock Exchange guidelines, even where the holding trust and other entities in the structure are related. Typically, independent directors also comprise a majority on the income trusts' investment and audit committees of an income trust.

One would have thought, in today's poisoned atmosphere, that corporate governance issues would be no-brainers. But that's hardly the case. "You still have to balance the issuer's desire for control with market expectations regarding independence and governance mechanisms," Koval says.

According to Temkin, the endless balancing in the context of innovation makes experience particularly critical for lawyers working in the income trust field. "The transactions are extremely complex, so the lawyers have to have a sense of how they're going to manage the transformation into a REIT expeditiously, because uncertainty in the market is your worst enemy. The lawyers you want are the ones who have the experience to understand the need to execute speedily without worrying about the word games."

The clients also see it this way. "It's the complexity of the corporate and tax structuring combined with the need for creativity in a fairly new area that has kept the legal market small in the income trust area," says Richard Matheson, managing director of RBC Capital Markets. "We tend to go back to the people who originally came up with the ideas that worked, because they're the ones most likely to make the deals work again."

And the current market continues to look strong. "Investors in public securities are ascribing materially better value to REIT securities than to securities of a traditional corporate entity," says Allan Kimberley of CIBC World

Jonathan Levin



REITs & Income Trusts

Markets. So much so that issuers are getting multiples of nine to eleven on cash flow when converting to REITs.

“That’s much higher than what can be obtained in the private market,” says Joel Binder of Fasken Martineau. “And most REITs and income trusts are being sold with a very large institutional book.”

But what of the medium- and long-term future? Will REITs, and perhaps income trusts, disappear from view and from law firm balance sheets as readily as they did in the early and late 1990s?

“In 1993 and 1994, we had a fledgling submarket in REITs,” says Allan Kimberley. “Then in 1997 and 1998, we got up to about \$3 billion in market cap before REITs disappeared. Now we’re approaching \$9 billion, which gives REITs the kind of presence and liquidity that amounts to real staying power. So REITs will still be subject to economic cycles, but they won’t disappear again.”

Kimberley feels the same way about the income trust phenomenon as a whole. “Income trusts are no longer peculiar entities,” he says. “The public has become comfortable with them and their relatively attractive performance has given them appeal. The new S&P indices will give them even more appeal by creating further opportunities for the public to become aware of their existence.”

Matheson at RBC Financial is of the same mind. “There will always be a market for REITs, although their

popularity will be impacted by the broader market,” he says. “People don’t have the expectations for returns they once had. Instead they want to preserve capital and get decent yields.”


Patricia Koval



Still, the fact remains that none of the existing Canadian REITs have survived a downward real estate cycle. “In the past, REITs have dissolved because they were not able to earn satisfactory returns through the business cycles,” says Jonathan Levin. “The REIT and income trust models have not proven that a business plan that is accretive to shareholders rather than to earnings is viable in the long term. The question is whether these structures, which are not designed to retain earnings, will have sufficient reserves to withstand downturns, make the necessary capital expenditures as time goes on, and continue to grow.”

Like any good lawyer, Levin is considering all the alternatives. So much so that he recently authored a paper, “Restructuring Issues Relevant to Business Trusts,” in which he points out that Canadian insol-

vency and restructuring legislation has not been designed to deal with trust vehicles.

It sounds like Levin is gearing up for the cycle. It would be surprising if firms as successful as [Goodmans](#), Torys and Davies Ward haven’t given the matter considerable thought as well. 

Julius Melnitzer is a Toronto-based legal affairs writer.

About Goodmans

Goodmans LLP is one of Canada's premier business law firms. Described by Lexpert Magazine as a "corporate powerhouse", Goodmans is regarded as the most creative of Canada's "Seven Sisters" – the country's top law firms. Goodmans provides a complete spectrum of legal advice and representation to domestic and foreign business clients ranging from entrepreneurial businesses to multinational corporations and financial institutions across a wide range of industries from offices in Toronto, Vancouver and Hong Kong.

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