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Canadian Income Trusts: An Alternative Exit Strategy for U.S. Portfolio Companies of Private Equity Sponsors

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Canadian investment banking firms have been aggressively marketing the "Canadian Income Trust" structure to private equity firms as an alternative exit strategy for their U.S.-based portfolio companies. The Canadian Income Trust market consists of over 100 trusts with a total market capitalization of more than C$50 billon (although as yet relatively few of these trusts hold exclusively U.S. companies, this is widely expected to be the next phase in the market). Because the income trust is designed to distribute a steady income stream to its investors, investor interest in these equity investment vehicles has increased dramatically as stock market returns and interest rates have fallen. As an indicator of this trend, of the approximately C$12 billion in proceeds raised in Canada during 2002 through initial public offerings, approximately 85% were attributable to income trusts. Although not all companies are ideal candidates for the income trust structure, it is an exit strategy that should be considered by private equity firms seeking liquidity for their investment.

An income trust is an investment vehicle for the distribution, in a tax-efficient manner, of cash flows from an operating company to investors. It is similar to a U.S.-styled real estate investment trust or a master limited partnership, but unlike these vehicles its use is not limited to specific industries. The income trust is a pass through entity for Canadian income tax purposes, and is only permitted to own passive investments such as common stock and debt instruments. As a result, the proceeds from the public offering are typically invested in the securities of a Canadian holding company capitalized with common equity and subordinated debt with a view to minimizing taxable income (and maximizing cash available to be distributed to the holders of trust units) that in turn owns an operating company. The pre-tax cash flow of the operating company (which preferably is a partnership or wholly-owned limited liability company but, with added complexity, may be a corporation) is typically distributed through the holding company to the income trust principally as interest payments on the subordinated debt, but on occasion also by a combination of principal repayments and dividends on the common equity.

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Trust distributions are not guaranteed to the trust's investors, and may be reduced if the operating company is not generating sufficient cash flow. Because investors in Canadian income trusts are focused primarily on receiving a

steady stream of distributions, only companies with a history of stable and predictable cash flows are good candidates for the income trust structure (e.g., companies in highly cyclical industries are not typically considered for conversion to an income trust). In addition, the company should have reasonable and predictable capital expenditures, and a moderate prospect for growth. Finally, although not necessarily a prerequisite, the ideal candidate would have a recognized brand or presence within Canada, whether through its business operations, identity of ownership or otherwise.

Unlike a typical initial public offering in the United States, continued ownership by existing shareholders (e.g., the private equity sponsor) is not a requirement for a successful offering. It is, however, necessary to ensure that management of the business remains with the company to maintain operations. The ability to exit with the proceeds of a trust offering makes the income trust well suited for private equity firms seeking liquidity. To the extent that existing shareholders do maintain a portion of their existing investment after the initial offering (usually due to limitations on the size of the inital offering), liquidity is often achieved through a contractual right to exchange the retained equity in the operating company for units of the investment trust, which then would be sold in the Canadian markets (often within a relatively short time after closing the initial offering). For marketing or pricing purposes, all or a portion of the ownership interests retained by the existing shareholder group may have to be subordinated to the ownership interests held by the trust for a certain period of time after the initial offering (often determined based upon the investors receiving a minimum return over that period of time). Corporate governance rights such as board seats can also be maintained by the existing shareholder group at the operating company level, although ultimate control over the operating company will typically reside with the trustees of the trust.

Because the income trust is acquired by an investor for its projected yield, valuation is typically based on a multiple of the operating company's distributable cash flow. This is generally defined as EBITDA less capital expenditures, interest on third party debt and ongoing cash charges not captured in EBITDA (such as management expenses). Distributable cash flow may be maximized by effective structuring to increase leverage and to minimize taxes. As a result of their tax efficiency to Canadian investors, and because the entity will in effect pay little or no tax after the acquisition (as the intention is to strip out all income by way of interest payments which are deductible against the company's income), income trust valuations tend to be higher than would typically be achieved in a sale or traditional initial public offering in the U.S. capital markets.

Careful Canadian and U.S. income tax planning is essential for the income trust to be an effective structure for a U.S. company. Ideally, the income trust will be structured in a manner that avoids U.S. withholding taxes on interest payments and complies with earnings stripping rules that would limit the deductibility of interest payments. In addition, the debt created between the holding company and the trust must be structured so that it is treated as debt for U.S. income tax purposes. If treated as equity, the holding company's U.S. tax liability would increase, resulting in a reduction in cash available to be distributed to the holders of the trust units.

The income trust must also qualify as a "mutual fund trust" under Canadian income tax law in order to obtain the desired tax treatment in Canada. Qualification as a "mutual fund trust" requires that the trust satisfy a variety of criteria, including restrictions on majority ownership by persons not resident in Canada and that the holding company be Canadian with a limited degree of Canadian-based expenses. As a result, income trust units are not listed on U.S. stock exchanges and are dependent predominantly on the Canadian markets. In addition, because the trust must be considered a resident of Canada for tax purposes, all of its trustees must be Canadian residents.

Income trust investors do not receive the same degree of statutory protection from liability under Canadian law as investors in corporations. In part as a result of the lack of protection from limited liability, income trusts have historically not been eligible for inclusion in Canada's S&P/TSX Composite Index. This fact, together with the risk of liability, has negatively impacted the ability to market trust units to institutional investors. However, the provinces of Ontario and Alberta, where the majority of income trusts are based, have proposed legislation that would provide investors in income trusts with the same limited liability protection accorded to shareholders of corporations. If adopted, many expect that income trusts may be added to the Canadian

S&P/TSX Composite Index, which could spur investment by institutional investors and further enhance the market for these vehicles.

In part due to the risk that debt created between the holding company and the trust may be characterized as equity rather than debt for U.S. tax purposes, two recently filed U.S. public offerings may spur the use of a variation on the Canadian income trust structure in the U.S. In July 2003, registration statements for Income Deposit Securities ("IDS") were filed with the Securities and Exchange Commission by American Seafoods Corporation and Volume Services America Holdings Inc. In lieu of a public offering by the Canadian trust, the proposed offering consists of an IDS (which is an investment unit consisting of a common share and a portion of a subordinated note) to be sold by a U.S. company. The economics of the Canadian income trust structure are substantially equivalent to the economics of the IDS structure. However, the IDSs may be listed on a U.S. and Canadian exchange, potentially broadening the market for the securities. Because the debt and equity are separable, the risk of debt recharacterization from a U.S. tax perspective is reduced while the benefits of the Canadian income trust structure are maintained.

Canadian income trusts remain a relatively unproven vehicle for U.S.-based companies, as very few have gone to market to date. However, given the higher valuations applied to Canadian income trusts in low interest rate environments, they may be a viable option for private equity sponsors seeking to exit an investment in a properly positioned U.S. company through its acquisition by a Canadian income trust. Although premature at this time, the recent IDS offerings may also prove to be a useful exit strategy if the structure gains marketplace acceptance.

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