High Yield Equities

Income Trusts — An Introduction

PRIVATE CLIENT RESEARCH
January 27, 2004

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Toronto, Ontario

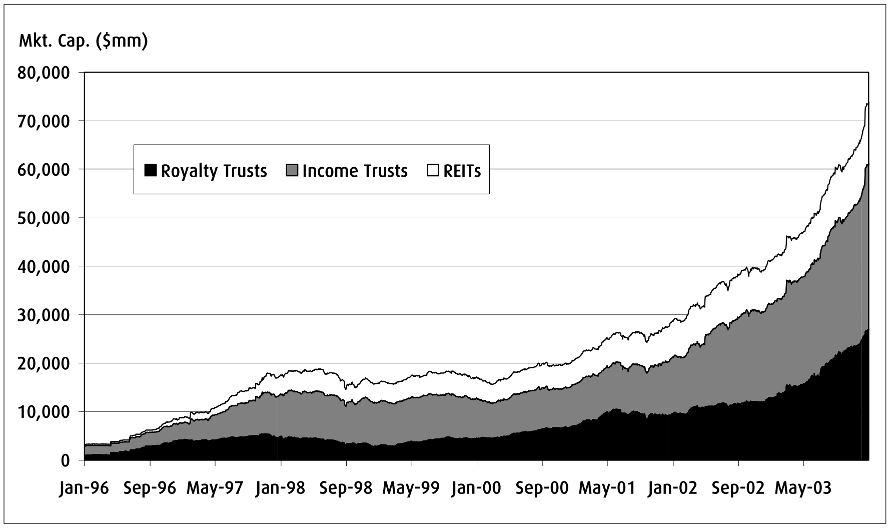
Income trusts are equity investments designed to provide unitholders with a relatively high level of income. An income trust is created when a company sells all or a portion of its assets to a trust, and then interests in the trust are subsequently sold to investors. Historically, the income trust universe consisted mainly of Oil and Gas Royalty Trusts, Electric Power Generation Trusts and Real Estate Investment Trusts (REITs). In recent years however, the sector has expanded significantly to include a wide variety of businesses. Restaurant chains, garbage collectors, trucking companies, water heater rental businesses and food and household product manufacturers are just a sample of the newer 'business trusts'. In this article, we refer to all of these investments generically as 'income trusts'.

Although income trusts have existed since the 1980s, they only became a significant investment category in the mid-1990s. The intention is to use a trust as an intermediary to transfer cash flow from an operating company to unitholders on a tax-efficient basis. Businesses that are well suited to an income trust structure generally (1) are in a mature industry and (2) generate sustainable, stable cash flows from (3) a diversified portfolio of long-life assets. Moreover, (4) the company has relatively low ongoing capital expenditure needs and (5) is managed using incentives that tie management's interests to those of unitholders.

Income trusts have received much attention in recent years, particularly in light of low bond yields. Total market capitalization for the sector has now grown to over $73 billion. *Chart 1* on the following page highlights the growth and composition of the income trust market since 1996.

In this article we take a look at the risks and rewards, taxation and valuation considerations of income trusts. Issues that are covered by BMO Nesbitt Burns Equity Research are listed on Pages 7 and 8.

Chart 1
Market Capitalization of BMO Nesbitt Burns Trust Composite



High Yielding Equities

Several characteristics distinguish income trusts from fixed-income investments. Specifically, distributions from income trusts are dependent on the underlying business' operating cash flow. Distributions are not fixed and may be variable. Moreover, income trusts do not offer a specific maturity date or guarantee of capital. Like shareholders of common stock, the interests of unitholders are subordinate to those of debt holders and there is no legal obligation on the part of the issuer to make payments. Therefore, we characterize trust units as high yield equities, not as fixed income investments.

Most income trusts yield between 6% and 19%, compared to a 10-year Government of Canada bond yield of approximately 4.5%. In order to achieve these higher yields, unitholders must take on equity market risk.

Tax-Efficient Structure

Trusts are tax-efficient because they substantially reduce, if not eliminate, tax at the corporate level. Income is taxed only once — in the hands of the individual investor. The tax-efficiency stems from the trust's unique capital structure. For example, most income trust units represent ownership in the securities of a company that owns the operating assets, rather than direct ownership in the assets themselves. The structure may include notes (or debentures) and common shares. The shares entitle unitholders to dividends. The notes, if any, are generally subordinated and unsecured, and bear a relatively high interest rate. The interest rate is set at a level that transfers a substantial portion of the operating cash flow from the company to the unitholders. (While most REITs are structured differently in that they own the assets directly, the same tax efficiency exists).

Taxation of Income Trusts

As a result of this unique capital structure, distributions from income trusts may consist of ordinary income and/or dividends. Income and dividends are taxable at the investor's marginal tax rate, and amounts received each year are reported on T3 forms. Dividends, if any, are eligible for the dividend tax credit.

Income trusts may also pay distributions that are called a *return of capital.* This term can be misleading because it is a tax concept and not necessarily the actual return of one's capital. For tax purposes, a unitholder is only required to include in income their portion of the trust's taxable income. To the extent they receive cash in excess of the trust's taxable income, that portion of the distribution is called a return of capital and is not considered income for tax purposes.

A return of capital usually arises when the trust is able to claim a tax deduction, such as Capital Cost Allowance (CCA) or the Canadian Oil and Gas Property Expense Allowance (COGPE), on behalf of unitholders. These deductions reduce the trust's taxable income for the year but do not impact distributable cash flow. Consequently, the actual cash distributed to unitholders can exceed the trust's taxable income.

Distributions which are designated a return of capital (or described as tax-deferred), are considered a reduction in the cost base of the unit for tax purposes. Therefore, a unitholder must adjust their cost base by the cumulative amount of the return of capital. Upon disposition of the units, a capital gain will be realized if the sale price exceeds the adjusted cost base (ACB). This effectively defers the payment of tax until the units are sold, hence the term tax-deferred.

The example on page 4 illustrates how a unitholder would adjust the unit cost base for tax purposes. It is important that investors keep track of the amount of the return of capital in order to be able to perform this calculation. The information is usually available by the end of March, and can be obtained from your BMO Nesbitt Burns Investment Advisor or the issuer's website. If units are purchased at several different times at different prices, the reasoning is the same — the ACB is the average price paid less the cumulative return of capital received.

Units that are held for a number of years may reach a point where the ACB is reduced to zero. From that point on, the ACB stays at zero and any return of capital distribution received in future is taxable as a capital gain in the year in which it is received.

The amount of tax deduction varies widely from trust to trust, and may decline over time. Unitholders should assume that an increasing percentage of their distributions will become taxable over time.

Example: Adjusting the Unit Cost Base

On January 1, 2002 an investor purchased 1,000 ABC units at $10.00 per unit. During 2002, they received $1.00 in distributions, of which $0.40 was taxable as ordinary income and $0.60 was a return of capital (RoC). At the end of 12 months, the ACB was $9.40 ($10.00 - $0.60). Similar distributions are made in each year for the next five years as illustrated below. At the end of the period, the units are sold for $10.50 per share. At that time, the ACB would be $6.35 and the gain upon disposition would be $4.15 ($10.50 - $6.35).

YEAR	DISTR.	INCOME	RoC	**ACB**
2002:	$1.00	$0.40	$0.60	**$9.40**
2003:	$1.00	$0.40	$0.60	**$8.80**
2004:	$1.01	$0.40	$0.61	**$8.19**
2005:	$1.02	$0.40	$0.62	**$7.57**
2006:	$1.00	$0.40	$0.60	**$6.97**
2007:	$1.02	$0.40	$0.62	**$6.35**
Total:	**$6.05**	**$2.40**	**$3.65**	

Key Risks

Variability of Distributions

A key factor that influences an investment decision is the variability of distributions. The degree of variability differs from issue to issue. Generally speaking, the high quality electric power generation trusts tend to have the most stable cash flows. The reason for this is that they operate under long-term contracts called *power purchase agreements* where prices for the electricity they generate are established for periods of 7 to 17 years.

REITs generally own and/or manage retail, office, residential (i.e., apartment), lodging (i.e., hotel) and/or industrial properties. Depending on economic conditions, business cycles and property fundamentals, operating cash flows from these properties may vary. However, with the exception of the hotel sector, REITs generally operate under long-term leases, which range from 5 to 10 years in term. The relatively long-term nature of the leases provides an element of stability to a REIT's operating cash flow. In addition, a well-managed REIT will stagger the dates on which its mortgages come due in order to minimize refinancing risk.

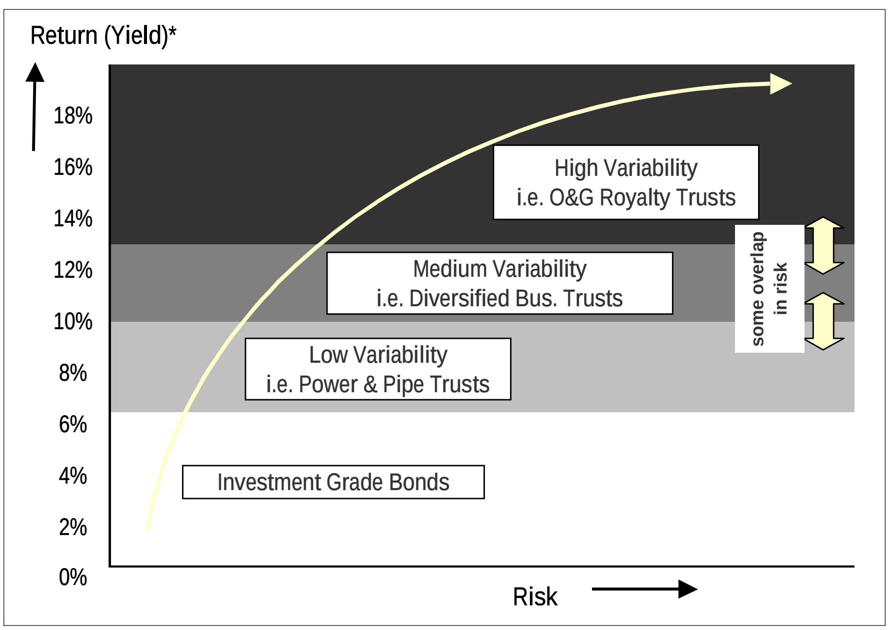
Business trusts are diversified in terms of variability of distributions. Much will depend on the quality of assets, sensitivity to the economy and whether the business operates as a quasi-monopoly (i.e., with few competitors) or in a competitive environment.

Oil and Gas Royalty Trusts tend to have the most variable distributions as a result of the swings in market prices for oil and gas. Changes in commodity prices can have a significant impact on unit valuation, as investors assess the impact of price forecasts on future cash distributions.

Chart 2 illustrates that income trusts with more variable distributions offer both higher yields and higher risk. Canadian REITs would generally lie between electric power trusts and diversified business trusts on the risk-return spectrum.

Some income trusts are rated by Standard and Poor's and Dominion Bond Rating Service as to the stability of their distributions relative to other rated Canadian income trusts. Stability ratings, which range from SR-1 (highest) to SR-7 (lowest), are helpful in terms of gauging distribution risk.

Chart 2
Approximate Risk-Return Relationship



** Yield to maturity for bonds; 2003E cash-on-cash yield for trusts*

Interest Rates

In addition to the risk that distributions may vary as economic and business conditions change, income trusts are affected by changes in interest rates. Specifically, if the yield on longer-term Canada bonds rises significantly, an income trust's market value will usually come under downward pressure; when yields drop the reverse can be true. However, some income trusts are more interest-sensitive than others. Electric power and pipeline trusts tend to be highly interest-sensitive because distributions are relatively stable over long periods. Other types of businesses will prosper during such periods, as rising bond yields are generally accompanied by economic growth. Higher operating cash flow resulting from higher levels of activity should support market valuation on these issues despite an increase in market yields.

Given the distribution and interest rate risks that income trusts are exposed to, it is important to consider the following factors prior to making an investment decision: (1) the outlook for the trust's business; (2) the stability or predictability of distributions; (3) the expected life of the underlying assets or reserves; (4) management's ability to manage risk and enhance returns; (5) the outlook for interest rates; and (6) the investor's risk tolerance and investment objectives.

Conclusion

In a low interest rate environment, investors look for innovative ways to increase the income from their investments. As income trusts are specifically designed to pay out relatively high distributions, they appeal to income-oriented investors. However, income trusts are *high yield equities and not fixed income securities.* As such, distributions tend to be variable and there is no guarantee of principal repayment.

Income trusts represent a major component of the Canadian equity market, and the number of new issues should continue to grow. Many high quality issues are available to investors who understand and can tolerate the inherent risks. BMO Nesbitt Burns Equity Research Analysts follow many of these issues *(Table 1 on Page 7)*. Your BMO Nesbitt Burns Investment Advisor can advise you as to the suitability of income trusts to your personal investment objectives.

RT10144 (01/04)

Table 1
BMO Nesbitt Burns Research Coverage

Company Name	Symbol	Rating	Price Level	Price Target	Distribution 04E	Distribution 05E	Pre-Tax Yield (a)	Pmt Freq	% Tax Def. 04E	% Tax Def. 05E	S&P (b)	DBRS (b)
Oil and Gas Royalty Trust												
Acclaim Energy	AE.un	Mkt	$12.16	$10.50	$1.52	$1.22	12.5%	M	100%	100%		
Advantage Energy	AVN.un	Mkt	$18.14	$16.00	$2.10	$1.88	11.6%	M	35%	30%		
ARC Energy Trust	AET.un	OP	$14.83	$13.00	$1.50	$1.28	10.1%	M	15%	10%		
Enerplus Resources	ERF.un	Mkt	$39.50	$34.00	$3.60	$3.30	9.1%	M	15%	10%		
Freehold Royalty	FRU.un	Mkt	$15.60	$14.00	$1.30	$1.20	8.3%	M	25%	20%		
NAL Oil & Gas	NAE.un	OP	$11.23	$10.25	$1.40	$1.15	12.5%	M	35%	30%		
Paramount Energy	PMT.un	Mkt	$10.04	$10.60	$1.90	$1.55	18.9%	M	30%	30%		
Pengrowth Energy	PGF.un	Mkt	$19.81	$17.50	$2.10	$1.80	10.6%	M	35%	35%		
PrimeWest Energy	PWI.un	Und	$27.65	$24.00	$2.90	$2.40	10.5%	M	40%	35%		
Shiningbank Energy	SHN.un	Mkt	$18.72	$16.50	$2.08	$1.72	11.1%	M	25%	20%		
Ultima Energy Trust	UET.un	OP	$6.95	$6.00	$0.84	$0.70	12.1%	M	60%	55%		
Vermillion Energy	VET.un	OP	$16.75	$15.25	$1.65	$1.46	9.9%	M	25%	20%		
Simple Average:							**11.2%**					
Mining and Forestry												
Canadian Oil Sands	COS.un	OP	$47.83	$54.00	$2.00	$2.50	4.2%	Q	10%	10%	S-4	
Fording Coal	FDG.un	OP	$45.10	$50.50	$4.27	$4.86	9.5%	Q	0%	0%		
SFK Pulp	SFK.un	Und	$7.89	$6.60	$0.39	$0.58	4.9%	Q	0%	0%		
TimberWest Forest	TWF.un	Und	$12.43	$12.00	$1.08	$1.08	8.7%	Q	0%	0%		S-3L
Simple Average:							**6.8%**					
Electric Power Generation												
Algonquin Power	APF.un	OP	$10.74	$10.60	$0.94	$0.94	8.8%	M	65%	60%	S-2	S-3H
Boralex Power	BPT.un	Mkt	$10.69	$10.25	$0.90	$0.90	8.4%	M	50%	50%	S-2	S-3H
Clean Power	CLE.un	Mkt	$10.05	$10.00	$0.95	$0.96	9.5%	M	65%	65%	S-2	S-3H
Great Lakes Hydro	GLH.un	Mkt	$16.99	$16.25	$1.20	$1.26	7.1%	M	30%	25%	S-2	S-2H
Northland Power	NPI.un	Mkt	$12.20	$11.75	$1.00	$1.02	8.2%	M	30%	30%	S-2	S-3H
TransAlta Pwr, LP (c)	TPW.un	Und	$10.01	$9.20	$0.79	$0.79	7.9%	M	100%	100%	S-2	S-3H
TransCda Pwr, LP (c)	TPL.un	Mkt	$36.60	$34.25	$2.56	$2.56	7.0%	Q	55%	50%	S-1	S-1M
Simple Average:							**8.1%**					

Notes:
M = Monthly Payments; Q = Quarterly Payments.
(a) Distribution yield is based on 2004 estimate.
(b) S&P and DBRS rating indicates the expected stability of cash distributions (S-1 = highest; S-7 = lowest).
(c) Limited Partnership (LP) is deemed foreign content for registered accounts.
(d) CDPU and CFPU are under review pending the release of restated financial statements.

Table 2
BMO Nesbitt Burns Research Coverage

Company Name	Symbol	Rating	Price Level	Price Target	Distribution 04E	Distribution 05E	Pre-Tax Yield (a)	Pmt Freq	% Tax Def. 04E	% Tax Def. 05E	S&P (b)	DBRS (b)
Pipeline												
Enbridge Income Fund	ENF.un	Und	$12.50	$11.40	$0.82	$0.82	6.6%	M	35%	n/a		S-2M
Ft Chicago, LP (c)	FCE.un	OP	$10.58	$10.00	$0.86	$0.94	8.1%	M	100%	100%		
Inter Pipeline, LP (c)	IPL.un	Mkt	$8.30	$7.50	$0.72	$0.72	8.7%	M	35%	35%	S-3	
Pembina Pipeline	PIF.un	Mkt	$13.08	$11.90	$1.06	$1.07	8.1%	M	12%	10%		
Simple Average:							**7.9%**					
Diversified Business												
Associated Brands	ABF.un	Mkt	$11.35	$11.25	$1.08	$1.11	9.5%	M	30%	30%		
Atlas Cold Storage (d)	FZR.un	Und	$6.92	n/a	$0.92	n/a	13.3%	Q	60%	n/a		
BFI Canada	BFC.un	Mkt	$16.42	$15.75	$1.29	$1.34	7.9%	M	14%	14%		
Consumers' Waterheater	CWI.un	Mkt	$14.00	$13.00	$1.07	$1.10	7.6%	M	4%	4%		
Davis & Henderson	DHF.un	Mkt	$17.25	$16.50	$1.45	$1.50	8.4%	M	5%	3%		
Firm Capital Mtg	FC.un	Mkt	$11.58	$10.50	$0.94	$0.95	8.1%	M	16%	15%	S-3	
Gaz Metro	GZM.un	Mkt	$22.22	$21.25	$1.37	$1.38	6.2%	Q	0%	0%	S-1	S-1L
Great Lakes Carbon	GLC.un	OP	$11.73	$11.60	$1.28	$1.28	10.9%	M	0%	0%		
Heating Oil Partners	HIF.un	Mkt	$14.00	$13.60	$1.42	$1.40	10.1%	M	0%	0%		
IAT Air Cargo	ACF.un	Und	$8.84	$8.25	$0.87	$0.92	9.8%	Q	0%	0%		
Livingston Int'l	LIV.un	OP	$16.30	$16.50	$1.35	$1.40	8.3%	M	10%	7%		
Menu Foods	MEW.un	Mkt	$13.76	$13.75	$1.28	$1.38	9.3%	M	30%	25%		
Sun Gro Horticulture	GRO.un	Mkt	$8.74	$7.50	$0.94	$0.98	10.8%	M	0%	0%		
Superior Plus	SPF.un	Mkt	$26.73	$24.00	$2.28	$2.30	8.5%	M	0%	0%		
Westshore Terminals	WTE.un	Mkt	$7.34	$7.50	$0.66	$0.67	9.0%	Q	0%	0%	S-4	
Yellow Pages	YLO.un	OP	$11.75	$12.25	$0.94	$0.97	8.0%	M	0%	0%	S-2	S-1L
Simple Average:							**9.1%**					
Oil and Gas Forecast Assumptions:					**2004E**		**2005E**					
Oil Price (WTI US$/b)					$28.00		$25.00					
US$ / C$ Exchange Rate					$0.73		$0.73					
Natural Gas AECO Spot (C$/mcf)					$5.26		$5.07					
10-year Government of Canada Bond Yield					5.3%							

Notes:
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