

*Journal of***APPLIED CORPORATE FINANCE**

A MORGAN STANLEY PUBLICATION

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Canadian Business Trusts: A New Organizational Structure

by Paul Halpern, University of Toronto, and
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In a much cited article published in the *American Economic Review* in 1986, Michael Jensen noted the tendency of mature companies with more cash than investment opportunities to destroy value in mistaken attempts to build market share in declining core businesses or, perhaps worse, diversifying acquisitions.¹ According to Jensen, the leveraged acquisitions, LBOs, and other leveraged recapitalizations of the 1980s represented a U.S. capital market solution to this “free-cash-flow problem.” By substituting high and contractually binding interest and principal payments for low and discretionary dividend payments, such companies effectively committed themselves to paying out their excess cash. And because interest payments are tax deductible while dividends are not, the recapitalized companies distributed the cash in a way that reduced the corporation’s tax bill without imposing significant additional taxes on their investors.

In 1995, the Canadian capital markets came up with a security designed to accomplish much the same combination of heavy cash distribution and low taxes. The security, known as a “business trust,” has since become a popular alternative to the traditional Canadian corporate structure.² Business trusts are a subset of investment vehicles called “income trusts,” which include real estate investment trusts (REITs) and oil & gas trusts. At the end of 2005, there were about 170 business trusts (mostly in Canada, though with a handful in the U.S. as well) with a market value of about \$90 billion and representing a variety of industry groups: consumer products, professional services, energy services, marketing and distribution, industrial products, restaurants, media, telecommunications, transport/storage, and power and pipelines.

When a public company, or one of its divisions, is converted into a business trust, the result is a structure that bears a strong economic resemblance to a company that has been taken private through a leveraged buyout or, more

precisely, has remained public while undertaking a large leveraged recapitalization. In either case, the company is forced to pay out a significant portion of its cash flow as interest payments, thereby minimizing its tax liability as well as the agency costs of free cash flow. But the business trust structure also has a unique feature that was used in some of the early LBOs in the 1980s and offers a major advantage over leveraged recaps—namely, “stapled” financing, which is the combination of subordinated debt and equity into a single security. Investors in business trusts own units, not shares, which pay out a combination of interest and dividends. The virtue of such a stapled security is that, during times of financial distress when debt obligations can be difficult to meet, the interest component of the unit distribution can be easily reduced because the unit holder, by virtue of its equity claim, has a vested interest in avoiding default. The overall result may well be an optimal capital structure that, through high “effective” leverage, eliminates the tax liability at the operating company level while reducing *both* the agency costs associated with having too much equity and the financial distress costs associated with too much debt.

After a large number of Canadian business trust listings in 1995 and 1996, very few trusts listed during the period 1997-2001, when investor interest seemed concentrated in high-growth stocks. Since then, however, trust-related issues have become very popular. In 2003, business trusts accounted for roughly two-thirds of all Canadian equity issues and almost all of the IPOs. From September 2004 to the end of 2005, the number of listed business trusts jumped from 106 to 170 (and 75% of the value of all IPOs in 2005 involved some form of income trust). From January 2006 to the end of May 2006, there were another 12 issues of business trusts with an aggregate issue value of \$1.4 billion.³ And, as of this writing, there were a number of issues awaiting IPO, including one expected to raise \$700 million.

* The authors want to thank Gordon Tait, BMO Capital Markets for his invaluable advice and access to data.

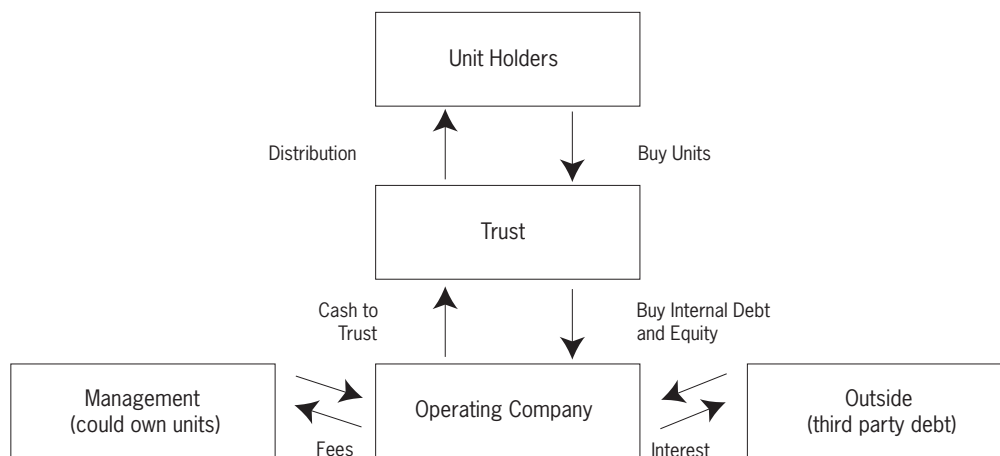
1. Michael Jensen, “Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,” *American Economic Review*, 76 (1986), 323-329. The agency costs of free cash flow refer to the potential waste of excess cash—the surplus left after funding general operations and all attractive investment opportunities—by managers, resulting in a reduction in shareholder wealth.

2. The Limited Partner (LP) structure is still available in Canada and unlike the U.S.

the tax advantages of LPs are largely intact. However, it is not used frequently; there are currently 7 LPs listed on the Toronto Stock Exchange, primarily in the power and pipeline areas.

3. On May 31, 2006, the aggregate market value of income trusts was \$198 billion Canadian. The S&P/TSX Composite index had a market value at the same date of CDN \$1,575 billion. As of December, 2005, the Index included trust at one half weight and at the beginning of March 2006 they were included at full weight. Prior to December 2005 they were not included in the index.

Figure 1 **Business Trust Structure**



With the resurgence of business trusts in 2002, Canadian investment bankers began to market the structure to U.S.-based companies. Although the initial efforts were aimed at persuading the companies to list in Canada, later attempts proposed dual listings in Canada and the U.S. But after some moderate early interest in this structure, the market for U.S. issuers has all but dried up. U.S. tax and regulatory obstacles are part of the explanation, as are the greater opportunities for high-yield investing in the U.S. But, as discussed below, the structure of the securities used (or proposed) for the U.S. companies differed from their Canadian counterparts in ways that likely contributed to their lack of acceptance. The success of Canadian trust instruments and the apparent failure of a different version in the U.S. can be viewed, at least in part, as a lesson in the value of securities design.

Structure and Performance of Business Trusts

The structure of the business trust, the essence of which is presented in Figure 1, is designed to produce single-entity taxation at the unit holder level. At the IPO stage, investors purchase trust units and the funds are used by the trust to acquire subordinated debt and equity issued by the operating company (alternatively, the units can be sold as a secondary issue by existing shareholders). Although the trust units are always priced at \$10 per unit,⁴ there is considerable variation around the average issue size of the IPOs—roughly \$150 million—with some issues raising as much as \$1 billion. The operating company is generally a limited liability corporation. The trust unit holder, through ownership of trust units, is now both a shareholder and lender to the underlying operating company.

The amount of debt owned by the trust is typically greater than the equity and consequently has a yield that reflects this “leverage.” But keep in mind that the debt purchased by the trust is not the same as—and, indeed, is effectively subordinated to—all debt issued to third parties (senior debt), such as banks or other financial institutions. The term leverage is surrounded by quotation marks because the unit holder owns both internal debt and equity of the underlying operating entity. In effect, the debt and equity are stapled together, and the unit holder has a claim to the underlying cash flows of the operating entity *after* payment of interest on third-party debt. The main purpose of this internal debt is to eliminate any remaining operating company corporate tax through interest deductibility. Indeed, the internal debt level and interest rates are deliberately set at levels designed to achieve this outcome.

But if much of their returns take the form of interest, unit holders have what amounts to an equity security in the sense that they are residual claimants to the overall cash flow of the operating entity. As with equity claims in general, business trusts provide no guarantee of any distribution payments from the operating corporation; these payments can and do vary with fluctuations in the underlying cash flow of the operating entity. Both the interest generated from debt ownership and the dividends resulting from equity ownership are paid to the trust, which in turn redistributes cash to the unit holder. Distributions are not taxed at the trust level provided the trust meets certain technical requirements.

The external, or third-party, leverage takes the form of senior debt that is typically held by banks in two- or three-

4. The trust is valued by applying a multiple to the total distributable cash flow of the trust. With the \$10 price pre-set, the number of shares is a variable quantity. Thus, if

the multiple is reduced before the issue, the value is reduced and the number of shares issued is lower.

Table 1 **Average Debt Ratios for Business and Power and Pipeline Trusts: 2003-2005**

	Year	Debt/ Enterprise value	Interest coverage (x)	Debt/EBITDA
Business trusts	2003	0.2	7.7	2.0
	2004	0.19	8.0	2.1
	2005*	0.21	7.2	2.1
Power and Pipeline	2003	0.18	6.2	3.0
	2004	0.23	5.6	3.6
	2005**	0.23	3.5	3.3

* Estimated for 2005 as of June 2005

** Source: BMO Nesbitt Burns

year facilities. Some trusts roll this debt over through private placements with institutions with terms of five or ten years. While such third-party debt increases unit holders' risk, the debt is generally small in relation to the trust's operating cash flows.

Table 1 presents external leverage and coverage ratios for business and for power and pipeline trusts.⁵ The average leverage ratios, measured as debt-to-enterprise value, are about 20% for both trust types. Nevertheless, business trusts generally have larger interest coverage ratios than power and pipeline trusts, which reflects the more variable operating company cash flows produced by business trusts.

The operating company generates "distributable cash flow," which is equal to cash flow from operations (CFO) minus "sustaining" capital expenditures. Distributable cash flow is not a generally accepted accounting term, but is widely used in promotional and prospectus materials. Sustaining capital expenditures are those needed to continue generation of the current operating cash flow and exclude capital expenditures intended to finance growth.

Cash flows are distributed to the trust in a combination of interest, dividends, and capital gains, which together comprise the *return of capital* as well as the *return on capital*. Each of these different distribution forms has a different personal income tax consequence for investors. The operating company generally does not pay out all distributable cash, which leaves a reserve to smooth future distributions. The return of capital element reduces the investor's tax base and the investor pays a capital gain when units are sold. In essence, the return of capital element is a return of the

original investment in the trust, which should be reflected in a reduction in the value of units.⁶

While any company can organize itself as a business trust, the best candidates are operating companies with characteristics conducive to the delivery of stable distributions to unit holders. These characteristics are similar to those for companies that issue high-yield debt, the most important being relatively stable operating cash flows. This requirement implies that the firm is not cyclical; has little existing or potential competition; is a mature product in a mature market; has a low level of fixed to variable costs; and has consumer demand that is relatively insensitive to changes in income.

The second factor is a minimal need for new investment, either to grow the company or to meet changing technology. To maximize unit holder payout, the operating company should have few expenditures beyond maintenance capital spending. This implies that any growth will be financed by the issuance of new units. Although oil & gas trusts and REITs frequently resort to such secondary issues, they are less common for business trusts.

Payout Policy

In the conventional corporate structure, management is concerned about the stability of dividends and typically engages in dividend-smoothing behavior. Since dividends are usually a small proportion of cash flow, there is sufficient slack for management to smooth dividends by retaining larger fractions of earnings in years with above-normal cash flows and paying out larger fractions in lean years.

The situation in a business trust is different. While stability of dividends is important, there is limited scope to smooth dividends in the event of a reduction in operating cash flow. The operating company can and does keep some cash in reserve, and it may use short-term external debt to fund dividends when cash flows are insufficient. But this is not a viable long-run strategy. An increase in cash retention can lead to potential problems associated with excess cash available to management. And the use of short-term debt will increase leverage and may generate problems of default and violation of restrictive covenants that can negatively affect the ability of the company to pay distributions. Finally, the trust cannot reduce sustaining capital expenditures in the long run to fund any shortfall. All of these factors working together lead to a strong link between cash flows and dividends.

The *raison d'être* of an income trust is to provide large distributions to unit holders. As shown in Table 2, the ratios

5. This and subsequent tables are based on BMO Nesbitt Burns data. This data includes only those trusts that BMO covers; these may be the larger and more liquid trusts in each trust category. Thus there may be a slight bias in the results.

6. Return of capital distributions are most prevalent in the oil and gas trust area. The percentage of distribution that was deemed to be return of capital—and hence tax deferred—in 2005 was 85% for oil and gas trusts, 38% for power and pipeline trusts, and 17% for business trusts. This result reflects, among other factors, the relative capital intensity of the companies in each category.

Table 2 **Ratio of Distribution to Operating Cash Flow by Trust Type for 2002 to 2005**

	2002	2003	2004	2005
Business				
Average	0.78	0.82	0.83	0.81
Median	0.77	0.87	0.87	0.82
Listed over 2003-05		0.87	0.80	0.79
Power and Pipeline				
Average	0.94	0.87	0.79	0.76
Median	1.00	0.93	0.88	0.77
Listed over 2003-05		0.87	0.80	0.79
Oil and Gas				
Average	0.84	0.74	0.72	0.62
Median	0.84	0.80	0.78	0.63
Listed over 2003-05		0.84	0.77	0.65

Source: BMO Nesbitt Burns

of distributions to operating cash flow in 2005 ranged from about 0.80 for business and power and pipeline trusts to 0.60 for oil & gas trusts—and for some individual trusts are even in excess of 1.0 (which reflects the use of short-term debt or excess cash that has been set aside). These ratios have decreased over time for the total sample and for the subset of companies that was listed during the 2003-2005 period. The distributions are generally paid monthly.

Fluctuations in underlying operating cash flows thus will ultimately lead fairly directly to fluctuations in distributions. While distributions can be maintained by having the trust borrow to pay the full amount in the short run, in cases of longer-term shifts in cash flow due to economic conditions or firm- or industry-specific events, distributions may be reduced or even eliminated. During the period January 2001 to February 17, 2005, 52% of a group of 107 business trusts maintained their distribution, 36% increased it on average by 9.7%, 7% had an average decrease of 17.6%, and 5% totally suspended their distributions. For those trusts making a change in their distributions, the average market response was an announcement-day return of 2.7% for the increased distribution group, an 8.7% decline for the decrease sample, and a 38% drop for the suspended distribution class.

Performance

Investor interest in securities depends upon their risk and expected return. We assess these properties by looking at annual Sharpe ratios for rates of return on indexes of business trusts, oil & gas trusts, a trust composite, and the overall stock market (TSX composite index) during the period January 1996 to June 30, 2004. (All indexes are value weighted and prepared by BMO Nesbitt Burns.) These

Table 3 **Annual Sharpe Ratio for Trusts and TSX Index**

Year	Trust Composite	Business Trusts	Oil and Gas	TSX Composite
1996	0.242	0.170	0.171	0.162
1997	0.046	0.007	0.009	0.062
1998	-0.093	-0.050	-0.116	-0.016
1999	0.043	-0.083	0.211	0.112
2000	0.217	0.117	0.272	0.013
2001	0.117	0.231	0.028	-0.048
2002	0.109	0.114	0.089	-0.054
2003	0.434	0.398	0.301	0.142
2004	0.023	0.031	0.018	0.025
N	4	6	6	

indexes, while not including all trusts, are representative of aggregate performance since they include a substantial number.

As shown in Table 3, which presents the annual Sharpe ratios for the years 1996 through 2003 (and half of 2004), the trust composite outperformed the TSX in four out of the nine years. The other trust indexes produced superior performance in six years, although not always in the same years. This outperformance has been concentrated mainly in the most recent several years. For example, all trust categories outperformed the TSX index from 2000 to 2003, although only the business trusts outperformed in the first half of 2004.

Analyzing the Benefits of the Business Trust Structure

The business trust structure has a number of benefits that are reflected in the value of the units when they are established (either through an IPO or conversion from a conventional corporate structure). The benefits, as mentioned earlier, include the present value of the expected future tax savings, the minimization of financial distress costs, and the reduction in the agency costs of free cash flow. As part of this third source of value, the contractual commitment to pay out free cash flow also effectively gives investors greater control since it forces management to return to the capital market to fund additional investment.

To get a crude estimate of the value of these benefits, one can simply look at the increase in a company's share price upon the announcement of its conversion to a trust. The average abnormal return for such companies' shareholders over a two-day announcement event window was 12.8%. What's more, from two days after the announce-

Table 4 **Tax Gain per \$ of Before Tax Net Operating Income**

After-tax cash flow to:	Retail Investor		Institution
	Dividends	Capital Gains	
Shareholder	\$0.42	\$0.47	\$0.61
Unit holder	\$0.54	\$0.54	\$1.00
Net Gain from Trust form	\$0.12	\$0.07	\$0.39

ment date to the consummation of the conversion—a period that averaged about two to three months⁷—the average company return was another positive 7% (while the broad market over the same period fell by 0.7%). Thus, from announcement to consummation of the conversion, shareholder value increased by roughly 20%.

We consider each of the benefits in more detail below.

Tax Efficiency. As in the U.S., under Canadian income tax legislation, investors in corporate shares face double taxation, first on profits and then again on dividend distributions or capital gains when shares are sold. The business trust structure eliminates this double taxation by eliminating tax at the corporate level through the use of internal debt. Cash-flow distributions to the unit holder are taxed based on the form of income received by the trust—dividends, interest, or capital gains. The bulk of the distribution is in the form of interest.

A simple example demonstrates the impact of double taxation and the benefit of the trust structure. Assume that the corporate tax rate is 39%, the personal tax rate on interest income is 46%, the effective tax rate on dividends is 31%, and the effective tax rate on capital gains is 23%.⁸ Now consider \$1 of pretax net operating income in a corporation. After the corporation pays tax, \$0.61 is available to shareholders. If the company pays this amount out to investors as dividends, the after-tax amount available is \$0.61(1-.31) or \$0.42 (see Table 4 for the calculations). If the company retains earnings and the investor sells the shares, there is a capital gain, and the after-tax amount available to the shareholder is \$0.47, assuming the stock is sold at the end of the year.

Now consider a business trust that has issued a sufficient amount of internal debt to eliminate corporate tax. If distributed cash is equal to interest payments, the unit holder ultimately must pay tax on the full amount of the

net operating income at the personal tax rate of 46%. The after-tax amount available to the unit holder is \$0.54. Thus, the gain to the trust structure ranges from \$0.07 to \$0.12 per dollar of pretax net operating income.⁹

In some situations, the investor is not taxable or, to be more precise, the tax is deferred to a later period. This is the case for pension funds and those who invest in a tax-deferred retirement account.¹⁰ In such cases, the unit holder does not pay any personal tax and the gain from the trust form is even greater, as much as \$0.39 per dollar of pretax net operating income.¹¹

Although the business trust market is primarily retail, in recent years institutions have become more involved. And even for the retail market, the relative importance of tax-deferred compared to taxable holdings is unknown. The net result is that, although there is a tax benefit from the trust structure, it is difficult to determine *a priori* its exact size due to possibly different tax rates based on the identity of the marginal investor.

Financial Distress Costs. In the typical corporate structure, distress costs can arise when the firm has trouble meeting debt service obligations due to a shortfall in cash flow. Attempts to resolve distress can reduce firm value as management's time and energy are diverted from what should be its primary focus: running the firm as efficiently as possible and investing in its future.

In the business trust structure, since both debt (other than the external debt) and equity are owned by the same investors, an unexpected reduction in cash flows and inability to make a full interest payment on internal debt will not necessarily trigger financial distress since the unit holder is likely to agree to a reduction in interest payments/distributions in line with the reduced cash flows.¹² It is this flexibility provided by internal debt that allows the company to handle enough of it to eliminate corporate tax at the operating level. Of course, third-party debt also needs to be considered when making this calculation, since it is senior to other outstanding securities issued by the company and the company can be in default if these debt obligations are not met.

As noted earlier, business trusts provide an interesting analogue to the highly leveraged transactions of the 1980s. Many companies, including poorly performing ones, were restructured, usually as the result of a hostile takeover or through a going private transaction that saddled them

7. The time period increased to five or six months if there were any complications in implementing the conversion.

8. These tax rates on dividends, regular income, and capital gains are theoretical average values and the corporate rate is for an Ontario corporation.

9. For a Limited Partnership, since income is not taxable in the partnership but in the hands of the investors, the first level of taxation is missing and the gains for the LP arise without the use of internal debt. However, without the debt component there is no internal incentive to pay dividends and this benefit is not present. Researchers on U.S. conversions to LPs from the standard structure observe positive abnormal announcement day returns. J. Collins and R. Bey, "The Master Limited Partnership: An Alternative to the Corporation," *Financial Management* 15 (1986), 5-14, Karen Denning and Kuldeep Shastri, "Changes in Organizational Structure and Shareholder Wealth: The Case of Limited Part-

nerships", *Journal of Financial and Quantitative Analysis*, 28 (1993), 553-564 and William Moore, Donald Christensen and Rodney Roenfeldt, "Equity Valuation Effects of Forming Limited Partnerships," *Journal of Financial Economics*, 24 (1989) 107-124.

10. Institutional investors (pension funds) did not invest heavily in these securities in the past, citing the lack of limited liability. This condition was removed by provincial legislation in Ontario and Alberta. The market, however, remains primarily retail, although many retail investors have tax-deferred accounts.

11. This calculation ignores the present value of future taxes.

12. While a number of trusts have had to reduce or eliminate distributions due to negative operational impacts on cash flows, these changes were undertaken without distress issues that could have occurred in a typical corporation with high levels of debt.

with a large amount of debt. And the debt in these deals proved to be a double-edged sword. While providing more pressure for efficiency and profit (see below), the debt in such recaps also led to arduous and costly negotiations with debt holders—and in some cases Chapter 11—when cash flows turned down, as they did for many companies in the early '90s.¹³ Had such companies instead been structured as business trusts, much of the value they lost in financial distress might have been preserved.

Agency Cost of Free Cash Flow. To the extent that public companies have large and stable cash flows and few needs for capital to grow, cash flows in excess of the company's maintenance capital expenditures can be held in cash or invested in projects that do not increase and may actually reduce shareholder value. These latter projects may increase the amount of assets held by the firm, but do not generate returns above the firm's cost of capital. This agency problem is exacerbated by the current personal and corporate Canadian tax structure, where it is in the firm's best interest to retain the funds since the tax on capital gains is less than that on dividends.

The business trust structure reduces such agency costs in two ways. First, with the need to pay large and stable distributions under the trust structure in order to maintain unit values, a management team with little margin for error will face greater pressure to increase operating efficiencies than managers operating with a conventional, low-leverage corporate structure. Second, to fund growth opportunities that may arise, the company will have to issue more units because all operating cash flow except that set aside for maintenance expenditures is paid out to the unit holders. Each time the firm goes to the capital market to issue new units, it faces increased scrutiny from investors, which, along with the pressure exerted by debt, should also act as a deterrent to ill-advised capital spending projects. In both of these ways, the business trust structure introduces a discipline in spending funds, and removes operating inefficiencies, resulting in an increase in value. In support of this argument, studies of leveraged recapitalizations provide evidence of the role of debt in disciplining capital spending and otherwise improving efficiency.¹⁴

Potential Problems

While business trusts have many advantages, there are some potential problems that limit their range of application. These concerns include potential distress costs generated by

third-party debt and the use of the structure by inappropriate companies, and Federal government concern about loss of revenue.

Potential Distress Costs

Although financial distress costs are lower for business trusts, the possibility of distress costs or even default can arise when there is third-party debt in the capital structure. Third-party leverage can potentially disrupt cash distributions, even if cash is available, due to the triggering of covenants that restrict payment of distributions. But this problem can be managed by limiting the amount of third-party senior debt in the capital structure.

As we saw earlier, the business trust structure is best suited for companies that produce stable cash flows and distributions, with little need for capital for investment. But, as demand for business trusts increases at the retail and institutional investor levels, more companies considering the trust structure may not have the right characteristics. Underwriters, observing demand for these securities, might be tempted to bring inappropriate businesses to the market as business trusts,¹⁵ resulting in a high probability of distress in the future.

An even larger cost of financial distress would be the failure of operating companies set up as business trusts to take advantage of promising growth opportunities that materialize. On the other hand, as we already observed, business trusts that find themselves with growth opportunities do have the option of going back to the market to issue new units.

Revenue Losses to Government

A more serious threat to the future of trusts comes from the fact that the tax gain from the trust structure is a loss to government coffers, which is even larger when the unit holder is an entity such as a pension fund or other tax-deferred investors.¹⁶ One major risk to the business trust structure is the government's concern about the possible conversion of large corporations to the trust form. To prevent further tax losses, the government could change the tax treatment of trusts.

Indeed, there have been two attempts by the Canadian Federal Government to curtail the growth of income trusts. The first was a budget provision that placed limits on pension fund investments in business trusts. These limitations, which applied only to business trust holdings by pension funds,

13. See David Denis and Diane Denis, "Causes of Financial Distress Following Leveraged Recapitalizations," *Journal of Financial Economics* (1995); and David Denis and Diane Denis, "Leveraged Recaps and the Causes of Financial Distress," *Journal of Applied Corporate Finance*, Vol. 8 No. 4 (Winter 1996).

14. See David Denis and Diane Denis, "Managerial Discretion, Organizational Structure, and Corporate Performance: A Study of Leveraged Recapitalizations," *Journal of Accounting and Economics* (1993); and David Denis and Diane Denis, "Leveraged Recaps and the Curbing of Corporate Overinvestment," *Journal of Applied Corporate Finance*, Vol. 6 No. 1 (Spring 1993).

15. Some have argued that a related scenario played out in the late 1980s, when an overheated leveraged takeover market in the U.S. led to overpriced transactions, reckless structuring or both. Steven Kaplan and Jeremy Stein, "The Evolution of Buyout Pricing and Financial Structure in the 1980s," *The Quarterly Journal of Economics*, 108 (1993), 313-357.

16. However, taxes for these entities are paid when the beneficiary or investor receives payments from the fund. And when the present value of future taxes payable by tax-deferred investors is considered, the loss to the Government is reduced. Research in this area is undecided about the size of the resulting reduction in the tax loss.

Table 5 **Business Trusts Originating as US Companies**

Panel A			
Issuer	Symbol	Date	Dollar Size (CDN)
Canadian Income Funds			
ACS Media Income Fund	AYP.UN	April 2003	190
Associated Brands Income Fund	ABF.UN	September 2002	118
Custom Direct Income Fund	CDI.UN	May 2003	127
Great Lakes Carbon Income Fund	GLC.UN	July 2003	204
Heating Oil Partners Income Fund	HIF.UN	May 2002	149
Menu Foods Income Fund	MEW.UN	May 2002	129
Specialty Foods Income Fund	HAM.UN	February 2003	210
Panel B			
Issuer	Symbol	Date	Dollar Size (CDN)
IPS listed on TSX only			
Medical Facilities Corp.	DR.UN	March 2004	222
Atlantic Power	ATP.UN	November 2004	368
Student Transportation of America Inc.	STB.UN	December 2004	128
Keystone North America Inc.	KNA.UN	January 2005	188
FMF Capital Group Inc.	FMF.UN	March 2005	198
Royster-Clark Ltd*.		July 2005	325
New Flyer Industries	NFI.UN	August 2005	200
Primary Energy Recycling	PRI.UN	August 2005	285
Panel C			
Issuer	Symbol	Date	Dollar Size (CDN)
Cross Border IDS (listed on TSX and AMEX)			
Centerplate	CVP.UN	December 2003	364
Otelco	OTT.UN	December 2004	163
Listed on AMEX only			
B&G Foods	BGF	May 2004	n.a.
Coinmach	DRY	February 2004	n.a.

* no longer listed: taken over

were subsequently suspended. The second occurred in mid-September 2005, when the Minister of Finance announced a freeze on advance tax rulings for companies converting to a trust structure. Although only applicable to conversions, the market interpreted this as a salvo at the trust structure, leading to a cessation in IPO activity and a reduction in the trust index value of approximately 20%. Following intensive lobbying by investors, the Minister backed off these plans and instead announced a change that effectively reduced the tax on dividends, which removed most of the appeal of trusts for taxable investors. But even so, trust conversions

continue to have tax benefits for tax-deferred investors. Thanks to political pressures from investment groups, the risk of a change to the tax-advantaged status of income trusts is low, but always a possibility.¹⁷

Other Reasons for the Success of Canadian Business Trusts

Given the significant benefits, with relatively few drawbacks, it is not surprising that the supply of business trusts has been large. The valuation multiples commanded by the trusts have been significantly larger than those applied to the standard structure, as demonstrated either when a conventional company converts to a trust structure or when a private company or a division of a private company undergoes an IPO. As mentioned earlier, the demand for trust structures has grown substantially since 2000, when there was a renewed interest by both retail investors and pensions funds. The pension funds were attracted in part by the large cash distributions, which could be used to meet their periodic pension obligations.

Another, closely related factor in the success of these securities is the relative scarcity of high-yield investment products available in Canada, for which all trust types generally provided a substitute. As already discussed, there are a number of important similarities between trusts and highly leveraged transactions, such as the kinds of companies that use them, the use of interest payments to reduce corporate tax, and, at first blush, the extent of leverage used. At the same time, as we have also pointed out, there are dramatic differences. First, the financial risk of the business trust unit is low since the effective leverage depends upon the third-party external debt and not on internal debt, which can be easily "renegotiated." Second, the trust unit represents "strip" financing where the investor holds both the internal debt and equity in the same proportion and the units cannot be deconstructed into debt and equity components.

The U.S. Business Trust Market

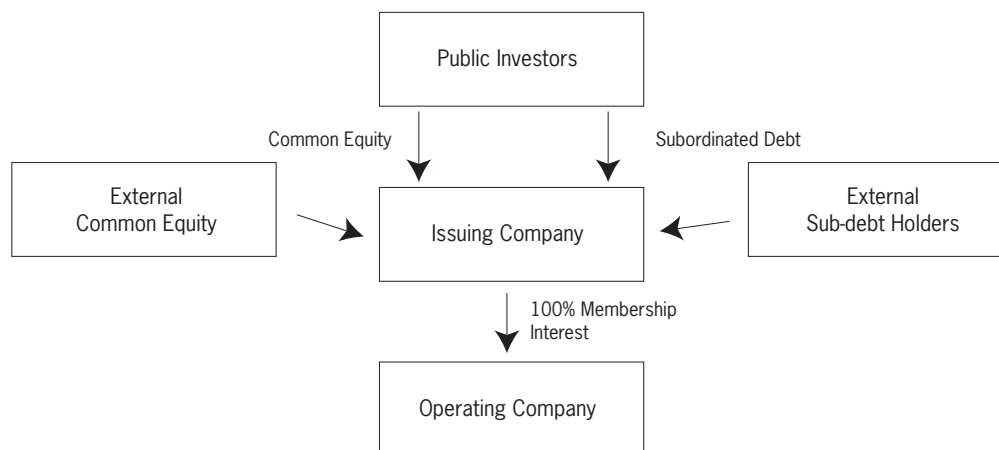
In 2002, Canadian investment bankers, looking to expand the use of the business trust structure, attempted to interest U.S. companies in using the structure and listing on the Toronto Stock Exchange (TSX). The first U.S.-based trust, Menu Foods Income Trust, was listed in May 2002. This issue was followed by six more (see Table 5) in 2002 and 2003, raising a total of CDN\$1.1 billion.

But unlike the Canadian users of the trust structure, the U.S. companies did not use a trust vehicle, but instead introduced a partnership entity between the unit holders and the operating entity. The units issued by the partner-

17. Another potential problem is the agency costs of dispersed owners. Since trusts are owned largely by many dispersed retail investors, they don't have the concentrated ownership structure as in a buyout, where investors have a strong incentive to monitor. However, this problem is not that important for a number of reasons. First, management

generally has an ownership interest in the trust and hence an incentive to increase distributions. Second, a significant amount of the retail ownership is through mutual funds and they have an incentive to monitor.

Figure 2 Revised Structure to Meet Auditor Requirements



ship were used to purchase the equity and subordinated debt, which carried a market-based, risk-adjusted interest rate. The debt and equity were “stapled,” as in the Canadian trust structure.

By the end of 2003, however, the northward flow of U.S. trusts stopped after an accounting firm raised tax-related questions about the trust structure. It cited the possibility that the subordinated debt could be found by the IRS to be equity (even though no authority directly addressed the treatment of securities such as subordinated debt in the context of a joint offering with equity and the IRS had not challenged the structure).

In response, a revised structure was developed for U.S. companies that intended to list only on the TSX. The structure was called Income Participating Securities (IPS), and the first company to use an IPS was Medical Facilities Corporation, which raised CDN\$222 million through an offering in 2004. As shown in Table 5 (Panel B), there have been 8 IPS issues that have raised a total of CDN\$1.9 billion.

The IPS structure, as presented in Figure 2, is in essence an issuing company that is interposed between (and owns most if not all of) the operating entity, which is a partnership, and public investors. There is no trust in the structure. Investors purchase a unit that remains a combination of common equity and subordinated debt issued by the intermediary company, and the company uses its interest payments to the unit holders to offset income received from the operating entity (in which it owns all or substantially all of the membership rights), thereby eliminating corpo-

rate tax and passing cash flows to the public as interest, dividends, and capital gains.

A similar structure was introduced for trusts that intended to list on both the AMEX and TSX, called an Income Depositary Security (IDS).¹⁸ In December 2003, the first IDS was issued by Volume Services America Holdings (VSAH) for CDN\$364 million and a second in 2004 by Otelco, a rural telephone company. By the end of May 2004, 17 companies had declared their intent to use the new structure (with planned issuance of almost \$10 billion) and were awaiting SEC approval. The SEC appeared to be holding up the issues because it wanted the companies to forecast future dividends from projected earnings, but the companies were reportedly reluctant to do so. Further, some outstanding questions remained about the tax treatment of the structure.¹⁹

Then, in August 2004, American Seafood Corp, one of the companies on hold, failed to obtain investor interest for its \$577 million IPO, even with a forecast yield (expected distribution divided by issue price) of 12.5%, and shelved the offering. Since then, Iowa Telephone, which originally intended to use an IDS structure, announced that it was going public with a conventional equity issue with a higher than average payout rate. And, with that, the great expectations for these cross-border securities evaporated.

Analysis of Changes in the U.S. Structure

The changes in the structure of the U.S. trusts made the internal debt look more like external subordinated debt, thereby eliminating any concern about the tax treatment of

18. Investment bankers have their own name for the security. For example Merrill Lynch called their version of the security COUGARS, Cash flow oriented units for growth and return. There are some investment bankers who use IDS to refer to what we have called IPS. We use the original names in this paper.

19. Reported in Bloomberg news, June 24, 2004. http://quote.bloomberg.com/apps/news?pid=email_s&refer=canada&sid=acQZ_PirqeOo.

the interest payments. First, the debt had terms and conditions that were consistent with those that would be in place in an arm's-length transaction.²⁰ Second, to avoid thin capitalization rules in the U.S. tax code, the principal amount of the subordinated debt had to be "reasonable" (that is, not too large) in relation to the aggregate capital of the issuing company. Third, the units could be separated after a specified number of days from the issue's closing date, and the equity in the separated unit itself could trade on the TSX alongside any non-separated units.²¹ Fourth, the underwriters represented in the prospectus that, in the event of a separation, it would agree to list the equity and facilitate a market in both securities.

Under the standard Canadian structure, the unit holder owns both the subordinated debt and equity in fixed proportions—a pure example of strip financing. In the U.S. it is necessary that this equal proportion *not be present*. To satisfy this condition, at least 10% of the subordinated notes are placed privately with third-party lenders. These bonds are called "bachelor" debt, and their issuance must take place prior to the issuance of the units. In addition, in some structures, 10% of the equity will be placed with investors that do not hold the underlying units; this equity is referred to as "spinster" equity and is found as class B common shares in the corporate structure. Equity holders cannot exchange the equity (and sub debt) for the underlying unit for a fixed number of years. Having either subordinated debt or equity that is independent of the unit issue provides an independent (market-based) assessment of the viability and reasonableness of these financial instruments.

Another requirement for the U.S. securities is a tax opinion. In addition there are situations in which the subordinated noteholders must act as creditors—for example in the event of default on the subordinated notes. In such situations, the unanimous approval of all subordinated debt holders is required to waive certain conditions, such as the payment of interest. This provision effectively provides bachelor debt holders with a veto and ensures that sub debt holders will behave as creditors and not equity holders. Finally, coming on top of and consistent with the above provisions, there is a requirement for a third-party certification that the sub debt is in fact a debt instrument. All of these changes discussed above, incidentally, were intro-

duced at the urging of auditors²² and not in response to queries from either the IRS or the SEC.

Why the U.S. Market Has Failed to Develop

At the time of this writing, none of the units issued by U.S. entities had been separated into their component securities. Nonetheless, of the eight IPS issues listed in Panel B of Table 5, all but Medical Facilities²³ had issued subordinated debt that was *not part of the unit*. As a proportion of the total subordinated debt outstanding, bachelor debt ranged from 12% to 18%.

As noted in Panel C of Table 5, there are two cross-border trusts that used the IDS structure and two that listed only on the AMEX. But there has been no activity using these structures since late 2004.

As suggested earlier, the IPS and IDS structures have two important modifications that reduce the benefit of the basic structure. First the underlying financial securities in the unit are "clipped" rather than stapled, as in the original structures. This modification permits the separation of the unit into its component parts either on the option of the holder, after a specific time period following the issue, or upon the occurrence of a change in control. Second, subordinated debt is issued that is not part of the unit.

Both of these changes reduce the benefit of the expected reduction of financial distress costs in the event of default on the debt. Under the original stapled version, in the event of a reduction in cash flows that affects payment of interest on the subordinated debt, there is no incentive for the unit holder to agitate for default since what they gain as a bondholder they more than lose as an equity holder. But, in the new structures there are subordinated debt holders who, although not holding a large percentage of the debt, can agitate for default. Since this external subordinated debt was issued as a private placement, the holders face minimal transactions costs to veto reorganization attempts to enforce their claim.

Further, in the event of poor performance of the company, the unit holders may separate the units and sell their equity securities in order to have debt claims that may be enforceable under a default. Given that the subordinated debt securities will be publicly held, it will be difficult for the equity holders to negotiate with the debt holders to restructure the company.²⁴ If the economy or corpo-

20. In evaluating the company an important piece of information is the impact of senior debt and restrictions on the company's ability to pay interest on subordinated debt and dividends on the equity. These provisions are similar to those found in high yield debt.

21. A holder of the common shares and subordinated notes can combine them to form an IPS/IDS.

22. In March 2004, the U.S. offices of the big four accounting firms issued a series of guidelines which cross border income trusts must meet in order for the accounting firms to provide a clean audit opinion which will facilitate issues. These guidelines have not been released to the public and, according to the accounting firms, are not to be used as requirements with the specific provisions for each entity depending upon its unique characteristics. Finally, the unit value of \$10 was allocated to the equity and subordinated

debt component at the time of the issue. Just as for the Canadian business trust and the precursor to the IPS, the face value of the each unit was set at \$10. However, this was not the case for the IDS units.

23. The Medical Facilities issue was completed before all of the new provisions were introduced.

24. For a discussion of the increased incidence of financial distress and ultimately bankruptcy in high leveraged transactions when debt is publicly held and difficult to renegotiate, see Paul Halpern, Wendy Rotenberg and Robert Kieschnick, "The Role of Debt Composition in Highly Levered Transactions," Working paper, University of Toronto (2004).

rate performance turns down, the U.S. trusts are likely to incur losses similar to those experienced by the “junk” bonds used to fund the highly leveraged U.S. transactions of the 1980s.²⁵ One implication of the high financial distress costs in the U.S. structure is that the U.S. issues will support significantly less external debt than the original cross-border or wholly Canadian structures. Alternatively, only U.S. companies with very low cash variability may be willing to accept the financial risk and, more important, the high financial distress costs that come with having public debt holders.

Since the changes in the U.S. trust structure, there have been very few companies with listings in the U.S. and a limited number of IPS listings. The growth of the cross-border market has been disappointing to investment bankers, especially given the continued appetite for business trusts in the Canadian market. What is the explanation for the relative lack of success of cross-border structures?

As suggested, given the revised U.S. structure’s resemblance to high-yield debt, the threat of default—and the costs that are likely to come with it—may be sufficient to deter investors. For U.S. based investors, the structure is new and, although the threat of tax authorities interpreting the sub debt as equity appears to have dissipated, there remains residual uncertainty. The cross-border issues that have used the new structure have been relatively small in size. While the size is sufficient to engage analyst coverage in Canada, given the number of analysts who already specialize in the trust market, the issues are unlikely to get much coverage in the U.S. market, which could limit the interest of U.S. investors in this structure.

From the investment banker’s perspective, a trust with a U.S. listing such as an IDS is a risky proposition, and not only from the tax perspective. As a new security, it is subject to more intense scrutiny and hence slower progress through regulatory requirements. Thus a firm using this structure may have to wait much longer to complete the transaction than when using a normal corporate structure. As observed in this market, firms may decide against waiting for approval, especially if the funds are needed quickly. Also, the sales effort is more costly and the underwriting fees are greater due to the complex structure. Third, with more high-yield alternatives available in the U.S., the premium multiples assigned the trusts by U.S. investors (relative to those on standard corporate structures) may not be as large as those obtained for a purely Canadian issue.

Conclusions

The business trust structure has demonstrated strong and continued growth in the Canadian market. In effect,

it provides investors with what amounts to a combination of subordinated, high-yield debt and high-yielding equity that has the virtues of paying out excess corporate cash and capital while minimizing corporate and investor taxes. And, perhaps equally important, because the debt and equity are “stapled” together in the same security—a feature borrowed from the “strip financing” once used in U.S. LBO financing—the costs of financial distress are significantly lower. In the event of financial trouble, unit holders can be expected to cooperate in any restructuring of interest payments since the benefits of so doing accrue to the equity portion of their units.

The original income trust structure was also used successfully by a number of U.S.-based companies that listed their shares on the TSX. But, in the attempt to make the securities suitable for U.S. listing on the AMEX, and in response to auditor demands intended to address potential IRS concerns, the instruments were modified in ways that sacrificed one of the important benefits of the original. The changes were designed to give the subordinated debt, issued as part of a package with equity, characteristics of external, third-party subordinated debt; and in so doing, the low-cost restructuring feature built into the Canadian version was lost.

Based on this revised structure for U.S. companies, there are two cross-border trust instruments in existence—one (IPS) listed solely on a Canadian stock exchange and the other (IDS) listed on both a Canadian and a U.S. exchange. While there has been modest interest in the IPS, both structures have been largely unsuccessful in attracting new listings even as the market in Canada for trusts continues to be strong. There are a number of reasons for this difference. First, the separability of the internal debt and equity in the cross-border instruments may well increase investors’ perception of the probability of a costly financial distress. On the supply side, being a new instrument for U.S. investors, the issues face high marketing costs as well as a slower and more costly regulatory process. Finally, with a number of high-yield alternatives available to U.S. (but not Canadian) investors, the multiples commanded by U.S. trusts may not be much greater than those obtained when the standard structure is used.

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25. See Kaplan and Stein (1993), footnote 16.

Journal of Applied Corporate Finance (ISSN 1078-1196 [print], ISSN 1745-6622 [online]) is published quarterly, on behalf of Morgan Stanley by Blackwell Publishing, with offices at 350 Main Street, Malden, MA 02148, USA, and PO Box 1354, 9600 Garsington Road, Oxford OX4 2XG, UK. Call US: (800) 835-6770, UK: +44 1865 778315; fax US: (781) 388-8232, UK: +44 1865 471775.

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