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Tough rules are needed for trusts

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The Gazette

Monday, September 18, 2006

Stock in Metro Inc. was flying high last week on speculation the grocery-store operator might be the next big Canadian company after Telus Corp. to convert itself into an income trust.

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This speculation certainly can't be coming from any sane Metro shareholder. They've been treated too well by the company.

Over the last five years, Metro's stock has almost doubled and the dividend has increased by 20 per cent a year on average. (Disclosure: I own a small number of Metro shares.)

Chief executive Pierre Lessard has spent $830 million over the last five years to upgrade Metro's stores, adding small bolt-on acquisitions and waiting for a big grocery chain to become available for purchase. His patience paid off last year when he netted A&P Canada for $1.8 billion.

How much of this would have been achieved as an income trust, a structure in which a company pays out almost all its cash to investors?

We know for sure one group of Canadians who are pulling for the conversion of Metro and other large Canadian corporations. The banks through their investment banking arms rake in huge fees advising on these deals.

But is the creeping income-trustization of the Canadian economy in the interest of investors or the country?

Shareholders in Telus Corp. certainly enjoyed a big pop in the stock price when the company announced last week that it would be the biggest company yet to convert itself into an income trust. How many other big companies are now looking to follow suit? Analysts are talking not only about grocery chains but other telecom companies, cable companies and the TSX Group. Can the banks be far behind? A year ago, the Royal Bank said it was considering a conversion.

Trusts don't pay corporate income tax and this allows them to offer distributions that are much larger than even the most generous dividends paid by common-share corporations.

This leads investors to bid up the value of trusts, encouraging more companies to convert to the structure.

The federal government has tried to solve the problem by enhancing the tax treatment of dividends paid by corporations to put them on an even playing field with trust distributions in the hands of investors.

But there remains a big problem with pension funds and RRSPs where investors don't pay tax on dividends. As well, foreigners pay the same 15-per-cent withholding tax whether they are receiving a trust distribution or a corporate dividend.

These investors still have a preference for distributions from income trusts and a valuation premium persists in the market.

Obviously, there's a threat to government revenues from large corporations converting to trust structures under which they pay no income tax. But a larger problem is the toll on the Canadian economy from some of biggest and best companies moving into a structure that can squelch growth and innovation.

As for investors, the juicy yields advertised by trusts have all too often turned out to be cruel illusions.

Blackmont Capital analyst Barbara Gray keeps tabs on trusts that have either been forced to cut distributions or eliminate them altogether, invariably leading to devastating capital losses for unitholders. The number now stands at 35 and Gray expects it to reach 75, or half of all business trusts, within two years.

Independent analyst Diane Urquhart notes that many trusts are able to offer extravagant yields because they are paying distributions well above their earnings.

This return of investors' capital means the trust is either skimping on money it sets aside for upgrading and replacement of assets; or it's eating into cash reserves; or it's borrowing to meet its commitments.

This is "an elegant ponzi scheme," said Urquhart, who formerly headed the research departments of two major brokerage firms.

In an ideal world, Urquhart would like to see trusts restricted to paying out no more than their net earnings. That's effectively the practice for dividend-paying corporations.

But she acknowledges such a rule is an "extreme solution" that would kill the trust market. Alternatively, trusts should be made to clearly disclose to investors how much their distributions exceed income. Yield should be calculated only on the income portion, she says.

Tough new disclosure rules for trusts would give investors a clearer picture of their true yield and risks. And that would help curb the appetite for more trust conversions.

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