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Key measures of income trusts

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If you invest in income trusts, you may feel nervous to hear about each new incident of sudden distribution cuts and falling unit prices.

So, how do you find income trusts that can sustain their payouts, even if the economy goes into recession?

In last Wednesday's column, I talked to Diane Urquhart, an investment analyst (now retired) whose research shows that many trusts pay out more cash than they earn.

She thinks income trusts that distribute too much cash to investors are vulnerable if the economy goes into a slump. This makes them risky to own, especially for a retiree.

Some readers found her comments alarming. They wished she had named the most and least trustworthy companies in the trust universe.

MoneySense magazine runs an annual feature, using public numbers to grade the top 100 income trusts from A (the best) to F (the worst). It's in the summer issue, still on the newsstands, or on the Internet at http://www.canadianbusiness.com (scroll down to the bottom left corner). Analyst Norm Rothery looked at three criteria:

- Yield. The more money a trust puts in your pocket, the better. Does it have a yield of more than 5 per cent (better than most stocks)? Keep in mind that you may pay more personal taxes on trust distributions than on Canadian dividends, which received extra tax breaks in the last federal budget.

- Reliability. Is the trust's underlying business in good shape? Is there a margin of safety? High grades were awarded to trusts that paid out less in distributions than they generated in cash flow. Extra marks went to trusts that had low debt, which made it more likely they could sustain their payouts.

- Value: Does the trust trade at low prices compared to its cash flow? How does the trust's price-to-cash-flow ratio compare to other trusts in the same industry? The survey also looked at price to book value. Ten trusts won an A mark: Atlas Cold Storage Income Trust, Brick Group Income Fund, Daylight Energy Trust, Dundee REIT, Esprit Energy Trust, Inter Pipeline Fund, Peak Energy Services Trust, Prime West Energy Trust, Progress Energy Trust and Sunrise Senior Living REIT. (Atlas stopped making distributions in early 2004 after a financial and accounting meltdown. The company cut its debt and resumed payouts again this year with a 5 per cent yield.)

Another 20 trusts earned a B, including: BFI Canada Income Fund, Boralex Power Income, Enbridge Income Fund, North West Company Fund, Osprey Media Income Fund and UE Waterheater Income Fund (if you focus on just the business trusts). Two received an F or failing grade: Canadian Oil Sands Trust (which has a low yield) and TimberWest Forest (which has high debt).

One-quarter of the trusts paid out 100 per cent or more of their cash flow to investors, *MoneySense* found. Another dozen paid out 90 per cent to 100 per cent.

"A payout ratio of more than 95 per cent is cause for concern," says Gordon Pape, who publishes a newsletter for income investors. "It means the trust is skating close to the edge and any reversal of business fortunes could result in a distribution cut."

The *MoneySense* survey is based on Bloomberg data from May 5. If you want to find more current information, check company websites for press releases or go to Canada's database of publicly listed companies, Sedar.com.

For example, the Brick Group Income Fund had a conservative distribution-to-cash-flow ratio of 57.4 per cent in the survey. But in a later press release, the furniture retailer said its distributable cash payout ratio for the year ended June 30 was 92.7 per cent.

The Brick has sustained its distribution since becoming an income trust almost two years ago, but it's getting into more risky territory — especially as the housing market slows down.

MoneySense did the same survey last year, but with different results. Only two trusts won an A mark: Advantage Energy Income Fund (which went down to C this year) and TransCanada Power (which was acquired by another firm).

Another 12 trusts were awarded a B mark last year. North West Company Fund and Shiningbank Energy Income Fund stayed at B this year, while Peak Energy Services Trust became an A. The rest went down to C.

So, things change. If you're worried about unsustainable distributions, read those press releases carefully. And keep a finger on the trigger in case you see payouts edge up to 95 per cent or higher.

Ellen Roseman*'s column appears Wednesday, Saturday and Sunday. You can reach her by writing Business c/o Toronto Star, 1 Yonge St., Toronto M5E 1E6; by phone at 416-945-8687; by fax at 416-865-3630; or at erosema@thestar.ca by email.*

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