Income Securities: The Next Generation of Income Trusts

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A flurry of recent activity on Wall Street—and the accompanying press—heralds the arrival of a new entrant in the ever-evolving parade of securities developed to meet liquidity needs of companies and entice interest among investors. The latest? Income deposit securities (IDS) and their sisters, income participating securities (IPS). IDSs and IPSs offer yield-hungry investors steady returns and an opportunity for appreciation. The hope is that a U.S. income securities market will develop, analogous to its long-established Canadian counterpart, the income trust market. This, in turn, will allow traditional businesses that have been largely shut out of the IPO market since the beginning of the tech boom in the '90s new access to public capital in the U.S.

WHILE THE INCOME TRUST VEHICLE IS NOT RECOGNIZED BY REGULATORS HERE, THE ECONOMIC MODEL COULD BE DUPLICATED THROUGH THE ISSUANCE OF TWO SECURITIES, A STRIP OF SUBORDINATED DEBT AND SHARES OF EQUITY

The Cross-Border Income Trust

To understand the emergence of income securities, one must first look at the recent evolution of the cross-border Canadian income trust. An income trust (also called an income fund or a mutual fund trust) is a vehicle much like a real estate investment trust (REIT) or oil and gas master limited partnership (MLP). It is structured to raise capital through an offering of interests, or shares, and invest that capital in debt and equity securities of a holding company for an operating business. The operating business produces a steady stream of interest and dividends, which are then distributed by the income trust to its shareholders. The income trust itself is not subject to taxation, and a variety of structuring mechanisms are designed to maximize the distributable cash flow by lowering the overall tax burden of the operating company and its related entities. From the investors' perspective, the investment decision is predicated on the income trust's projected yield, or distributions to shareholders. While the potential for growth is part of the analysis, the focus is on the anticipated cash flow (often expected to be in the 8 to 12% range). The investment therefore is designed as an alternative to bonds or bond funds, with the added benefit of possible appreciation through growth of the underlying business. Valuation is based on the level of predictable distributions; accordingly, suitable businesses must produce steady, sustainable cash flow.

The Canadian public has a twenty-year history of investment in income trusts, and in the current low interest rate environment institutional and retail interest in these vehicles has grown. Current estimates are that the market capitalization of income trusts represents as much as 5 to 7% of the total Canadian public market. A *Wall Street Journal* article recently reported that 91% of all initial public offerings in Canada last year were made by income trusts.

Beginning in 2002, a number of U.S. businesses seeking liquidity for their shareholders or funding for other needs accessed the Canadian markets through income trust offerings. (For a short discussion of the typical cross-border income trust structure, see http://www.goodwinprocter.com/publications/hodges_taylor_03_10_03.pdf) The first such transaction, by Heating Oil Partners Income Fund (a home heating oil distributor), was brought to market in May 2002. Over the next 18 months, a number of American companies, in businesses including a household bleach manufacturer, a company investing in landfill gas-to-energy projects and a provider of yellow pages advertising directories, completed offerings of income trust securities These companies' success in raising capital at valuations higher than those available from private market sale transactions attracted attention from private equity sponsors seeking liquidity for their portfolio companies with no prospects for U.S. IPOs.

Emergence of the Income Securities Structure

South of the border, issuers and their advisors wondered, why not in the U.S.? While the income trust vehicle is not recognized by regulators here, the economic model could be duplicated through the issuance of two securities, a strip of subordinated debt and shares of equity. These paired securities offer the same benefits of yield plus possible growth to investors and maximize distributable cash flow through the use of interest deductions for income tax purposes. In December of 2003, the first offering of "income deposit securities" was consummated by Volume Services America Holdings, a catering and sports arena concessions company. Our Canadian neighbors were quick to adopt the concept: in March of 2004, the second offering of income securities, this time with the acronym IPS, or income participating securities, was closed in Canada by Medical Facilities Corporation, a U.S. based chain of surgical centers.

Recent Developments—Accounting Changes

In the fall of 2003, issues raised by auditors for several cross-border income trust vehicles put a sudden halt to new filings and threw pending deals into limbo. The accounting community was struggling to come to a consensus about a key issue underlying the economics of the securities: were they confident that the IRS would respect the debt embedded in the structure, and thus the shelter afforded to the income of the operating business by virtue of the interest deductions? (Although U.S. taxing authorities are aware of the transactions and of the analysis that allows counsel to render opinions that the debt "should" be respected, they have made no proclamations confirming or disputing that analysis. Tax practitioners will generally say that debt-equity issues exist in numerous contexts—and are not particular to income trusts or income securities—and that the IRS's approach is generally to consider situations on a case-by-case basis, taking into account the specific factual circumstances of each transaction.)

Over the ensuing months, potential issuers, their financial advisors, counsel and consultants tinkered with the income trust and income securities structures to develop models that would give additional comfort to the accountants. One at a time, a handful of income trust offerings by U.S. companies were consummated, along with the first IDS offering in the U.S. and the first IPS offering in Canada mentioned above. Today, it appears the major accounting firms are on the verge of proclaiming a collective view of the deal elements required for the auditors' blessing. Notable among these will likely be a mandate that issuers also place, with investors that are not holders of income trust shares or income securities, an "independent" strip of debt of the same class as the income trust's debt investment in the holding company (in the case of income trusts) or as the notes issued as part of the paired income securities (in the case of income securities structures). (This requirement may well spawn an "echo" market in the independent debt strips.) Similarly, a level of independent equity ownership may be required, although the interest retained by the private equity sponsor or other pre-offering shareholders can be anticipated to satisfy this need.

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