



THE CANADIAN INSTITUTE

ADAPTING TO INCOME TRUSTS TAXATION

THE WESTIN HOTEL, CALGARY, ALBERTA

MAY 28-29, 2007

**VALUATION OF TAXED TRUST UNITS:
REAL-WORLD CONSIDERATIONS**

by

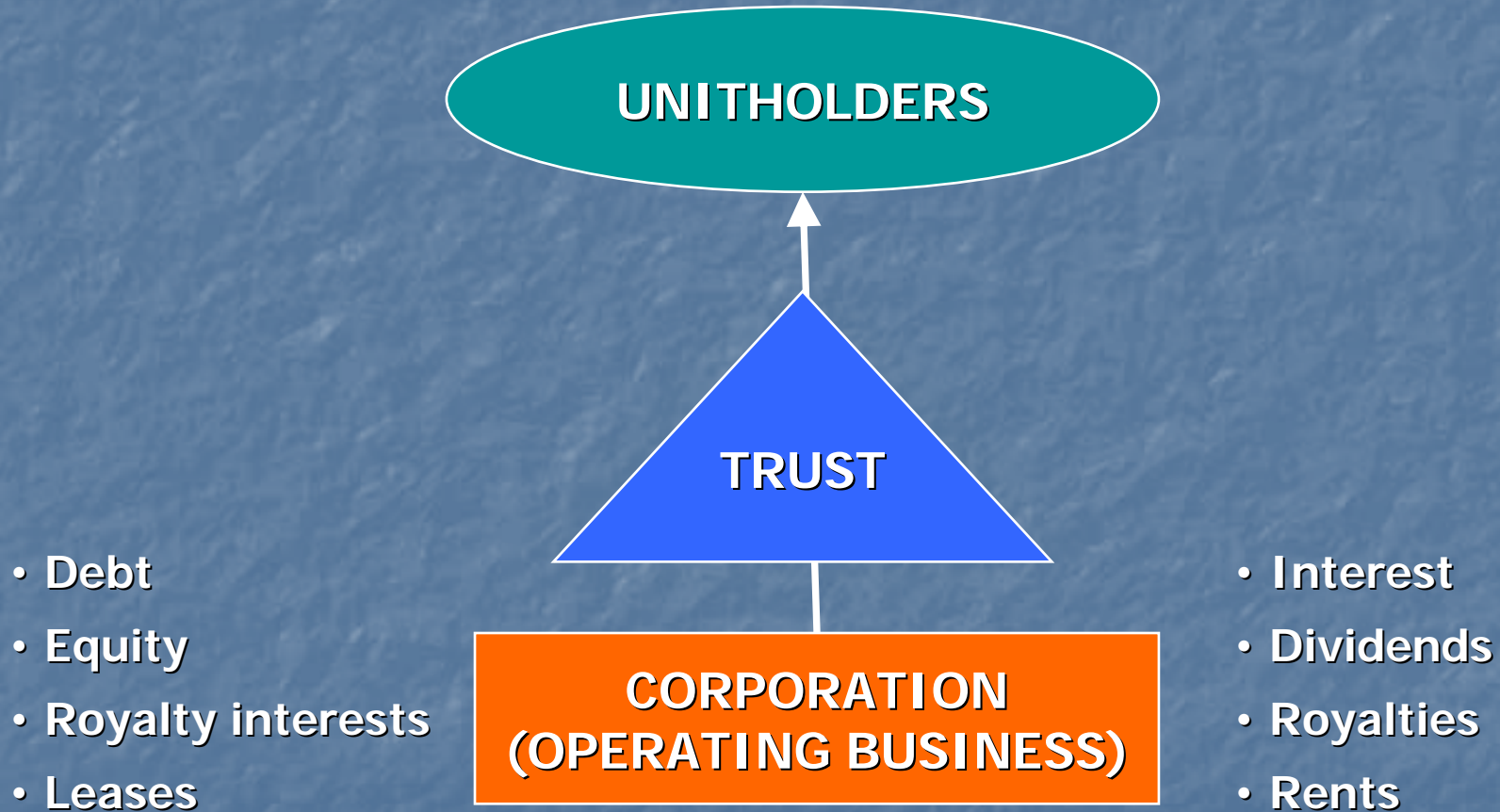
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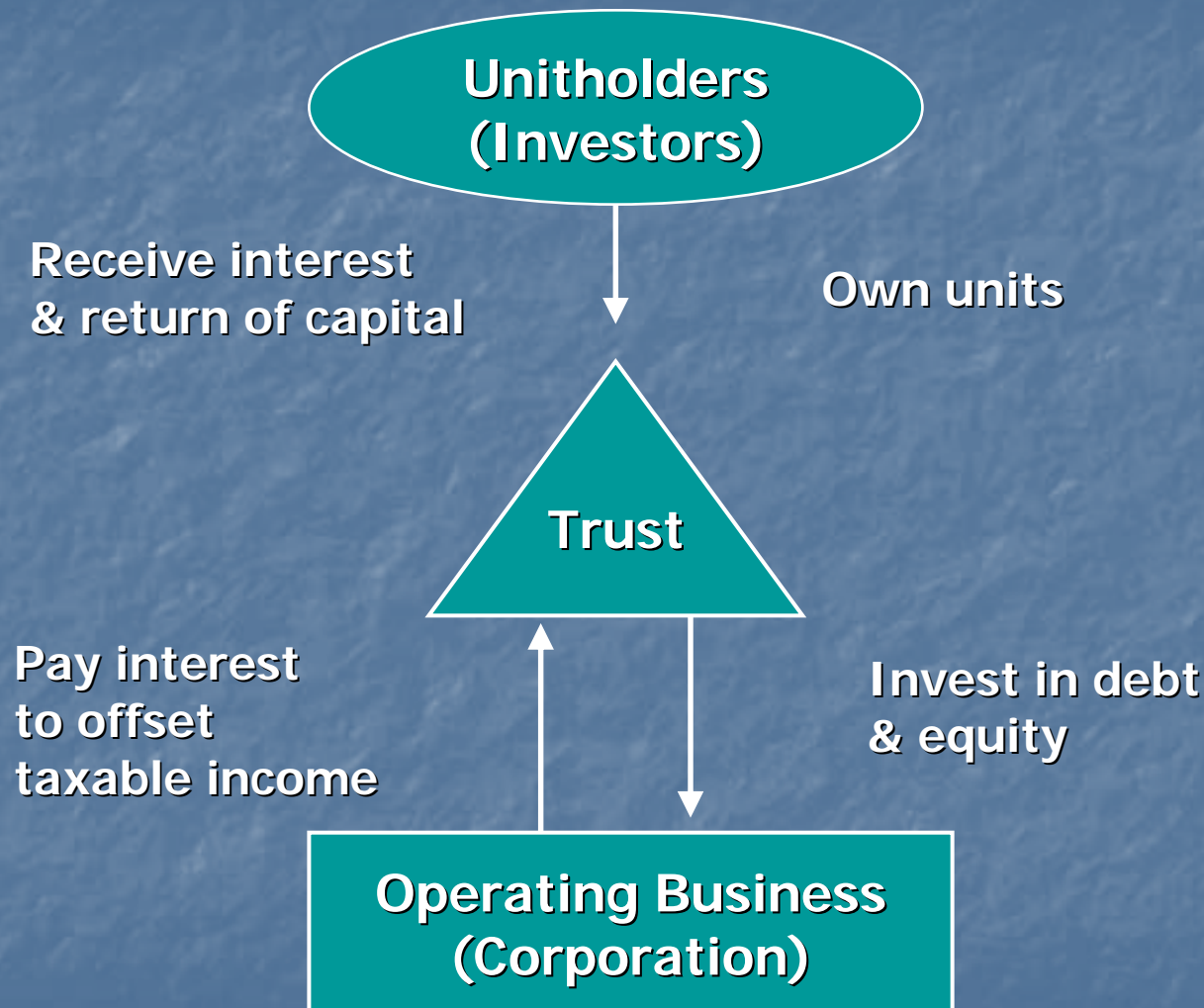
Business Valuation • Fairness Opinions



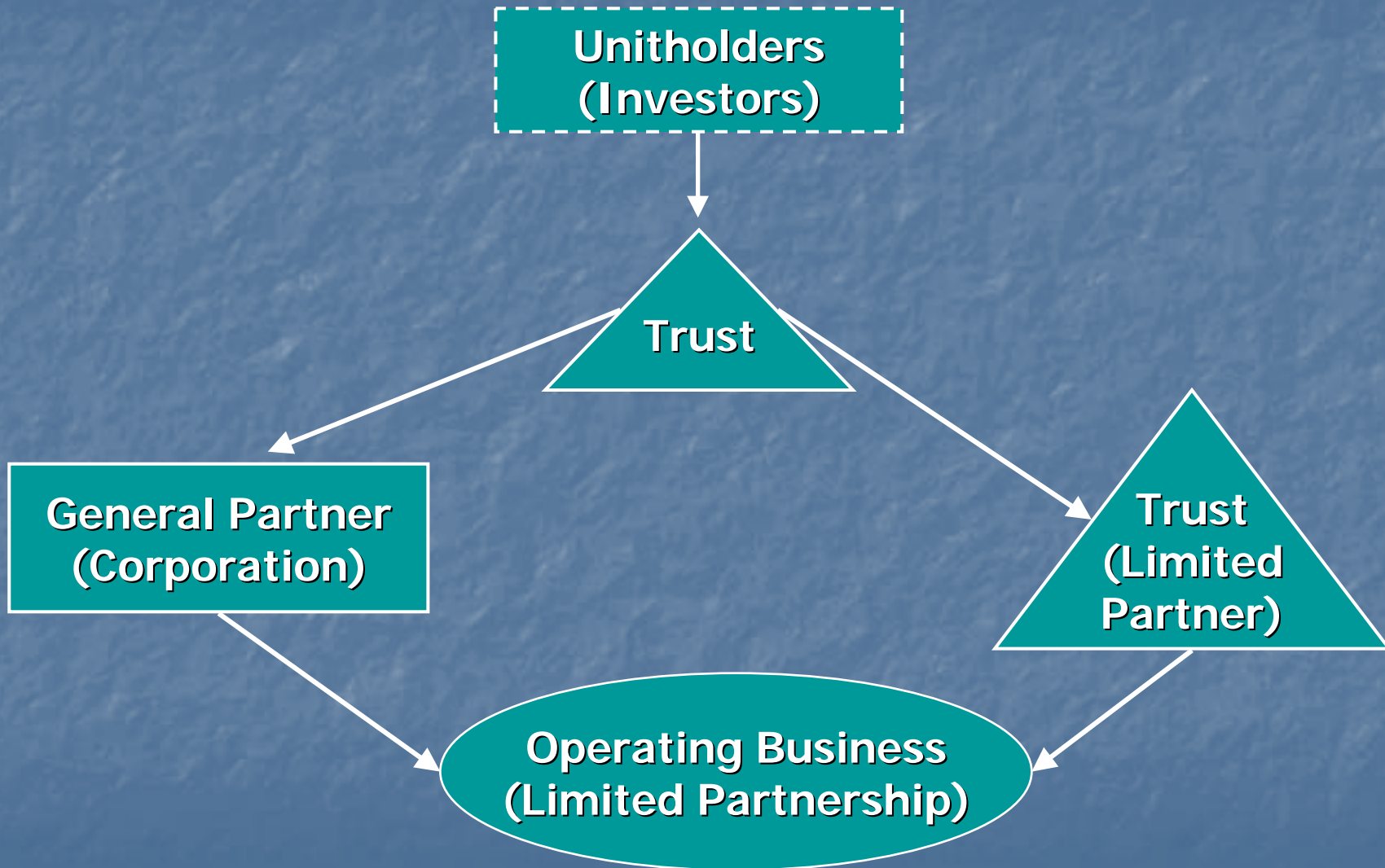
STRUCTURE OF INCOME TRUSTS



BASIC STRUCTURE OF INCOME TRUST



BASIC STRUCTURE OF INCOME TRUST



PRE-OCTOBER 2006 PROPOSALS

VALUATION OF CORPORATE SHARES

versus

VALUATION OF INCOME TRUST UNITS



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INCOME TRUST CONVERSION ANALYSIS

JANUARY 1, 2002 TO AUGUST 31, 2004

Company	20 Trading Days Average Closing Price Prior to Announcement Date	Closing Price Prior to Announcement Date	Announcement Date	Closing Price on Announcement Date	Announcement Premium	Conversion Date	Closing Price on Conversion Date	Conversion Premium
	(A)	(B)		(C)	(D) = [C/A]-1		(E)	(F) = [E/A]-1
Altagas Income Trust	\$14.60	\$15.30	15-Feb-04	\$18.82	29%	05-May-04	\$20.95	44%
Badger Income Fund	3.52	4.42	05-Feb-04	4.60	31%	05-Apr-04	4.60	31%
Enterra Energy Trust	22.74	21.47	05-Aug-03	20.00	-12%	28-Nov-03	25.00	10%
Peyto Expl. and Dev.	12.72	13.70	14-Apr-03	13.76	8%	04-Jul-03	16.00	26%
Newalta Income Fund	3.11	3.90	11-Nov-02	4.15	33%	03-Mar-03	4.65	49%
Average					18%			32%
Median					29%			31%



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2006 TAX PROPOSALS

- To eliminate tax-advantaged status of income trusts and similar issuers
 - Result: All investors (including taxable individuals, non-taxable entities and non-residents) should be indifferent to receiving trust distributions or dividends from corporations
- Effective dates:
 - 2007 for all entities that become publicly-traded on or after November 1, 2006
 - 2001 for existing entities



2006 TAX PROPOSALS

(CONT'D)

- Market price of trust units considers tax status in future
- Some trusts might convert to corporations during grind-down of 4-year tax holiday
- Private equity firms are potential buyers of income trusts



2006 TAX PROPOSALS

(CONT'D)

- Rules apply to most publicly-traded income trusts and partnerships regarding their “non-portfolio properties”.
- Exception for REITs and similar vehicles owning real property in Canada and earning passive income (but retirement homes and hotels might be subject to new rules).
- No exception for oil and gas royalty trusts (unless value of resource properties is less than 50% of value of entity).



EFFECT ON PRICE OF OCTOBER 2006 ANNOUNCEMENT

- Assume income trust paying 9% return to unitholders based on original subscription price.
- Effective 2011, income trust subject to tax at 31.5%. After tax, return to unitholders therefore declines to 6%.
- Canadian income trust market lost \$19 billion in market capitalization one day following October 31, 2006 announcement.
- Unit value of income trusts subject to these rules dropped by 15% to 20%.



CORPORATE INCOME TAX RATES AND VALUES

	2005	2006	2007	2008	2009	2010	2011
Cash Flow Before Taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Corporate Income Tax Rates</i>	<i>36.0%</i>	<i>35.5%</i>	<i>35.0%</i>	<i>34.5%</i>	<i>34.0%</i>	<i>33.0%</i>	<i>32.5%</i>
Income taxes	-36.0	-35.5	-35.0	-34.5	-34.0	-33.0	-32.5
Net Cash Flow	64.0	64.5	65.0	65.5	66.0	67.0	67.5
<i>Value Multiple</i>	<i>10x</i>	<i>10x</i>	<i>10x</i>	<i>10x</i>	<i>10x</i>	<i>10x</i>	<i>10x</i>
Valued	640	645	650	655	660	670	675
<i>Improved Valuation to 2005</i>		<i>0.8%</i>	<i>1.6%</i>	<i>2.3%</i>	<i>3.1%</i>	<i>4.7%</i>	<i>5.5%</i>

SOURCE: Department of Finance, PricewaterhouseCoopers and RBC Capital Markets estimates.



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PROFITS OF TRUSTS vs. CORPORATIONS AFTER CORPORATE AND PERSONAL TAXES

	Current Income Trust	Current Large Business	
		100% Payout	40% Payout
Corporate Profit Before Tax	\$100.00	\$100.00	\$100.00
Business Trust/Corporate Taxes	—	\$36.12	\$36.12
Net Corporate Profit After Tax	\$100.00	\$63.88	\$63.88
Retained Profits	—	—	\$38.33
Cash to Unit/Share Owners	\$100.00	\$63.88	\$25.55
<i>Personal Taxes:</i>			
• Income	\$46.41	—	—
• Dividends	—	\$20.02	\$8.01
• Capital Gains	—	—	\$8.89
Total Taxes	\$46.41	\$56.14	\$53.02
Corporate Profits After Total Taxes	\$53.59	\$43.86	\$46.98
		14%	



CORPORATE AND TRUST VALUE COMPARISONS

		Co. A	Co. B	Trust B No Tax	Trust B 2011
Cash Flow Before Taxes		100.0	100.0	100.0	100.0
Income Taxes	31.5%	-31.5	-31.5	0.0	-31.5
Cash flow After Taxes		68.5	68.5	100.0	68.5
<i>Value Multiple</i>		10x	10x	10x	15x
<i>Cash Yield</i>		10%	10%	10%	7%
Valued	(a)	685	685	1,000	1,000
<i>Value Differential from Conversion</i>				46%	

SOURCE: RBC Capital Markets estimates.



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CORPORATE AND TRUST VALUE COMPARISONS (CONT'D)

TAXABLE CANADIAN INVESTOR		Co. A	Co. B	Trust B No Tax	Trust B 2011
Trust Income				100.0	0.00
Dividend		68.5	68.5	0.0	68.5
Dividend Gross-up	45%	30.8	30.8	0.0	30.8
<hr/>					
Taxable Income		99.3	99.3	100.0	99.3
Tax Thereon	46%	45.7	45.7	46.0	45.7
Dividend Tax Credit	32%	-31.8	-31.8	0.0	-31.8
<hr/>					
Total Taxes		13.9	13.9	46.0	13.9
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After-Tax Cash Flow	(b)	54.6	54.6	54.0	54.6
After-Tax Return on Investment	(b)/(a)	8.0%	8.%	5.4%	5.5%

SOURCE: RBC Capital Markets estimates.



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CORPORATE AND TRUST VALUE COMPARISONS (CONT'D)

CANADIAN PENSION INVESTOR	Co. A	Co. B	Trust B No Tax	Trust B 2011
Income/Dividend	68.5	68.5	100.0	68.5
<i>After-Tax Return on Investment</i>	10.0%	10.0%	10.%	6.9%

SOURCE: RBC Capital Markets estimates.



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VALUATION IMPLICATIONS OF 2006 TAX PROPOSALS

- Decline in unit values will require trust management to review various issues impacting valuation:
 - Goodwill impairment
 - Revaluation of debt
 - Valuation of contingent consideration
 - Unit- or stock-based compensation
 - Other



FACTORS IN TRUST VALUATIONS

- Particular type of income fund
- Return of capital
- Foreign income
- Types of operating assets
- Payout ratio
- Other factors



FACTORS IN TRUST VALUATIONS

(CONT'D)

- **Other factors:**
 - **Organic vs. inorganic growth**
 - **Liquidity**
 - **Oil prices**
 - **Volatility of trust unit**
 - **Access to capital**



OTHER FACTORS IMPACTING VALUE OF INCOME TRUSTS

- Changes to business model/structure
- Sustainability of distributions
- Changes to taxation
- Calculation and disclosure of distributable cash



VALUATION CONSIDERATIONS

- Expected distributions and yield
- Growth in distributions
 - Strengths of underlying businesses
- Acquisition mode of business
- High debt might cause trust to reduce distributions (to pay down the debt)
- Organic v. inorganic growth
 - Increased cost of capital for acquisition-based trusts
- Pre-tax and after-tax yields



VALUATION CRITERIA

INCOME APPROACH: CASH FLOW METHOD

- Starting point: Earnings pursuant to Canadian GAAP.
- Must look at accounting policies and disclosures of particular vehicle.
- Earnings are affected by capital structure: debt versus equity and transactions; acquired loss carryforwards or tax pools.
- Taxation is important issue and management will attempt to reduce cash taxes on earnings, resulting in increased cash flow.
- GAAP earnings for a company in the same business can vary widely.



DISTRIBUTABLE CASH IN INCOME TRUSTS AND OTHER FLOW-THROUGH ENTITIES

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

GUIDANCE ON PREPARATION AND DISCLOSURE IN MANAGEMENT'S DISCUSSION AND ANALYSIS

DRAFT INTERPRETIVE RELEASE
November 2006



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CICA DRAFT FOR COMMENT

- **DEFINITION AND COMPUTATION OF DISTRIBUTABLE CASH FROM OPERATIONS**
 - Components of Distributable Cash from Operations
 - General criteria for adjustments
 - Productive capacity maintenance adjustment
 - Adjustment for changes in long-term unfunded contractual operational obligations eventually funded from or contribute to operating cash flows
 - Adjustment for financing restrictions caused by debt covenants



CICA DRAFT FOR COMMENT

(CONT'D)

- Disclosure for adjustments to cash flows from operating activities
 - Nature and reason for adjustment
 - Method for computing adjustment
 - Estimates and assumptions
 - Trends
 - Comparison with amounts reported in the financial statements



CICA DRAFT FOR COMMENT

(CONT'D)

- Disclosure of Distributable Cash from Operations and reconciliation to cash distributions
 - Disclosure of Distributable Cash from Operations in total and on per-unit basis
 - Disclose Cumulative Distributable Cash from Operations and distributed cash
 - Payout ratios
 - Time period for determining cumulative amounts
 - Reconciliation of Distributable Cash from Operations with distributed cash



DEFINITION AND COMPUTATION OF “DISTRIBUTABLE CASH FROM OPERATIONS”

- Distributable Cash from Operations defined as periodic cash flows from operating activities as reported in the GAAP financial statements, including change in non-cash working capital and excluding any cash flows from discontinued operations, less provisions for:
 - a. productive capacity maintenance expenditures;
 - b. funding of long-term unfunded contractual obligations arising from operations; and
 - c. restrictions on distributions arising from compliance with financial covenants operational at date of calculation of Distributable Cash from Operations and those likely to become operational within 12 months of that date.

- No other adjustments for “one-time” or “unusual items” to be made to cash flows from operating activity in calculation of Distributable Cash from Operations.

SOURCE: CICA Draft for Comment.



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SUMMARY OF CICA'S NEW DRAFT GUIDANCE FOR "DISTRIBUTABLE CASH"

- CICA'S guidance in Management's Discussion and Analysis addresses four key questions:
 1. How much cash generated during the period and source thereof?
 2. Is sufficient cash being retained to provide for all long-term unfunded contractual liabilities, such as pension plans?
 3. Is sufficient cash being retained within trust to maintain productive capacity?
 4. If distributable cash to be distributed, is it likely that entity will meet future commitments (e.g., loan covenants) for foreseeable future?



AOL TIME WARNER INC. YEAR ENDED DECEMBER 31, 2002

Reduction in Carrying Value of

Billions
(U.S.)

Goodwill (AOL)	\$33.5
Cable segment	10.6
Music segment	0.6
Brands and trademarks at Music segment	<u>0.9</u>
Impairment charge (to operating income)	<u>\$45.5</u>



AOL MANAGEMENT EXPLANATION OF WRITE-DOWNS

“The \$33.489 billion charge at the AOL segment reflects the AOL segment’s lower than expected performance, including the continued decline in the online advertising market. The \$10.550 billion charge at the Cable segment reflects current market conditions in the cable television industry, as evidenced by the decline in the stock prices of comparable cable television companies. The \$1.499 billion charge at the Music segment reflects declining valuations in the music industry, primarily due to the negative effects of piracy.

“The impairment charges are non-cash in nature and do not affect the company’s liquidity ... ”.

