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Former Income Trusts to Lead High-Yield Surge: Canada Credit
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By Matt Walcoff

Jan. 28 (Bloomberg) -- Canadian companies that were once income trusts are preparing to sell about C$1.7 billion ($1.71 billion) in junk bonds after the cost of borrowing fell to the lowest level since July 2008 and as they seek to replenish cash paid out to unitholders.

Converted income trusts may account for all of the 49 percent increase in high-yield Canadian issuance in 2011, said Robert Follis, head of corporate bond research at Bank of Nova Scotia in Toronto. Penn West Petroleum Ltd., ARC Resources Ltd., Crescent Point Energy Corp. and Cineplex Inc. are among 17 new corporations that may issue debt, according to a presentation from Scotiabank’s high-yield trading desk.

The extra yield investors demand for Canadian high-yield bonds versus federal government debt fell to 4.63 percentage points on Jan. 24, the lowest in more than two years, according to Bank of America Merrill Lynch indexes. Although former trusts now retain more of their operating profit for reinvestment, that won’t make up for years of making monthly cash payouts to investors, said Geof Marshall, co-manager of the C$1.07 billion CI Signature Corporate Bond Fund.

“To the extent these companies were paying out large chunks of their cash flows, it’s quite possible they’re underinvested” in plants and research and development, said Toronto-based Marshall. “There are investments they need to make into their business.”

Two bond sales are planned by former energy trusts in the first half of the year, said J.J. McHale, director of debt capital markets at Bank of Montreal. Each company will issue between C$150 million and C$250 million, he said.

Inflation Target

Elsewhere in credit markets, Angelo Melino, an economics professor at the University of Toronto, wrote in a C.D. Howe Institute publication that the Bank of Canada should lower its inflation target to 1.5 percent from 2 percent this year and eventually to 1 percent. The change would help the bank meet its mandate of keeping price gains under control over long periods and correct “past deviations” from the target.

Melino was an adviser to the central bank in 2008-09. The C.D. Howe Institute does research and analysis on Canadian public policy.

Gross domestic product grew for a second month in November, increasing 0.2 percent, according to the median forecast in a Bloomberg News survey of five economists before Statistics Canada releases the data on Jan. 31. It also gained 0.2 percent in October.

Maple Bonds

Morgan Stanley, the New York-based investment bank, sold C$400 million in 4.85 percent Maple Bonds maturing in February 2016. Maple Bonds are debt sold by foreign borrowers in Canadian dollars.

Bank of Montreal, Canada's fourth-biggest bank, sold C$1 billion in two issues of floating-rate notes maturing in February 2012.

Canada plans to sell C$3 billion in 3.25 percent bonds maturing in June 2021 on Feb. 2.

The extra yield investors demand to own debt of Canadian corporations rather than the federal government was unchanged yesterday at 132 basis points, according to a Bank of America Merrill Lynch index. A basis point is 0.01 percentage point.
Yields fell to 3.95 percent, from 3.98 percent on Jan. 26.

The yield spread on Canada's provincial bonds slipped 1 basis point to 52 basis points yesterday, according to Bank of America data. Yields decreased to 3.37 percent, from 3.41 percent on Jan. 26.

The 10-year Canadian government bond yielded 3.28 percent, down from 3.31 percent on Jan. 26. The U.S. 10-year Treasury yielded 11 basis points more, an increase of one basis point and the widest spread in a week.

Trust Taxes

When Finance Minister Jim Flaherty announced in October 2006 that Canada would begin taxing income-trust distributions in 2011, 255 income trusts traded on the Toronto Stock Exchange, according to TMX Group Inc. They've all converted to corporations, with the exception of real estate investment trusts, which are exempt from the tax change.

Income trusts avoided most taxes because they paid out most of their cash flow to investors in monthly distributions. The market value of trusts had soared in six years to almost C$200 billion after firms were attracted to the tax breaks and investors were drawn to average dividend payouts of 8 percent a year.

No Limits

The conversions to corporations also mean the former trusts are no longer bound by caps on borrowing and expansion, allowing them to tap debt markets for financing.

"Income trusts used to be beholden to Jim Flaherty's rules about growth," said Robert Inglis, chief financial officer of First National Financial Corp. in Toronto, a former income trust that issued C$175 million in bonds last year. "Now that they've converted to corporations, they can do whatever they want.
You're going to see a lot of companies in those spaces issue."

Newly converted corporations may also want to issue debt to reduce their tax burden, said Jonathan Allen, head of Canadian credit research in Toronto at Royal Bank of Canada's RBC Capital Markets unit.

Former income trusts will find investor demand for their debt because of relatively low yields on investment-grade bonds and concern about volatility in the stock market, said CI Signature's Marshall, whose fund owns bonds of former income trusts including Yellow Media Inc., Bell Aliant Inc. and Superior Plus Corp.

First National

Bonds from converted trusts tend to receive so-called junk- bond ratings of lower than BBB- at Standard & Poor’s, meaning the debt is high-yield and high-risk, because the companies tend to be smaller and pay higher dividends than other issuers, Bank of Nova Scotia’s Follis said.

Groupe Aeroplan Inc., Homeq Corp. and Newalta Corp. issued bonds last year after converting to corporations, while four other companies, including mortgage lender First National, issued bonds before converting.

First National’s 5.07 percent bond maturing in May 2015, rated BBB by DBRS Ltd., has returned 9.2 percent since its issuance last May, compared with a 4 percent return for a Bank of America index of Canadian BBB rated corporate bonds.

The Bank of America Merrill Lynch Canada High Yield Index has gained 0.8 percent this year, adding to returns of 22 percent return last year and 32 percent in 2009.

In April 2009, investors demanded 15 percentage points more in yield for Canadian junk bonds over federal bonds. Since then, the yield on the High Yield Index has fallen to 7.4 percent from 16.9 percent.

More Sales

Marshall said his team has been pushing some former income trusts to sell bonds, hoping to be among the first to buy the securities. He said he has confidence in the companies’ track records and knows the coupons on their bonds provide protection in case interest rates rise.

“We like high-yield debt over investment grade at this point, and these are companies we’re already familiar with,” he said.

Cineplex has no plans to issue bonds, Pat Marshall, a spokeswoman for the company that owns interests in 132 movie theaters in Canada, said in a telephone interview.

Jason Fleury, a spokesman for Penn West; Trent Stangl, a spokesman for Crescent Point; and ARC Resources Chief Executive Officer John P. Dielwart didn’t return phone calls.

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