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Income Trusts, Income Deposit Securities, Enhanced Income Securities and Income Participating Securities

A new breed of financial product is currently getting attention in the U.S. investor community.[1] This memorandum is intended to inform our private equity clients about this product, as it may represent, in appropriate circumstances, an attractive exit strategy.

Income Deposit Securities ("IDSs") first appeared in the U.S. marketplace in December, 2003 when they were sold in a $250 million initial public offering by Volume Services America Holdings (AMEX – CVP). An initial public offering of up to $650 million of IDSs by American Seafood Corporation is currently on file with the SEC, and B&G Food Holdings Corp. has recently filed with the SEC for an initial public offering of up to $565 million of Enhanced Income Securities ("EISs"). IDSs and EISs are similar securities, each consisting of a linked high-yield debt security and a dividend-paying common share that are traded on U.S. exchanges (to date, the AMEX). An initial public offering of Income Participating Securities ("IPSs") by Medical Facilities Corporation (a South Dakota chain of ambulatory surgical centers) closed on March 29, 2003, and these securities are now trading on the Toronto Stock Exchange[2]. IPSs (effectively the same as IDSs and EISs) are yet another new iteration of this product.

History

The Volume Services, American Seafood and B&G Food transactions are the first of their type in the U.S. capital markets. The Volume Services IPO was lead-managed by CIBC World Markets, the U.S. investment banking affiliate of the Canadian bank, CIBC. The two other transactions currently on file with the SEC are being led by CIBC World Markets and RBC Capital Markets, a U.S. investment banking affiliate of the Royal Bank of Canada. The lead underwriter in the Medical Facilities transaction was BMO Nesbitt Burns. That these deals are led by these underwriters is not surprising in light of the fact that the structure has its roots in the Canadian income trust. The Canadian income trust has been an enormously popular IPO structure in Canada over the last few years. In 2002, for example, when the United States had one of its slowest IPO years ever, Canada had one of its most

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1 See "Deal and Deal Makers: Is Wall Street's Latest Kosher" in the Wall Street Journal, April 7, 2004.

2 Ticker Symbol is DR_U. Paul, Weiss was U.S. counsel to the underwriters in this offering.

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active IPO years ever, with over 90% of the IPOs in Canada that year in the form an offering of trust units by income trusts. This trend continued through 2003, with issuances of trust units totaling Cdn. $10 billion. The current market capitalization of income trusts on the Toronto Stock Exchange exceeds Cdn. $40 billion or 5% of the total capital markets in Canada

A Canadian income trust is a publicly traded trust that invests in an operating company that owns assets that produce stable and consistent cash flow. The structure contemplates payments by the operating company to the publicly-traded trust of large annual cash amounts in the form of royalties, dividends and/or interest payments with that cash flow then passed through to the trust's unitholders without taxation at the trust level. Because much of the income paid out by the operating subsidiary is in the form of tax-deductible interest or royalty payments, a substantial portion of the operating company's pre tax cash flow is available to be distributed to the trust and then by the trust on to its unitholders.

The Canadian income trust was developed as a variation on the Canadian oil and gas royalty trust, which originated in the mid-1980s (and shares many features in common with U.S. master limited partnerships (or MLPs)). In the past few years, the income fund became a popular vehicle for taking a variety of non-oil and gas businesses public in Canada. There appears to be no limit to the type of business that this structure can work for, provided that the assets of the operating company generate (and are expected to continue to generate) reasonably steady and consistent cash flow. The income fund structure has been used in industries ranging from cold storage facilities to sardine manufacturers and remains enormously popular in Canada. The yield on Canadian income trusts generally ranges from 8%-12%, and in the prevailing low-interest environment, these offerings have been well received by the Canadian investing public.

In 2002, Canadian investment bankers began actively promoting this product to U.S. companies and their private equity sponsors. The first such "cross-border trust" – Heating Oil Partners Income Fund – went public on the Toronto Stock Exchange in May 2002. A number of similar Canadian IPOs of U.S. businesses were completed in 2003.[3]

The IDS/EIS Structure

Because of the enormous appetite in Canada for high-yielding income trust securities, Canadian investment banks have begun to focus on the U.S. capital markets, asking whether this type of product might be of interest to the U.S. investor community. Several Canadian oil and gas royalty trusts have listed on the New York Stock Exchange (including PrimeWest, Pengrowth, EnerPlus) and found a welcome reception in the U.S. capital markets. However, the imposition of a Canadian trust on a U.S. operating company to enable it to become a Canadian income trust is complex and, more important, the Canadian capital market (as discussed below) does not easily accommodate IPOs

[3] Examples of Canadian income trust transactions by U.S. businesses include Heating Oil Partners Income Fund, KCP Income Fund, Associated Brands Income Fund, and Great Lakes Carbon Income Fund. Paul, Weiss represented the underwriters in the Great Lakes Carbon Income Fund.

above a certain dollar size. On the U.S. side, the use of a trust does not provide the tax efficiencies that it does in Canada (except in the case of real estate investment trusts). Consequently, Canadian investment banks have developed Americanized versions of the Canadian income trust in the form of the IDS and EIS that replicate the benefits of an income fund but do not involve the use of a trust. The IDS/EIS is a temporarily non-separable, U.S. exchange-traded unit that consists of a high-yield debt security and a common share (the linked security effectively serving as a surrogate for the trust unit that is held by a Canadian income fund investor).

In today's low-interest environment in the United States capital markets, U.S. investors may be enthusiastic about these new products. They provide similar tax efficiencies to Canadian income trusts and are high-yielding, publicly traded investments like the Canadian income trusts, but they avoid some of the complexities of the Canadian income trust. Most important, there appears to be an appetite for these securities in the U.S. capital market and thus the possibility of accommodating IPOs of significant size.

Most recently, our firm acted on behalf of BMO Nesbitt Burns as lead underwriter in an IPO in Canada of Income Participating Securities (similar to IDSs and EISs) offered by a U.S. company, Medical Facilities Corporation. BMO Nesbitt Burns, a leading Canadian investment bank, concluded that, due to the relatively small offering size (Cdn.$221 million), this particular company was better served by doing its IPO in Canada, with its IPSs listed only on the Toronto Stock Exchange. Going forward, this structure is likely to replace the income trust structure for U.S. businesses that do their IPOs in Canada by selling a yield bearing security as opposed to pure equity.

Our firm acts as counsel in several IDS offerings currently in process that have not yet been publicly filed.

Conclusion

In the North American capital markets (Canada and the United States) there are now three basic variations of the structure: (1) the TSX-listed Canadian income trust for Canadian-based businesses, (2) the AMEX-listed IDS or EIS for U.S. businesses with IPO sizes in the $200 million and above, and (3) the TSX-listed IPSs for IPOs by smaller U.S. businesses.

We understand that although the IDS/EIS securities were first developed by Canadian investment banks, many of the major U.S. investment banks are now familiar with these products and are marketing them to their clients.

The optimal candidate for an IPO involving the IDS/EIS/IPS security is a business whose valuation is in the $200 million - $1 billion range. The business needs to have stable and consistent cash flow and a management prepared to see the bulk of the business's cash flow distributed in the form of dividends and interest payments to public investors. But because of the high valuations given to companies whose IPOs have been effected in this fashion, these vehicles may be an exit vehicle worth considering by private equity investors.

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These structures present complex tax and other considerations. If you would like to discuss this further, please call any of us.

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