Capital Markets 101 and Utilities’ Investing

OEB - September 2009
Turmoil in the Capital Markets

- Events in the economy and the financial markets over the past 15 months are unprecedented
  - Extreme volatility and extremely low valuations
  - Lower equity valuations have made equity financing less attractive for most companies
  - Liquidity squeeze and higher spread levels made the cost of issuing new debt more expensive (public and private markets)
  - Capital market conditions have improved

- A period of several years preceding the credit crisis should not be considered normal market conditions
  - Capital was available at more attractive rates that it normally would be in a more normal lending environment
  - Capital was much more available in general and available more widely to companies with high leverage
  - Era of leverage buyouts, super-sized M&A deals, and of private equity involvement/influence
Historic Spreads (Corporate A)
Historic Yields (Government)
Issuance by Canadian Utilities

- Utilities maintained good access to the capital markets in 2008-2009
  - $3.2B of issuance in Jan-Aug 2009. Remaining 2009 maturities of $1.1B.
- Future issuance calendars will be busy
  - $1.7B of issuance to refinance 2010 maturities + $2.3B of new CAPEX
  - Approx $1.7B of issuance annually to refinance maturities in 2011-2013
All-In Funding Costs

- During 2009, overall cost of new debt was 5.5% (spread of 290 bps) for 10-year debt, and 6.3% (spread of 250 bps) for 30-year debt
- Covenant packages are largely unchanged from recent past
- Although corporate issuers in general shortened the term, highly rated Canadian utilities were able to issue 30-year debt

<table>
<thead>
<tr>
<th></th>
<th>10-year Utility</th>
<th>30-year Utility</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All-In Yield</td>
<td>Spread</td>
</tr>
<tr>
<td>Jun-07</td>
<td>5.3%</td>
<td>68 bps</td>
</tr>
<tr>
<td>Jun-08</td>
<td>5.0%</td>
<td>120 bps</td>
</tr>
<tr>
<td>Oct-Dec 08</td>
<td>5.9%</td>
<td>246 bps</td>
</tr>
</tbody>
</table>

Note: Trading Yield
Source: Bloomberg
US Utilities Issuance

- 2008 was a record year for new debt issuance. 2010 issuance is expected to be below 2009 levels.

Debt issuance by US utilities

- 2007: US$40 billion
- 2008: US$50 billion
- YTD 2009: US$30 billion

Source: Barclays Capital
Perspective on US Utilities

• A number of differences between Canadian and US utilities:
  – Ownership (few are municipally/provincially owned)
  – Diversified business profiles
  – Rate reviews less frequent than in Canada
  – Credit ratings lower than in Canada (A/BBB with Stable outlooks vs A)
  – Lack of bond covenants
  – Active pre-funding activity for 2010 and 2011 maturities (late 2008- H109)

Source: Merrill Lynch, Feb 2009 NARUC, Dr L Booth
Utilities as Bond Investments

- Have highly-levered balance sheets (60%-70% debt to capital)
- Have significant capital investment programs
- One of few sectors with rating upgrades and positive outlook changes
- One of few sectors able to raise 30-year debt financing
- Have generally been able to raise funds cheaper than many other sectors
- Significant capital investment programs and 30-year funding needs require
  - Stable regulation and cost pass-through
  - Expectation of stable credit ratings
  - Stable capital structures
  - Adequate levels of ROE to continue as a viable enterprise
- Core (but not the only) sector for investing fixed income monies
- Return and yield potential is
  - Viewed in the context of the overall portfolio and risk-adjusted return
  - Compared with return/yield potential in other sectors
  - Compared with return/yield potential of utility paper in other jurisdictions and/or other currencies
Bond Investor Concerns

• High leverage (60%-70% of debt in the capital structure)
• Investors want to see bond covenants
  – Well-defined change of control covenants with Canada calls (not just calls at par)
  – Financial covenants (max debt/cap with all debt accounted for, interest coverage tests, restrictions on distributions, interest step-ups as ratings go down)
• Different ownership structures may have different implications for:
  – dividend payments
  – total indebtedness (i.e. additional debt at the holding company level)
• Future M&A and leveraged buyouts (?)
  – Will increase perception of risk - of the company and the industry
  – Will increase cost of debt capital – for the company and the industry
  – Will decrease the company’s ability to raise long-term capital
  – Will shrink a pool of debt investors willing to provide capital
• Inadequate levels of compensation for taking on risk
  – Low equity ROEs could result in lower than optimal access to funding
  – Creates incentives for undertaking higher-risk, higher-return / unregulated activities by the holding companies
Lessons From Other Markets

- Transparent, explainable and consistent decision-making
- Regular investor updates (debt and equity, annual)
- Longer decision periods (3-5 years)
- Performance based regulation that motivates companies to out-perform their targets and shares the benefits of out-performance with the consumer
- Minimum credit ratings required by the regulator for operating companies (usually A-/BBB+) which takes care of regulated capital structures
- Use of embedded cost of capital
- Covenants – higher leverage requires more comprehensive covenant packages
- Other – setting risk-free rates
  - Theoretically correct but challenged by the practice of using government bond rates as risk-free rates (CDS?)
  - Use of min and max bond yield levels, set to recognize that for periods of 3-5 years financial markets can act outside the realm of reasonable, thus skewing results of a formulaic approach
Where Are We Now?

- We are in a post-bubble credit collapse environment
- The downturn has probably run its course, but the recovery is expected to be tepid and the gradual expansion remains vulnerable to shocks
- The global economy is being held afloat by fiscal stimulus
- New issuance was constrained for part of 2008 and 2009 by the credit crisis and by historically wide levels of corporate spreads
- Market conditions improved in Q2009 and new issuance followed
Robust Supply Over Next Few Years

- Over the next few years, the markets will be challenged by a wall of supply
  - Demand and supply are important drivers of borrowing costs
  - Peak refinancing needs for Canadian borrowers come in 2010-2011
  - Domestic corporate investment grade refinancing to grow 75% to the peak year 2010
- Government debt refinancings to grow 160% to the peak in 2010 and will remain elevated until 2015
Robust Supply Over Next Few Years

- Refinancing of existing debt is only part of the supply story
- Need to account for NEW financing needs from corporate and government issuers
  - In deficit-prone years, total government issuance exceeds debt retirements by a wide margin

Source: CIBC, Bank of Canada
Where Are We Going?

- Projections of high corporate and government bond supply for next few years
- Corporate spreads could widen over the near-term, but demand for income-type products (bonds and dividend paying stocks) should keep the spreads in check
- Despite improvements in global economy and easing in overall financing conditions, more credit losses and bankruptcies are in store
- Rate of deterioration in credit quality has slowed, but corporate default rates are projected to rise/remain high
Questions?