Sun Life Financial

Capital Markets 101
and
Utilities' Investing

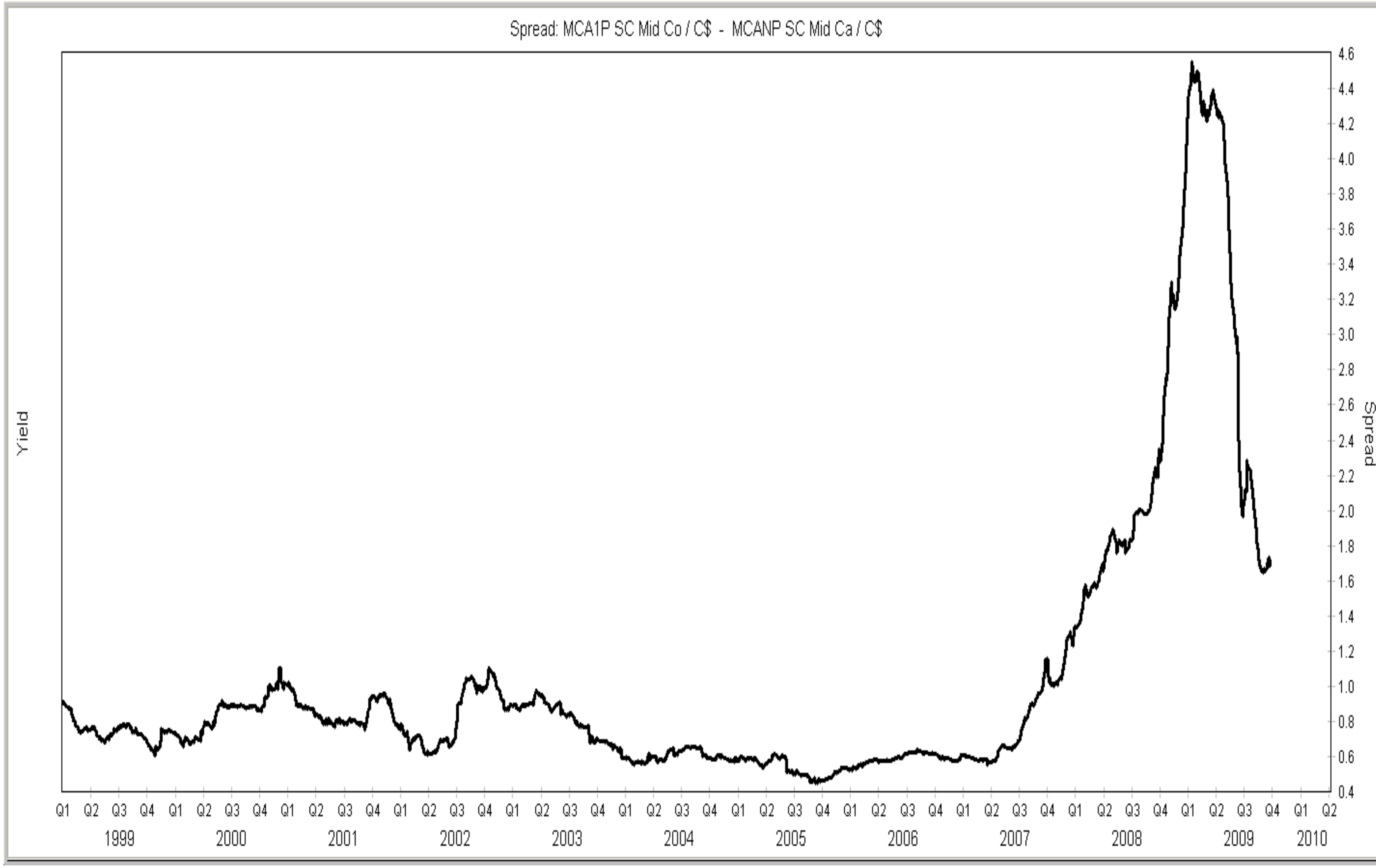
OEB - September 2009

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)

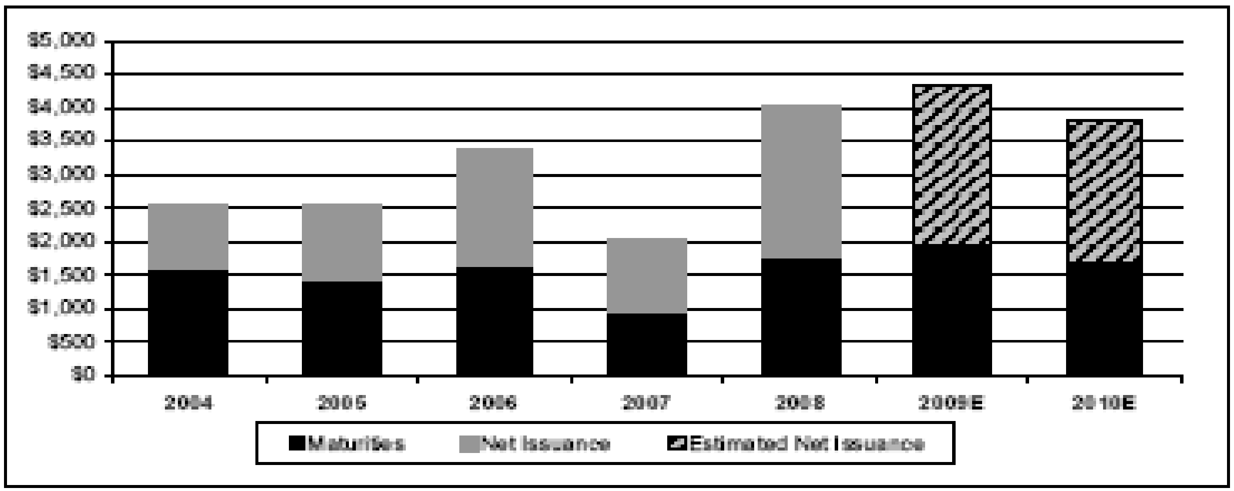


Historic Yields (Government)

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

Chart 1: Historical and Projected Debt Issuance



Source: BMO Capital Markets, Bloomberg

All-In Funding Costs

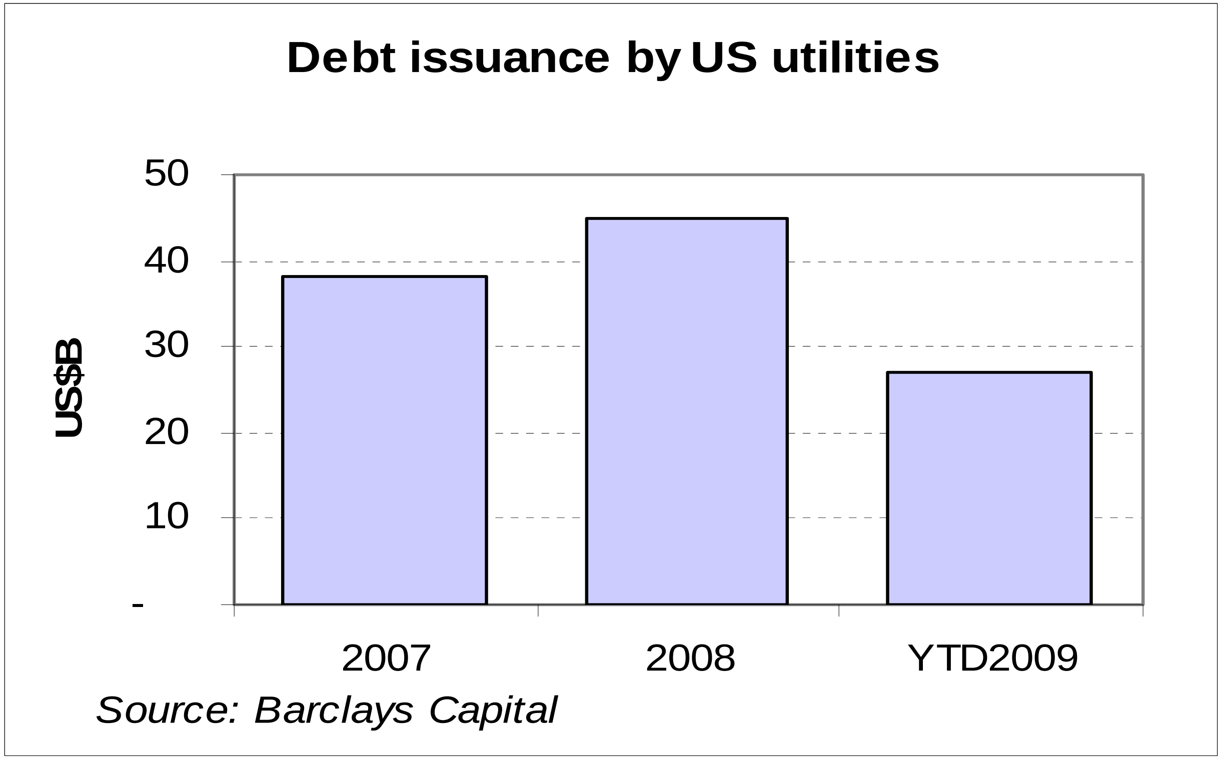
	10-year Utility		30-year Utility	
	All-In Yield	Spread	All-In Yield	Spread
Jun-07	5.3%	68 bps	5.6%	104 bps
Jun-08	5.0%	120 bps	5.7%	158 bps
Oct-Dec 08	5.9%	246 bps	7.0%	305 bps

Note: Trading Yield *Source: Bloomberg*

- 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

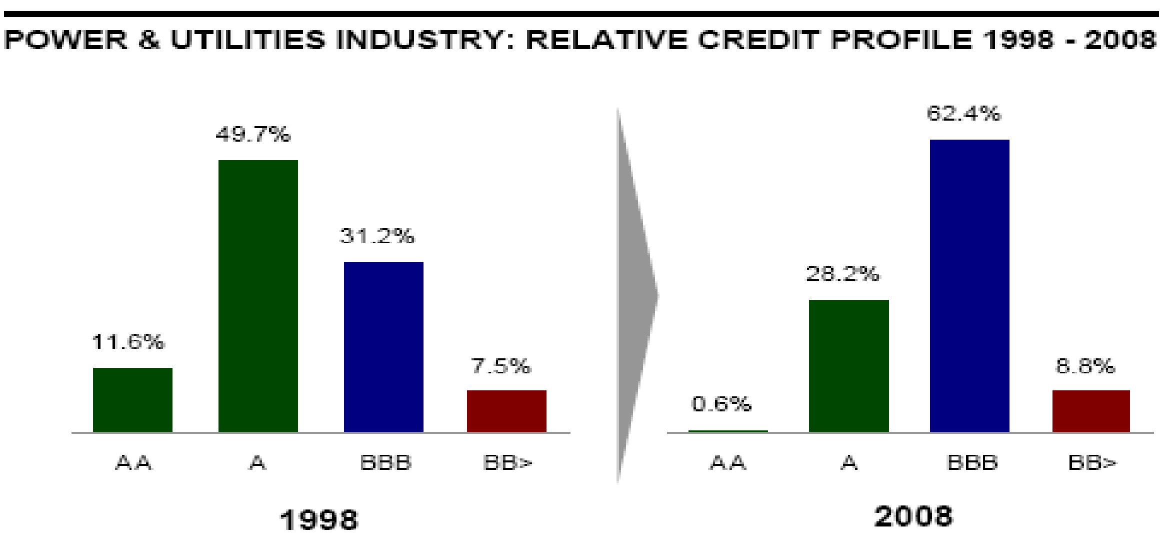
US Utilities Issuance

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



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 sector
- 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

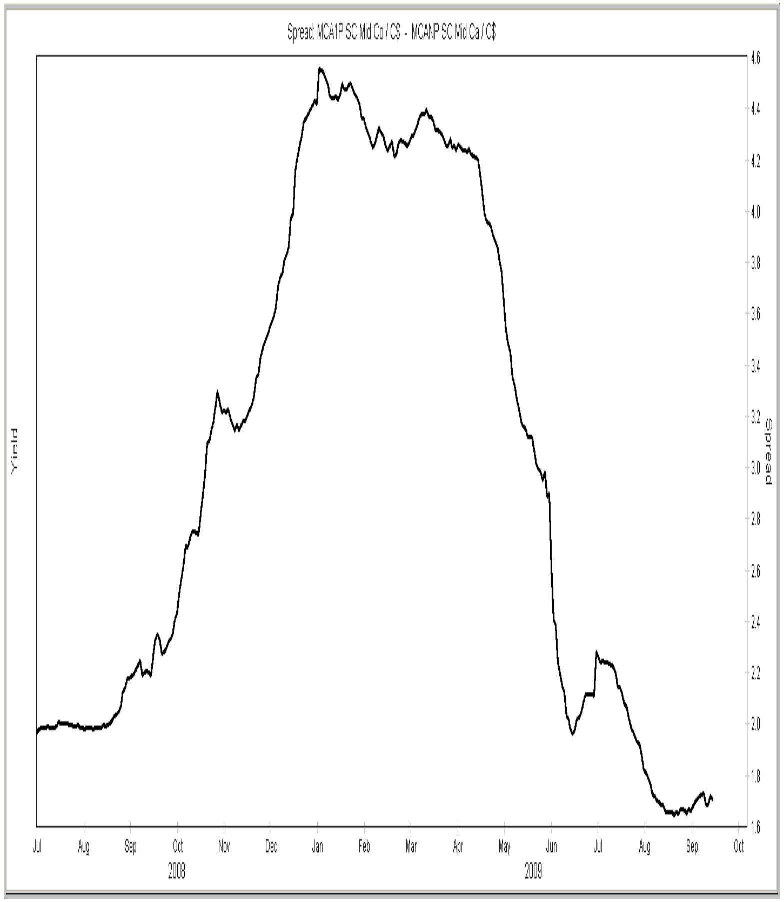
- High leverage (60%-70% of debt in the capital structure)
- Investors want to see bond covenants
  - Well-defined change of control covenants with Canada calls (not just calls at par)
  - Financial covenants (max debt/cap with all debt accounted for, interest coverage tests, restrictions on distributions, 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

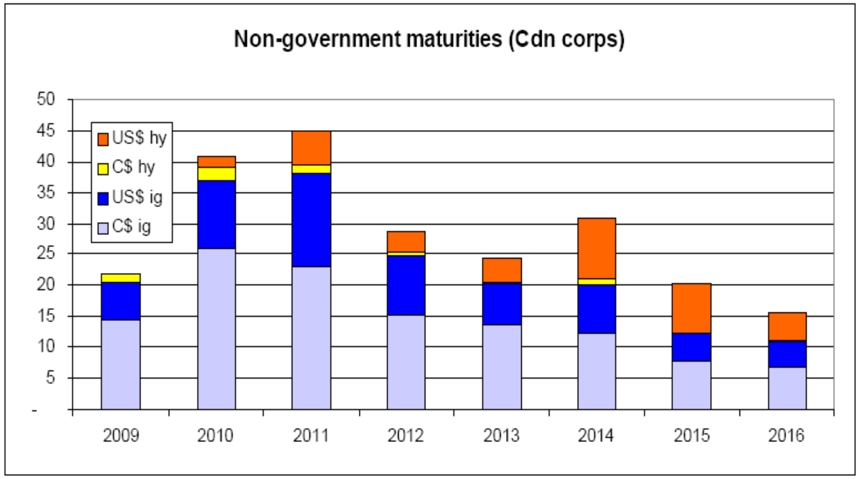
Where Are We Now?

- 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 Q209 and new issuance followed

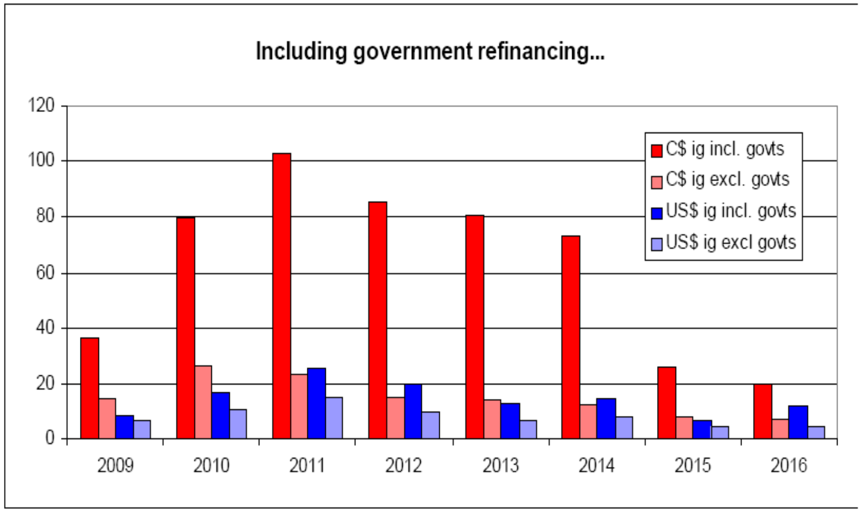


Robust Supply Over Next Few Years

- 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



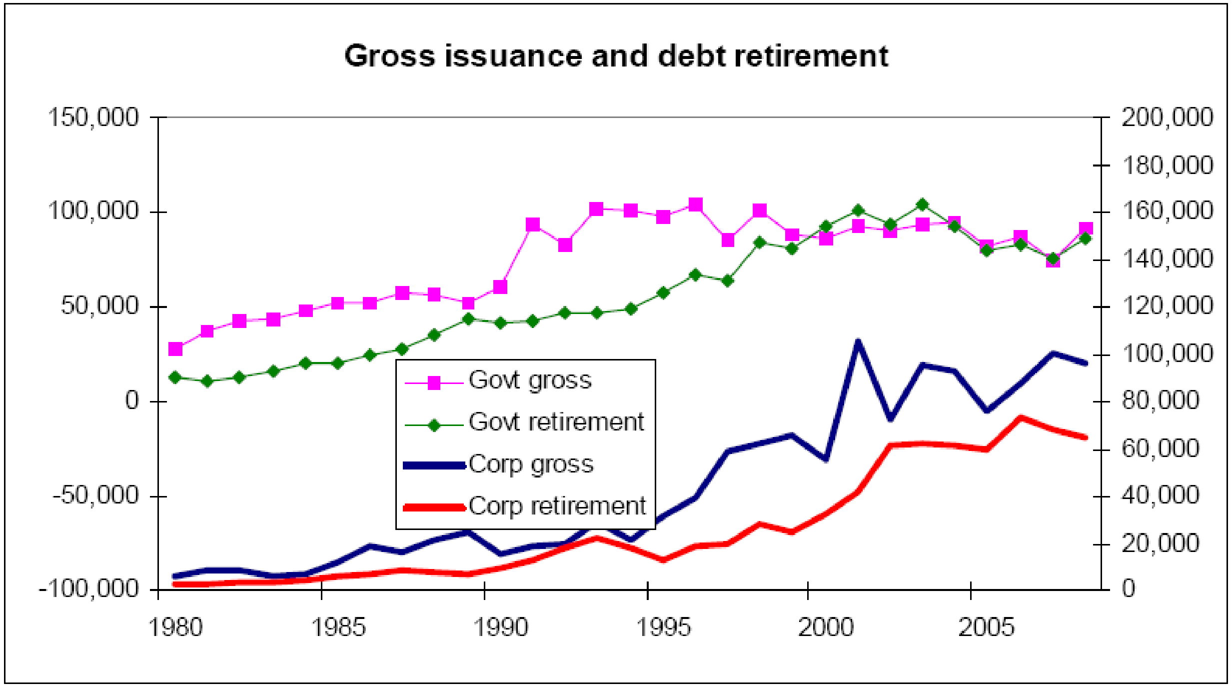
Source: CIBC, Bloomberg



Source: CIBC, Bloomberg

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?