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1 it's just giving a few more facts as well as repeating some
2 of the broad comments I made in each of these previous
3 sections, and with that, will conclude, and as expected, be
4 available for any questions after the session.
5 MR. GARNER: Thank you. Thank you, Harold.
6 Next we'll hear from Alexandra.
7 **PRESENTATION BY MS. ZVARICH:**
8 MS. ZVARICH: Can people hear me at the back if I
9 speak without that microphone? Not really. How about now?
10 Better, right?
11 So it's Alexandra Zvarich, director public fixed
12 income with Sun Life Financial. It's my pleasure to be
13 here and address you with this presentation. What I'd like
14 to offer is a view of a bond utility investor and a bond
15 investor in general.
16 The events of the past 15 months were truly
17 unprecedented. We've had extreme volatility, extremely low
18 valuations in both equity and debt markets. Lower equity
19 valuations have made equity financings unattractive for
20 most companies because they were expensive, and liquidity
21 squeeze on high spread levels have made the cost of debt
22 more expensive relative to the recent past. Capital
23 markets conditions have improved since then, as you've
24 heard from my colleagues here.
25 It should also be noted that a period of several years
26 preceding the credit crisis should not be considered normal
27 market conditions. Capital market was much more available
28 and at much lower spreads. It was not only much more

1 available in general to companies across the credit
2 spectrum but it was also more available to companies with
3 higher leverage and low credit ratings. What we ended up
4 having was an era of leverage buyouts, supersized M&A
5 deals, credit rating downgrades, sometimes by multiple
6 notches, and of course of private equity involvement in too
7 many companies.
8 Illustrated on this slide is historic spread for a
9 corporate A credit with average term to maturity of about 8
10 years. You've seen a similar or similarly looking slides
11 before. So the period since 2000 -- or between 2000 and
12 2002 we've seen some volatility but spreads have generally
13 come down to a low level in 2005, 6, and 7. What happened
14 there was, spreads blew out in the latter half of 2008 and
15 early part of 2009 to historically unprecedented levels but
16 they've improved since then.
17 This slide illustrates historic yields for government
18 securities. You can see that since 2001, the trend has
19 been down. An historically low level occurred in the first
20 half of 2009. And the reason for that is not only the
21 credit crisis but also the transfer of -- or the allocation
22 of new dollars into very safe, very liquid investments,
23 being government bonds. So we've seen some historically
24 low yield levels for government securities and the spread,
25 the yields have recovered to more normalized levels since
26 then.
27 Throughout all this time, a time of market turmoil and
28 time of volatility, utilities or Canadian utilities in

1 particular have maintained good market access in both 2008
2 and 2009.
3 Year-to-date in 2009, we've seen $3.2-billion of
4 issuance, and remaining 2000 maturities are just over a-
5 billion, which will bring total issuance expected for
6 Canadian utilities to just about 4.5-billion for the whole
7 year.
8 Looking forward, approximately $1.7-billion of utility
9 issuance in each of 2010, 11, 12, 13, will be due to
10 refinancings. So about the same amount, constant amount,
11 in each of these next one, two, three, four, I guess five
12 years. On top of that, with -- using 2010 as an example,
13 we'll have new CAPEX financing that is expected to be about
14 $2.3-billion, which is calculated by BMO capital markets,
15 bringing total expected issuance for 2010 to about 4-
16 billion, or slightly below the level expected for 2009.
17 Speaking of all-in funding costs, you can see that in
18 the first row of this chart, in June 2007, the cost of 10-
19 year utility yield at 5.3 percent, or the 10-year utility
20 yield of 5.3 percent is not too dissimilar from 30 year
21 yield for a utility at 5.6 percent. So only 0.3 percent
22 difference.
23 By June 2008, the cost of a debt for a ten-year
24 utility has gone down. Some of this was due, or a large
25 part of this was due to lower government bond yields, while
26 the 30-year cost of borrowing for a utility was virtually
27 unchanged.
28 By fourth quarter of 2008, the differential was much

1 wider than in the three to four months prior to that, with
2 most of the change due to a doubling in corporate spread
3 levels. You can see that ten-year utility spreads have
4 doubled from 120 basis points to 246, and 30-year utility
5 spreads have also almost doubled from 158 to 305.
6 During 2009, the overall cost of new debt was -- has
7 normalized, I should say, and more so in the second and
8 third quarters of the year than in the first quarter of the
9 year.
10 Although corporate issuers in general had to shorten
11 the term of their borrowings, highly rated Canadian
12 utilities - and by "highly rated", I mean A-rated Canadian
13 utilities - were able to issue 30-year debt quite
14 successfully.
15 Speaking of covenant packages, covenant packages are
16 largely unchanged. This is either due to the reputation of
17 the utility in the market because previous trust indentures
18 were used, or because there was some covenants in those old
19 trust indentures already, but there generally was no
20 change.
21 A discussion of utilities I guess in my opinion would
22 not be complete if we didn't touch upon utilities in the US
23 market. And here we can use a rule of thumb: By
24 multiplying Canadian issues by a factor of 10, you get the
25 US issuance.
26 As you can see from this chart, 2008 was a peak year
27 for US utilities' issuance. At $45-billion, issuance in
28 2008 was about $7-billion US higher than in 2007, and

1 issuance for 2009 is expected to be about $40-billion. And
2 the reason for that is that a lot of the US utilities are
3 looking at the risk levels of the market chose to pre-fund
4 their maturities for 2009 and for 2010 in late 2008, having
5 to, of course, do this pre-funding at a higher cost of
6 capital.
7 And this is, I guess, somewhat different from what
8 happened in the Canadian market. In the Canadian market,
9 there was not a lot of pre-funding in the utility space.
10 And by way of a perspective on US utilities, let me go
11 through some of the major differences as bond investors see
12 them between US utilities and Canadian utilities.
13 Few -- in our opinion, few US utilities are
14 municipally or provincially owned, so a higher risk level
15 there. They have more diversified business profiles, and
16 often times it's a plus. Rate reviews are less frequent
17 than in Canada. New bond issues generally lack any kind of
18 bond covenants unless the bond issues are done under
19 historic trust indentures or older trust indentures, which
20 often times is not the case.
21 And in terms of credit ratings, credit ratings are
22 lower in the US market, and the spectrum of credit ratings
23 is somewhere between an A credit rating and a BBB credit
24 rating, but of course it's more -- just looking at the
25 chart below, you can see that the average credit rating is
26 a lot more skewed to the BBB credit rating. This is versus
27 an average A level or single A level credit rating for
28 Canadian utilities.

1 Let me take a step back here and address a couple of
2 items that are important for utility bond investors. What
3 I'd like to look at is -- offer you a couple of things, go
4 over some of the things that bond investors look in
5 utilities, some of the bond investor concerns, and, as
6 well, some of the lessons we have learned from looking at
7 utilities in other jurisdictions.
8 So, generally, bond investors are very well aware of
9 the fact that utilities have highly levered balance sheets
10 and that they have significant capital investment programs
11 going forward.
12 However, we are also very cognizant of the fact that
13 the utilities sector is one of the few sectors that has had
14 either rating upgrades or positive outlook changes or
15 outlook changes, and this would include an outlook change
16 from stable to positive and from negative to stable, mostly
17 from two major credit rating agencies in Canada.
18 Also, utilities is one of the few sectors that has
19 been able to raise 30-year debt financing in Canadian
20 capital markets. And on top of that, utilities have
21 generally been able to raise funds at a cheaper rate, at a
22 lower rate, than issuers could do in many other sectors.
23 So, in our view, what would a significant -- what kind
24 of things would a bond -- a utility bond investor would
25 like to see for utilities that face significant capital
26 investment programs and for utilities that have 30-year
27 funding needs?
28 These are very simple things. They are things like

1 stable capital structures, stable regulation, ability to
2 pass through costs, stable credit ratings, and of course
3 adequate levels of ROE for these utilities to continue as
4 viable enterprises.
5 And, of course, it shouldn't be lost on the audience
6 here that utilities is a core, but of course not the only
7 sector, where bond investors choose to allocate their
8 investment monies into. When bond investors make an
9 investment, they think about such things as risk adjusted
10 return; how does this investment fit from a sector point of
11 view, a yield perspective; what is our weight in this
12 sector; what can we earn in other sectors; and can we
13 invest money in other currencies or in other jurisdictions?
14 Now a few points that worry bond investors when it
15 comes to utilities investing.
16 Well, high leverage is definitely there high up on the
17 list. We love seeing bond covenants, but well formulated
18 bond covenants. A change of control covenant in company A,
19 if formulated well, if defined well, would be of much
20 more -- much greater advantage to a utility investor than
21 in company B where it's simple and is not well defined.
22 We also like seeing as many financial covenants as we
23 can get, also well defined, so we are looking for things
24 such as maximum debt to capital with all debt being
25 accounted for - this is typically bank debt - interest
26 coverage tests, restrictions on distributions, interest
27 rate step-ups as ratings go down, in particular.
28 We're also well aware of the fact that different

1 ownership structures have different implications for
2 companies in terms of dividend payments or total levels of
3 indebtedness. I guess depending on the ownership
4 structure, a utility may choose to add more debt at the
5 holding company level, and this is certainly something that
6 would worry us.
7 M&A and leveraged buyouts are up there on the list,
8 even though M&A and leveraged buyouts would probably not be
9 doable in the current environment, but one cannot predict
10 what will happen in ten years or five years.
11 And, finally, what we also worry about is, in our
12 opinion, inadequate levels of compensation for taking on
13 risk, meaning low ROE levels. Why that matters is low ROEs
14 will prevent companies from accessing capital markets or
15 will make utilities' access to capital markets less than
16 optimal, and also create incentive for utilities to engage
17 in high risk/high return activities and may jeopardize
18 their credit ratings.
19 So what have we learned from other markets? What
20 really helps us? A couple of things here. Having
21 transparent, explainable and consistent decision-making
22 with regular investor updates for debt and equity
23 investors, depending on the market, would be a big, big
24 bonus.
25 We also like seeing longer decision periods, not
26 annual or once every two years. We like decision periods
27 that span three to five years.
28 We find that embedded cost of capital works, as well;

1 performance-based regulation that moderates companies to
2 outperform their targets and share their savings with
3 consumers, while leaving some of the outperformance for
4 themselves.
5 We are also of the opinion that regulators should
6 require operating companies to maintain minimum credit
7 ratings, and these would be in the low A to high BBB
8 spectrum for operating companies.
9 As mentioned before, we like seeing all different kind
10 of covenants, and even though covenants can be scarce in
11 the US, other markets -- utilities operating in other
12 markets still offer covenants.
13 And finally, this is a point for discussion in terms
14 of risk-free rate. As you know, there are many drivers for
15 government bond yields, including capital and currency
16 flows, inflation expectations, demographics, flight
17 equality and liquidity. And typically the closest proxy
18 for a risk-free rate is a government bond rate or
19 government bond yield.
20 But my question to this audience is: How can
21 government bond be viewed as a risk free investment if an
22 active CDS or credit default swap exists for government
23 paper? If the investment is truly risk-free, how can
24 somebody have a view or a desire to shed that risk that the
25 fund or investor holds in government bond yields? That's
26 one point.
27 A second point on the same is that for periods of
28 time, government bond yields can offer negative rate of

1 return to investors. Well, my question to this audience
2 is: How can a truly risk free investment can offer a
3 negative risk on rate of return?
4 And last but not least, what we believe will help is
5 recognizing that for periods of three to five years
6 financial markets can act outside the realm of reasonable
7 in perhaps establishing a minimum and a maximum bond yield
8 levels that will prevent skewing the results of a formulaic
9 approach.
10 Let's now turn to our outlook for the future and
11 understanding of what's happening in the capital markets
12 today from a very high level.
13 There is no doubt that we are in a pause bubble credit
14 collapse environment, and many believe that the downturn
15 has probably run its course but recovery will be slow to
16 take place. And the reason for that is actually several-
17 fold.
18 Firstly, the Canadian economy is very closely
19 intertied with the US economy, and the US consumer, and the
20 Canadian consumer remain very weak and overlevered, and
21 more so in the US.
22 But anyway, the two are related and the case in point
23 is that we should consider economic factors that the US
24 market offers for our review.
25 Secondly, in the opinions of many economists, the
26 global economy is being held afloat by fiscal stimulus, and
27 some calculate that all of the economic growth or GDP
28 growth in 2009 is attributed to fiscal stimulus programs in

1 various countries across the globe.
2 And also for 2010, the same group of economists says
3 that close to 80 percent of economic growth in 2010 will
4 come from fiscal stimulus.
5 Let's have a brief look at supply and supply
6 expectations for both corporate and government issuance,
7 and I'll break it into two parts: One is refinancings and
8 the other is brand new supply.
9 So the next couple of years, or in 2010 and 2011, will
10 present a very robust picture for supply of corporate bonds
11 and government bonds. If you look at the upper chart, the
12 light blue represents investment-grade issuance by Canadian
13 issuers in the Canadian marketplace.
14 2010 will be a peak year. And investment-grade issues
15 by corporate issuers is expected to jump 75 percent.
16 Taking this analysis down to government debt
17 refinancings, this is at the lower chart, I believe these
18 are red bars that include -- yeah, the red bars in Canadian
19 dollars, investment-grade government refinancing.
20 The peak will start -- the peak, I guess, period will
21 start in 2010 and will continue up until 2015, and if we
22 just look at 2010, the issuance level in 2010 is expected
23 to grow by -- this is for refinancings only, is expected to
24 grow by 160 percent over 2009. So quite a lot of supply
25 coming down our way.
26 But refinancings of existing debt maturities is only
27 part of the supply story. We also need to account for new
28 financing needs by corporate and government issuers. And

1 just explaining the graph -- or the chart here, the lower
2 two lines are for corporate issuance, and the blue one is
3 gross corporate issuance, which is expected to be quite
4 high in 2009, and I guess this only covers to 2010, but
5 we've seen what was happening with our maturity refinancing
6 expectations on the previous slide. And the top two lines
7 are for expected government issuance, and it's also at
8 quite high levels.
9 I guess a part of the moral of the story here is that
10 in deficit-prone years, total government issuance never
11 goes down, it always goes up and exceeds debt retirements
12 by a wide margin.
13 Many investors, given the supply, would seek to high-
14 grade their investment portfolios and move their investment
15 dollars towards higher-rated debt.
16 So where are we going? Well, we've already talked
17 about projections of high corporate and government supply
18 over the coming years and there's only a couple more points
19 to cover here.
20 Generally speaking, corporate spreads could widen over
21 the near-term, however, popular belief in the market is
22 that demand for income-type products, being bonds and
23 dividend paying stocks, will keep the spreads in check.
24 The final two points on this slide are about credit
25 conditions and default experiences. There is no doubt that
26 we'll be seeing improvements in global economy and local
27 economy over the next little while, the question is only
28 how sustainable it is. But nonetheless, we expect to see

1 more credit losses and bankruptcies, not necessarily from
2 larger institutions but also going down to smaller
3 companies.
4 The rate of deterioration in credit quality is slow
5 right now, but the number can go up, meaning that corporate
6 default rates can still be expected to be sustained at
7 fairly high levels.
8 With this, let me conclude my presentation and I'll be
9 happy to answer any questions.
10 MR. GARNER: Thank you, Alexandra. We're a little
11 behind but what I'd like to do just before we wrap up the
12 panel is just put back, at least in my mind, that was quite
13 a lot for us to digest, but I'd just like to tell you a
14 little bit what I heard, and Matthew, with the equity
15 reversal of fortunes and the divergence between dividend
16 yield and government bond yields. And Stephen speaking to
17 us about the repricing of risk and the links between bonds
18 and ROE. And of course Harold talking about the shrinking
19 credit market and showing us the steepening yield curve and
20 the volatility in the equity markets.
21 And finally, I thought, a nice wrap-up by Alexandra of
22 a utility bond investor point of view. And especially
23 enlightening a jurisdictional review between the US and
24 Canada in that matter, and the importance of covenants that
25 are becoming very important in the bond world.
26 And I think that's a lot for us to go through. And
27 we're a little behind time. But what I'd ask is two
28 things. One is that we thank our panel for this morning's

1 presentations, and the second thing is would we take a ten-
2 minute break, and keep to 10 minutes.
3 We do have coffee right outside the room. If you're
4 invested in Starbucks, the Indigo has a Starbucks. If
5 you're invested in Timothy's, there's one on the bottom
6 floor, but either way you're invested, we would like you to
7 be back in 10 minutes. We do have presentations outside
8 the doors for everybody to take a look at. And we've been
9 left with some questions already from the panel that will
10 maybe get us thinking when we get back. So if I could ask
11 everybody to be back by 11:20 by that clock. Thank you.
12 --- Recess taken at 11:10 a.m.
13 --- On resuming at 11:26 a.m.
14 MR. GARNER: Okay. We're going to start, and I'm
15 going to open it up to the floor to ask our panel any
16 questions that they have. And we'll just take it on from
17 there. Does anybody have any questions? I think -- are
18 there some mikes, Lisa, out there?
19 MS. BRICKENDEN: You've got one, and the other is a
20 roving mike.
21 MR. GARNER: There is a mike out there some place.
22 Maybe we can go do a search for the microphone. Does
23 someone have a microphone out there?
24 MS. BRICKENDEN: I'll just wander around the floor.
25 MR. GARNER: Okay. Well, why don't we start and
26 assume right now that we can find one and we'll give you a
27 microphone or this one, if we need to.
28 So can I look to the room? Are there any questions