Defining M&A

Considering trends in financing for mergers and acquisitions activity in Canada, we have selected and considered the M&A transaction as the undertaking of corporate strategy, corporate finance and management which deals with the buying, selling, dividing and combining of different companies and similar entities. We have further taken the expression "companies and entities" to include the assets of those entities. The intention of this review is to look at those fundamental corporate activities, absent consideration of the creation of a subsidiary, joint venture, or similar, but rather to consider the absorption of a company, entity or assets into the acquirer. As a consequence of the distinction between mergers and acquisitions becoming blurred, including as to the economic intentions or outcomes, in the context of considering trends in debt financing for M&A activity no differentiation has been made between an acquisition retaining separate entity and a share or asset transaction where the buyer and target are combined.

Considering the financing requirements.

Looking at 2014 trends in debt financing for M&A activity, we have considered financing using debt sources for the purpose of the acquisition of both the shares, or other equity interests of a target, and the assets of a target enterprise. The debt is being obtained for the purpose of completing the acquisition with the legal structure of the combination of the acquired entity or assets not being relevant for these considerations. Debt financing for M&A activity allows credit consideration to be given to using the value contributed by both the buyer and the buyer combined with the target. Debt financing for M&A activity accesses six core sources for the debt financing. Each of these sources has somewhat different attributes, different participants, different terms and accordingly somewhat different results.

The materials provide a high level overview of the major characteristics, and the most current trends, for each of the six sources identified for debt financing for M&A activity.

We have not included share for share deals, or combined share with debt deals, although those represent a viable financing option they are not debt finance. We have also assumed, but not discussed, that in structuring the M&A transaction the tax implications, and effect on the balance sheet of the acquirer has been considered, and appropriate steps to maximize deductibility of expenses and the costs of the debt financing by the borrowing entity. We note that in Canada this will generally involve a two-step acquisition, to ensure continued deductibility of interest on a debt financing.

Six Basic Sources of Debt Finance for M&A Activity

1. Sponsor based borrowing.

Defined

- Financing which is acquired based upon the strength of the proponent of the M&A transaction, the sponsor, generally based upon their credit worthiness and covenant to pay.
Characteristics

- Usually structured as a standard format term or revolving loan, or both, with a heavy requirement for sponsor support; sponsor support can be given by direct borrowing or co-borrowing, guarantee, support agreement or equity contribution agreement but the primary characteristic is the requirement for sponsor participation.

Borrower

- This can be the M&A acquiror, as combined with the target or a co-borrowing relationship with the sponsor depending upon the choice of sponsor support mechanism.

Guarantor

- The sponsor will always be required to provide a form of guarantee, this will range from full co-borrowing to equity support on a payment by payment requirement.

Sources of Funding

- Sponsor based funding generally is provided only by specialized lenders, these consist of some independent lenders primarily located in the United States, the lending arms of private equity or hedge funds, capital markets or sponsor based commercial departments within Canadian and U.S. banks.

Basic Terms

- Sponsor based funding is generally structured as a standard format term or revolving loan using corporate or commercial basic documentation (depending upon the size and appetite of the funding entity) and is supplemented by the additional requirements for the sponsor participation.

2014 Trends

- Sponsor based funding continues to be a viable but smaller, specialty team based, market. Sponsor based funding substantially disappeared as weakness emerged in the primary M&A sponsors, being the hedge and private equity funds, during 2009 to 2012 but with many of those sponsor funds in very liquid states and credit quality restored, specialized lenders are again interested in sponsor based funding. The terms of the underlying deals are remaining full covenant, but sponsor participation is easing up from full co-borrowing requirements to more commonly an operating support agreement or equity support agreement based upon defined triggers for cash contribution. Sponsor strength remains the primary consideration for terms, including rates and fees. Lenders remain concerned about demonstrated commitment to the borrower enterprise, the wounds of sponsor abandonment have not healed so a strong contractually required support is still prevalent.

2. Asset Based Financing

Defined

- Asset based financing for the purpose of this discussion is financing primarily based upon the value, and liquidity, of the assets of the acquiror, target, or acquiror and target combined.

Characteristics

- An asset based loan is structured to specifically identify, enhance reporting, maintain quality, and control ownership and disposition of the assets which form the subject matter of the credit
determination to fund based on assets. The two primary forms of an asset based loan are term loans against fixed assets and revolving loans against current assets. Asset based loans differ from commercial term or revolving loans because of the covenant and control focus on specified assets.

Borrower

- This will usually be the acquiror on the basis of the post-M&A transaction combination of the acquiror and target.

Guarantor

- The requirement for a guarantor will depend upon the credit worthiness of the intended borrower and the credit quality of the assets forming the security, a guarantee is not a universal requirement.

Sources of Funding

- There are two quite different sources for asset based financing. Term lenders providing loans against fixed assets will generally be lenders with longer term appetites such as trust companies, insurance companies, pension plans and funds compromising investors of that nature. Revolving loans against current assets are of interest to funders with shorter horizons including the specialized asset based lending groups at some banks and independents such as funds and non-regulated finance companies.

Basic Terms

- The terms of the credit arrangements will be designed to protect the assets, and to ensure the application of proceeds from the assets to the loans. This is generally done on the basis of a lending margin which uses a loan to asset value concept. Revolving lenders will frequently use a direction of the proceeds (collection of current assets) to ensure control on a repayment and readvance (sweep) basis. Term lenders will look to capture the revenue source related to the assets they are financing against to supplement the ability to liquidate through asset sale. Security over the assets will particularly key in the asset based transaction, but will often include a general security requirement for control and potential going concern sale for recovery.

2014 Trends

- The asset based lending sector is currently liquid and looking for suitable deals as a result lenders are moving closer to cash flow and covenant light terms. While asset protection terms remain common, covenant panels are easing and becoming much more directed to asset maintenance and quality specific to the assets under consideration with less focus on more heavy handed operational and financial covenants. There is a great deal of liquidity in the asset base lending pipeline and appetite for loans is outstripping demand resulting in a spread compression with resultant lowering costs and broadening of potential sources for an asset based finance. The asset based loan will now look more like the standard commercial loan in most instances as to term, rates and covenants. The use of enhanced asset valuation and monitoring is still prevalent and will continue to add cost and administrative burden.
3. **Cash Flow and Covenant Light**

**Defined**

- Cash flow and covenant light loans are loans based upon the credit quality of the borrower or the borrower and its guarantors, the revenue available to service and repay the loan. The debt is usually written with fairly light covenant panels focused on operations with minimal financial tests.

**Characteristics**

- These transactions are generally documented on very simplified, corporate format, documentation with few, credit quality and revenue based representations and warranties, covenants and defaults. Access to these loans requires a robust and assured source of revenue (such as might be the case in regulated utility funding) and higher credit quality, usually private or public near investment grade or investment grade credit quality.

**Borrower**

- The borrower will be the acquiror or the acquiror combined with the target, this will generally be driven by a high credit quality acquirer and no perceived deterioration from the transaction.

**Guarantor**

- These are not usually required.

**Sources of Funding**

- Cash flow and covenant light loans are generally available from specialized corporate finance groups at regulated financial institutions lending against the investment quality of the acquiror or the acquiror combined with the target. These are frequently oriented to government, or government type, revenue stream such as a regulated utilities or against revenue streams protected by a very strong credit quality on the customer counterparty level with long term protected contracts. The assured revenue base generally needs to be easily understood which is usually done by corporate finance groups specializing in larger corporates, utilities, and similar.

**Basic Terms**

- The basic terms are designed to protect, preserve, and ensure application of the revenue stream which comprises the cash flow, other than if there is very high credit quality borrower, in which case terms will effectively represent an expanded promise to pay. These loans are generally without the requirement for the provision of security.

**2014 Trends**

- There is an expansion of interest in cash flow and covenant light loans. These types of transactions essentially disappeared in 2008 to 2010. Since 2012 these types of loans are "back". These will take high credit quality or assured revenue streams backed by high credit quality. These types of loans are generally done by the investment bankers using club or syndicate deals or by corporate finance departments of large regulated financial institutions with a particular emphasis on the banking sector where there is a growing interest in enhancing returns. Spreads are still coming in, although there is generally a rate premium for deleting covenants and security. This has been countered by an excess of liquidity, a shortage of “good” deals and a flight to credit quality. 2014 continues to provide expanding access to funds for established borrowers in this sector with proven track records and credit quality especially for infrastructure, P3 and utility transactions.
4. **Traditional Project Finance**

**Defined**

- Project finance is defined as the funding for the construction and take out, or each separately, for the acquisition of a specific enterprise or the development of a specific project based business which is recourse limited to the project.

**Characteristics**

- These loans deal with the construction or acquisition of a specific business enterprise usually in a single location with a single business purpose and with recourse limited to that "project". Construction finance is generally characterized by documentation, diligence and conditions precedent requirements designed to assess the project and its likelihood of being completed, being completed on time and on budget, being completed to the specifications and performance requirements necessary, and to an assured revenue stream or take out. Take out term lending for a project is generally designed to have funding triggers based upon completion of the project or acquisition of the project, assurance of the revenue streams, and will then resemble the standard term loan in its characteristics.

**Borrower**

- This will generally be the owner of the project to be acquired or constructed.

**Guarantor**

- This will generally consist only of any related entities on an upstream or downstream basis or an assurance which is specific to the project revenue stream. The terms usually will not involve a requirement for guarantees from a full corporate group (if larger) because of project specific recourse.

**Sources of Funding**

- Project finance is generally provided by a specialized group within a larger fund or financial institution. Construction project finance is particularly specialized and requires teams, generally organized on an industry basis, which will usually be located at a trust company, insurance company, pension plan or specialized fund, banks while participating in this area are less likely to participate at the construction level except in their investment banking groups. Take out funding will be available from the previous noted sources, with a specific orientation to longer term interests such as life companies, pension plans and specifically formed funds.

**Basic Terms**

- The basic terms differ considerably between construction finance and take out finance. Construction finance will have its terms oriented to the factors noted previously, attempting to provide assurance of control over the project and its completion as to timeliness, specifications, performance and budget control. The concern at the forefront is meeting the terms for take out funding or commencement of revenue stream. The take out lending will generally be designed to preserve and protect the project and its assets including the related revenue stream. The covenants will include operational and credit quality representations, warranties and covenants from the borrower.
2014 Trends

- Project finance, particularly public private project finance which involves a public aspect and assurance of the revenue stream, is highly attractive in many of the finance sectors. Private funds have been able to raise 10 and up to 30 year funding for project finance and interest in the longer and is increasing recently, but only recently. Take out funding, particularly in the public sector markets where there is a utility like assurance to the revenue stream is attractive in the market at this time. Construction funding has been returning to the market with completion assurances through performance bonding and similar traditional project finance techniques being used to provide the completion assurances required. Unlike the structures in the early 2000s where construction and take out were rarely linked there is an increasing tendency to fund to take out with funds being designed on a sister fund or internal credit appetite basis to fund construction with an internalized take out (potentially with syndicate changes to accommodate duration appetite differences). Hedges are still being used to deal with rate and currency risk on a traditional hedge basis. CDOs and CLOs have not returned to this market. Short term funding for long term finance has also not returned to the market and there tends to be a better matching between the term of the finance and the term of the project finance needs. Structures need to reflect market appetite with secured or guaranteed bullet bonds being favoured over amortizing product (amortizing premiums remain in the 17-25 bps range). More liquid offerings, ability to secondary trade and at a size that creates a market (at least $300 million in the Canadian market) will be better received by banking and fund investors. The pensions and life insurance companies continue to have, in fact have increased, interest in longer term debt even if not liquid.

5. Structured Finance

Defined

- Structured finance for the purposes of this discussion is defined as finance where structuring is designed to alter liquidity and risk, or to transfer liquidity and risk aspects of the transaction to another person, in a manner intended to provide increased liquidity to lenders and increased sources of funding to borrowers.

Characteristics

- For the purpose of our discussion structured finance includes more than securitization, and includes such structuring techniques as the use of synthetic leases, lease to own, financing through structured funding vehicles, among others. The characteristic that creates structured finance is that the financing is other than a simple advance of monies by a funder to a borrower, supported by credit agreements and, where applicable, security but rather there are additional elements which have been designed to address specific requirements of the funder, borrower or transaction.

Borrower

- The borrower will generally be a special purpose vehicle which is intended to isolate the transaction from operating loss and risks of the operating entity.

Guarantor

- There will frequently be a guarantor, this guarantor will generally be the operating entity which is actually undertaking the business activity of interest, or its servicer or administrator, depending upon the structure being used.
Sources of Funding

- Structured finance is available from highly specialized participants in the capital markets. The specific source will vary depending on whether it is an asset backed securitization model, a derivative based model, or a leasing based model, each of these tends to be with different speciality funder or in a different group within a funder. The types of funders which generally provide these types of structured finance are the corporate funding departments of banks, investment banks, and specialized funds.

Basic Terms

- The basic terms of these transactions will be dependent upon the basis of the structuring, and its intended results. As a consequence of accounting changes there is rarely now the ability to achieve off balance sheet treatment which at one time was an important attribute. There is still the requirement to aim for true sale and bankruptcy remote treatment of either the borrower entity or the assets, and the revenue streams being used for repayment, assured revenue sources. Rating remains a common requirement and at least lower investment grade required. Simplicity of the transaction for funding purposes is generally built into the terms, the terms tend to orient heavily to the protection of the revenue stream and the isolation of the entity and the assets in the current environment.

2014 Trends

- Many aspects of structured finance have not recovered from the credit crisis but securitization is coming back. New issuances particularly automotive, utilities such as telecommunications, credit card and higher quality mortgages are going well and highly priced. These are generally only being offered through banks and bank dealers, and with limited access to commercial paper. The midterm bond market for these types of offerings has not recovered. Synthetic leasing is still struggling to restructure as a consequence of changes in accounting in United States GAAP, and in the balance of the world under IFRS, which makes off balance sheet treatment increasingly difficult. Structures are however being developed by specialized leasing groups within some of the investment banks and banks have been reintroducing synthetic lease structures for international asset acquisitions. Traditional leasing continues to be strong domestically, particularly vendor finance but is still challenging for cross border with challenges based on taxation particularly for Canadians where debt is free of withholding tax but lease payments are not. Leasing activity continues to be strong and bank and near bank participants have been increasing their volumes based on operating lease structures. Canadian banks continue to face challenges of residual value restrictions but are increasingly looking to solutions such as third party buyouts and residual value insurance to resolve these issues; derivative based structured finance has not seen significant re-emergence. Derivative structures are increasingly constrained the plain vanilla. While there is some derivative based product and appetite using complex structures regulatory constraints are restricting a re-emergence of the complex derivatives, in some instances using securities laws to limit the investor base (Voller type constraints and being considered for Canada) and in regulatory requirement such as capital cost for the participants.

6. Credit Supported Transactions

Defined

- A credit supported transaction is one where the credit quality of the acquiror, target, acquiror and target combined are assets would not be sufficient to allow the financing required to be obtained (generally because it is high ratio of loan to value or where the revenue stream for repayment is risky because of credit of counterparty or lack of track record) and accordingly third party credit support is required to allow the transaction to proceed.
Characteristics

- The transaction itself is of lesser concern than the credit enhancement to be provided and the nature of the credit enhancement becomes a primary element of the transaction.

Borrower

- The borrower will continue to be the acquiror or the acquiror and target combined as applicable.

Guarantor

- The guarantor is crucial in these structures, the guarantor will be the third party providing the necessary credit support, the nature of the credit support can vary from a full guarantee, insurance, bonding, operating support or equity support, the credit quality of the guarantor will be crucial and the structuring and nature of the guarantee and the ability to call on the guarantee will be vital.

Sources of Funding

- Many funders, including regulated financial institutions, will provide funding provided that the form, ability to call on, and credit quality of the third party credit support is sufficient (this is particularly the case for government provided support). Lenders who are interested in these types of arrangements are generally specialty teams who can assess the quality of the credit, this expertise will generally be housed in funds, investment banks and the corporate bank of the banks, some insurance companies have been building expertise in this area as well. Public issues of guaranteed debt is also possible where there is sufficient size (at least $300 million).

Basic Terms

- The terms of the underlying transaction will be heavily driven by the needs of the credit provider, the credit provider will frequently dictate what they require as to representations, warranties, conditions, draw or advance conditions, covenants and agreements. These will generally be done in traditional documentation and security format typical to the underlying transaction. There will be elements of control over the entity and project or business, and its revenue stream provided to the guarantor. The guarantor will frequently supplant the lender in terms of its control and ability to react and realize upon and operate the business or access the revenue stream, particularly if there is a payment on its credit support. Additional documentation tying in the rights of the credit provider will generally be entered into allowing a guarantor to step in and prevent default.

2014 Trends

The failure of the US based monoline insurance industry, which previously provided much of this type of credit support, has caused a retrenchment in credit supported transactions. Government has been increasingly been stepping up to provide this assistance, through its agencies or directly, to meet public policy demands particularly in public private infrastructure based project finance and mortgages for housing. This support is increasingly being provided by way of specialized guarantees, but also through insurance such as credit and project insurance provided out of government agencies and mortgage insurance. Another means of providing this type of credit supported financing is by lowering the requirements for credit quality, covenants and loan to value to allow advance by the funder without adverse regulatory impact or capital cost. Regulator is moving in the opposite direction and increasing credit risk assessment and capital requirements for banks and other regulated financial institutions will prevent this from being a significant source of funding for credit challenged projects or entities. The regulatory requirements for increased focus on counterparty quality and strength for the regulated financial institutions may restrict this sector to government based credit support. Recent transactions using a credit wrap style loan guarantee of the federal government were heavily oversubscribed and very
tightly priced. It is difficult to get a government guarantee but when available well received. The ongoing guarantee programs, such as NHA Mortgage Backed Securities remain very popular and well priced but volume constrains are starting during 2014.