**Permanent Debt and Equity Financing**

**Learning Outcomes**

After completing this module, students will be able to:

1. Compare the different forms of permanent debt and equity financing available from private and public institutions.
2. Describe the processes for raising new debt and equity capital and their costs.
3. Summarize how to raise capital using either a private or public placement.
4. Illustrate how to calculate lease payments and capitalize operating leases.
5. Determine whether it is more cost-effective to lease or buy an asset.
6. Decide whether a bond or preferred share issue should be refunded.
7. Demonstrate how rights offerings can be used to raise new equity capital.
8. Recommend the appropriate form of permanent debt or equity financing to use in different business scenarios.

**Introduction**

For small- and medium-sized enterprises (SMEs), commercial loans and leases are the primary sources of permanent debt financing. Leasing in particular has grown in importance because of the convenience and financial flexibility it provides to borrowers. Chartered banks, credit unions, and equipment leasing companies are the main providers of these funds which are supplemented by different government lending programs addressing the needs of SMEs that are traditionally underserved by private lenders.

For larger businesses, commercial loans and leases are still important sources of debt financing, but publicly-issued bonds and private loan placements with long-term institutional lenders and high-net-worth individuals are also crucial Compared to SMEs, larger companies have better access to public lending markets since the large amounts they borrow justify the high up-front costs of a public issue.

Many start-up companies naively believe they can borrow all the funds they need to launch their new ventures, but quickly realize they must balance their use of debt with equity to meet their high loan servicing obligations. Because start-ups do not have access to public equity markets, owners must look to other sources of equity such as the sale of their personal assets; loans and gifts from family and friends; angel investors; venture capitalists; or private equity placements. Once the venture is larger and more established, it can go public to raise capital. Even public companies are very hesitant to issue new equity because of the high issuance costs and potential loss of control and instead rely on their retained earnings to finance growth.

**1.1 | Commercial Lending**

**Commercial Lenders**

The five chartered banks in Canada are well known to borrowers because of their extensive systems of branches and business lending centers across the country that are used to originate commercial loans. Credit unions are also very active commercial lenders focusing on SMEs in the communities they serve.

Banks and credit unions provide approximately 70% of all business debt financing in Canada, but they are not the only source of funding. Institutional lenders or term lenders such as insurance companies, pension funds, and trust companies, and some Schedule 2 and 3 banks also provide commercial loans to larger businesses. They focus on longer-term (i.e. 5+ years) lending because most of their funds come from investors like company pension plans, university or hospital endowments, or family trust funds that are saving for the longer term. Banks and credit unions, on the other hand, receive most of their funds from short-term sources such as chequing and savings accounts, term deposits, and commercial paper so their loans are usually shorter (i.e. <5 years) in duration. Schedule 2 or 3 banks are subsidiaries or branches of foreign banks that are allowed to operate in Canada.

Instead of using a branch system like banks and credit unions, institutional lenders lend money with the help of investment banks or negotiate loans directly with borrowers themselves. Investment banks do not make loans or accept deposits but instead focus on helping large companies raise new debt and equity capital by bringing major borrowers and lenders together. Specifically, they help companies determine the amount of funds required, what type of debt or equity security best suits their needs, the price of each instrument, and how to best distribute them to investors. Institutional lenders and their investment bankers have helped develop a very competitive commercial lending market that serves the needs of both SMEs and large businesses.

**Lending and Monitoring Process**

The lending process for a commercial loan (also called a credit facility) can be divided into six steps:

**Step 1 - Comprehensive review of the business environment.** The lending process begins with a thorough risk assessment of the general economy and the prospective borrower’s industry. Is an economic slowdown expected? Are interest rates rising? Are changes in consumer tastes or technology making products or production processes obsolete? Are consumer and technological changes resulting in new business opportunities? Are raw material costs increasing? Is increased foreign competition lowering prices and hurting domestic producers? A healthy economy and industry are critical to the success of any loan, so financial institutions are far less willing to lend during difficult economic times especially to weaker businesses.

**Step 2 - Analysis of a company and its financial statements.** If a lender is satisfied that the economy and industry are strong, they will proceed with a detailed assessment or “size-up” of a business focusing on its strength and weaknesses. Does the company have a strong business strategy? What are its competitive advantages and are they sustainable? Is management capable and committed to implementing its plans? What products is it selling and in what markets? Who are its main competitors? Are there any new products in development? What is its online presence? Are its current production processes efficient? Is skilled labour in short supply? Does it have a strong financial management system?

Financial statement analysis tools are used to quickly evaluate a prospective borrower to determine if it is low risk and able to generate sufficient cash flows to service its debt obligations. From this analysis, a good lender can quickly determine the trends in the sales, profits, and key expenses; if accounts receivable and inventory are being managed efficiently; if accounts payable are being stretched to address cash shortages; whether long-term assets are excessive relative to sales; or if the company is over-leveraged. Using a database of information from its other loans, lenders can compare the borrower’s performance against the average performance of its competitors.

Before proceeding to the next step in the lending process, lenders conduct a due diligence review to verify certain representations made by the borrower concerning their operations. Does the company exist? Is the borrower able to legally act on behalf of the company? Has the board of directors approved the transaction? Are the financial statements provided accurate? Does the company own its assets or are they leased? Are there any liens against the property, outstanding legal proceedings, or other contingent liabilities? Any there any building code violations or environmental issues relating to its assets? Does the contract violate other loan agreements or the company’s bylaws? Lenders never want to expose their organizations to loss or embarrassment because they did not take the time to verify important facts, so a rigorous due diligence review is critical. To further protect the lender, borrowings must also guarantee in the loan agreement that all representations they made are true.

**Step 3 - Preparation of financial projections with sensitivity analysis.** Pro forma financial statements are prepared for a period at least equal to the life of the loan. These budgets help determine the company’s future working capital and long-term asset requirements; the amount of temporary and permanent financing needed to finance these assets; and whether there will be sufficient cash flows to make any down payments and to service the debt obligations. The pro forma financial statements also help assess whether the company can meet its loan conditions including collateral requirements; attain its goals relating to profitability and growth; and adhere to all capital structure, maturity matching, and dividend policies. Lenders use sensitivity and scenario analysis to study the effects that changes in key variables such as sales volume, price, input costs, and interest rates have on their projections.

**Step 4 - Final credit risk assessment.** After completing the preliminary credit risk assessment in Steps 1-3, a lender makes a final decision whether or not to provide financing. The debt service coverage ratio (DSCR) is often used to determine if a borrower has sufficient capacity to service all its fixed debt obligations over the term of the loan.

DSCR =

The exact DSCR formula varies by the financial institution. The numerator approximates a borrower’s cash flows for a period while the denominator includes all debt servicing costs. A lease is a substitute for debt, so it is included in the denominator along with interest and principal. Because principal payments are made using after-tax dollars, the amount is grossed-up by dividing by (1- tax rate) to determine the pre-tax amount the borrower must earn to pay this obligation.

The DSCR needs to be above 1.0X for a borrower to pay all its debt obligations, but financial institutions have higher benchmarks (1.3X to 1.5X are normal) to provide a margin of safety. The decision to lend or not is also influenced by the stability of the borrower’s cash flows. If they are unstable, the lender will be hesitant to extend financing and will focus more on the collateral available and whether a personal and third-party guarantee can be negotiated. Other factors such as the personal character of the borrower especially for small business lenders, a company’s credit history, and general economic and industry conditions are also important. A borrower’s character, capacity, capital, collateral, and conditions are together referred to as the 5 C’s of credit assessment.

**Step 5 – Interest rate determination.** If the decision to lend is made, then an appropriate interest rate must be determined. Term loan and commercial mortgage rates are usually fixed while lines of credits have variable rates. These rates are set at some premium above the lending institution’s prime rate based on an overall assessment of the borrower’s credit risk including the amount and quality of the collateral pledged. Rates will also increase if the lender provides generous terms such as flexible loan repayment or pre-payment privileges. Commercial banks focus on low-risk lending, so borrowers assessed at a premium above prime exceeding 3% to 4% are generally asked to look elsewhere for funds including government lending programs that focus on small businesses and other higher-risk lenders.

In addition to interest, financial institutions also levy different fees that raise the effective cost of borrowing. Front-end fees cover initial loan application costs, ongoing administrative fees pay for loan monitoring expenses, and commitment fees may be charged on the unused portion of credit facilities. Financial institutions also require borrowers to pay for any asset appraisals and title searches, or auditing costs relating to the verification of collateral and the preparation of financial statements.

**Step 6 – Preparation of a loan agreement.** For simpler loans, the terms and conditions are normally outlined in a commitment letter. If the loan is more complex, this will be followed by a formal loan agreement. The complexity of a loan agreement varies with its size and duration, but typical terms include:

* Name of borrower
* Name of lender
* Type of loan
* Loan amount and currency
* Term or commitment period
* Purpose of loan
* Interest rate and fees
* Representations and warranties
* Loans covenants or conditions
* Collateral requirements
* Personal or third-party guarantees
* Events that cause a loan default
* Repayment procedures
* Pre-payment privileges
* Transferability of the loan by the lender to another party

Representations are assertions of fact made by the borrower that are included in a lending agreement to encourage the other party to lend. A warranty is a promise to indemnify the lender If there is a breach in the contract and the lender seeks remedies against the borrower.

**Step 7 – Monitoring a loan.** A good lender continuously monitors a borrower’s performance and stays abreast of all new industry developments. The borrower regularly submits its financial statements to the lender for analysis and to determine if the borrower is complying with its loan conditions. The parties meet on an ongoing basis to discuss operations and any new challenges the business is facing.

Calling a loan for defaulting on a loan obligation, which generally leads to bankruptcy, is the last resort for any financial institution. Their first option is to work with the company to solve its financial problems and “workouts” may be possible which include restructuring loans by negotiating longer payment periods, lowering interest rates, or forgiving some principal. Lenders are usually quick to get involved with problem loans as it is easier to find solutions at an early-stage and they can also take steps to better protect their collateral. If solutions cannot be found, lenders may ask the borrower to find another financial institution that is willing to assume higher risk. Again, calling a loan is the final option.

When dealing with lenders, it is important for a borrower to always be honest. They should report any issues to the lender immediately and work closely with them and any outside experts they recommend to quickly solve problems. Larger companies may decide to borrow from several different lending institutions to diversify their financing sources, but for smaller businesses committing to just one lender may help to build loyalty which can be invaluable in difficult times. Borrowers should beware of significant and abrupt changes in the attitudes and practices of their commercial lenders, especially during difficult economic times.

In addition to lines of credit, term loans, and mortgages, lenders offer several specialized lending arrangements including syndicated loans, mezzanine financing, bridge loans, and project financing.

**Syndicated Loans and Loan Participations**

Syndicated loans are provided by a group of lenders for a variety of reasons:

* The originating institution has insufficient loanable funds and must access the resources of other financial institutions to meet its client’s needs.
* The loan is too large for one institution to absorb safely under the capital requirements established by regulators.
* The lender wants to diversify its loan portfolio among different borrowers and geographical regions and expand beyond its normal market.
* A smaller institution cannot generate sufficient lending opportunities on its own and can access the expertise of a larger lender with little additional cost.
* The originating institution can buy and sell loans to manage their liquidity and interest rate risk while still maintaining a relationship with borrowers to sell them other services and earn loan administration fees.

Typically, there is a lead commercial bank that serves as the arranger. The arranger negotiates the loan with the borrower, monitors it on behalf of the syndicate members, supervises any voting by syndicate members relating to key issues, and distributes all proceeds to them when received. Each syndicate member has a separate promissory note (i.e. loan agreement) with the borrower. The arranger sells or places the part of the loan they do not want with other lenders using one of the following methods:

**Best-efforts syndication.** Arranger sells as much of the loan as possible under its initial terms. If undersubscribed by other lenders, the arranger and borrower may raise the interest rate, pledge additional collateral, or purchase a loan guarantee to make the loan more appealing to complete the sale. The borrower may also withdraw the loan request (called an all-or-none agreement) or accept a smaller loan (called a part-or-none agreement). Traditionally, best-efforts syndications were used for riskier loans, complex loan agreements, or during poor market conditions, but it is now the standard method for loan syndication in the North American market.

**Underwritten deal.** The arranger buys the entire loan thus eliminating any risk to the borrower. If the loan sale is undersubscribed, the arranger can attempt to either sell the remaining loan at a discount or increase its share of the syndication. An underwritten deal is risky for the arranger but they are compensated with generous underwriting fees. Underwritten deals are also becoming less risky for arrangers with new rules that allow them to vary the interest rate in reaction to market conditions.

**Club deal.** The arranger and the other syndicate members divide the loan and any fees paid by the borrower equally. This method is commonly used when syndicating smaller loans.

Loan participations are different from syndicated loans in that there is only one promissory note between the borrower and the arranger and the arranger does not normally retain an ownership stake. Each participant purchases a share of the promissory note from the arranger. A participation agreement is established between the arranger and participants outlining each party’s rights and obligations. Most are blind participation agreements where the borrower is not informed of the different participants and the participants are forbidden from contacting the borrower directly. If there are loan losses, they can be shared equally by the arranger and participants, or the participation agreement can specify a senior/subordinate system for making claims such as last-in-first-out or first-in-first-out.

In the U.S., institutional investors have developed an active secondary market where they can trade syndicated loans and loan participations amongst themselves if needed. The Canadian market is not yet this sophisticated.

**Mezzanine Financing**

Mezzanine or “Mezz” financing is high-risk, unsecured lending, where a company has likely borrowed all it can against its existing assets from traditional secured lenders but needs additional “shortfall” funding to finance its rapid growth, acquisitions, or ownership succession. It is much more expensive than bank lending because of its higher risk but it is less costly than raising new equity through an angel or venture capitalist. Also, business owners do not have to dilute their equity positions or risk losing control by issuing additional shares. Because the lending agreement is unsecured and subordinate to other debtholders, only established companies with proven management, a strong competitive position, and established and stable cash flows are usually approved.

Repayment terms for mezzanine financing are flexible as lenders expect a company’s cash flows to improve significantly over the life of the loan. Typical terms include longer or no principal repayment periods; no limitations on prepayment; and interest deferrals. Lenders do not limit loan prepayments because they reduce the risk of the agreement.

The lender’s return in a mezzanine financing agreement comes from interest plus up-front and ongoing fees. To make loans more attractive, lenders are also allowed to participate in the success of the business through debt conversion options, stock options, or warrants. A warrant allows the holder to buy a certain number of shares at a specified exercise price within a set period. Like a stock option, if the company is successful and its share price rises about the exercise price, the warrant holders will earn a profit. Mezzanine lenders may also receive equity participation calculated as a percentage of sales, profits or cash flows in addition to or instead of interest.

The approval process for mezzanine financing is more in-depth than a typical commercial loan. Lending agreements are customized to meet each client’s unique borrowing requirements, and then carefully monitored. Because of this complexity, mezzanine financing is managed by specialized investment bankers who place the debt directly with different institutional investors particularly pension plans but continue to manage it on their behalf. Private equity funds also provide mezzanine financing.

Mezzanine financing is similar to equity because returns are dependent on the future success of the company like with common shares. Accountants usually classify mezzanine financing as equity on the balance sheet because it is generally convertible into common shares when interest and principal payments are not made. This type of financing has many different names including participating debt, junior debt, subordinated debt, quasi-equity, cash flow lending, leveraged loans, or venture debt.

**Bridge Loans**

A bridge loan is a short-term loan that provides funding until another agreed-upon source of financing is released, or new funding is negotiated. A bridge loan can be used to:

* Provide financing until the proceeds from a loan, bond issue, or equity issue are received.
* Fund operations until a venture capitalist provides a new round of financing.
* Supply firms experiencing financial difficulties with needed cash until an acquirer or major new investor can be found.
* Quickly close on an investment opportunity before long-term funding is secured.
* Fund a construction project to the point of completion after which a conventional mortgage is negotiated (also called a construction mortgage).
* Buy out one partner before a new partner buys into a firm.

Bridge loans generally have higher interest rates than conventional loans because:

* Loans are unsecured or utilize cross-collateralization where the same collateral is used for more than one loan.
* Higher fees are charged for negotiating the loan quickly.
* Fixed loan fees are being amortized over a shorter loan period.
* A borrower is experiencing financial difficulties exposing the lender to greater risk.

To secure a bridge loan quickly, lenders sometimes received equity participation using warrants. Bridge loans are similar to mezzanine financing because of their higher risk.

**Project Financing**

A new legal entity or special purchase vehicle (SPV) is established to operate a major capital project. Equity for the new entity is provided by one or more sponsoring companies while the debt or project financing is raised in the financial markets. This financing is usually provided on a non-recourse basis which means creditors can only make financial claims against the cash flows or assets of the SPV and not those of the sponsoring companies. This is done to reduce the risk of the sponsoring companies since an unsuccessful project could bankrupt them otherwise. Sponsoring companies may provide a legally binding performance guarantee for the new entity or a comfort letter that gives general assurances to investors but is not binding.

Project financing is used extensively in the resource and infrastructure industries where the cost of projects and the corresponding risks are very high. Governments also use them to limit their risk, better access capital markets, and secure private sector experience in managing complex projects. Many international development projects utilize project financing along with economic development bonds to finance infrastructure and other projects. In addition to claims against these projects, creditors generally require performance guarantees from the host developing country and/or a public development group such as the Canadian Export Development Corporation (EDC) or the Canadian International Development Agency (CIDA).

A key feature of many project financing arrangements are concessions, put-or-pay contracts, or take-or-pay contracts. Concessions are government licences that allow the company to operate the business for a specified period after which it is returned to the government. Put-or-pay contracts specify that key suppliers must provide a certain amount of inputs at a set price or compensate the company for the difference. Take-or-pay contracts specify that customers must buy a certain amount of product at a set price or pay the difference. These features help further reduce the risk of the project.

**Securitization**

Chartered banks frequently originate commercial loans, but then sell them to other investors to better diversify their portfolio of financial assets. They also sell loans to meet capital requirements or reserve ratios established by government regulators. Reserve ratios compare the bank’s equity to its total assets. The higher this ratio, the greater the equity cushion a bank has if its financial assets fall in value during an economic downturn. By selling loans and using the proceeds to reduce a bank’s liabilities, equity will rise as a percentage of total assets.

The process of selling commercial loans to other investors is called securitization. These loans are placed in an independent trust which then sells units to other investors and distributes the proceeds from the loans as received. These units are generally referred to as collateralized debt obligations (CDO), which can be further classified into collateralized loan obligations (CLO) and collateralized commercial real estate obligations (CRE CDOs). The trusts are established by investment banks who are also referred to as arrangers. The original loans are still managed by the chartered banks to earn administrative fees and maintain business connections with borrowers to sell them other banking services.

**1.2 | Leasing**

**Operating and Financial Leases**

Leasing is an important source of financing accounting for 34% of all equipment and commercial vehicle purchases in 2015. With leasing, one company owns the asset (called the lessor) and then rents it to another company that uses it in their operations (called the lessee). Leases can be categorized as either operating or financial.

Operating leases are short-term agreements where the lessee is one of many renters of an asset over its economic life. Given the short duration of the lease, the lessor normally maintains the asset and pays other ownership related expenses such as property taxes or insurance. If a lessee no longer needs the asset or technology changes, an operating lease can usually be cancelled on short notice. Operating leases are aimed at companies who only need an asset for a short period and do not want to go through the inconvenience and risk of buying and then re-selling the asset.

Financial or capital leases are non-cancellable long-term agreements that are substitutes for buying an asset using a commercial loan. The lessee makes regular lease payments usually at the beginning of each month over the term of the agreement and may have the option to purchase the asset during or at the end of the lease from the lessor at its market price or a price below market through a bargain purchase option. Lease payments are equivalent to loan payments in that they cover a large portion if not all of the cost of the asset and any interest owed. Because a financial lease is similar to buying an asset, the lessee is typically responsible for maintenance and other ownership expenses and is exposed to the normal risks and rewards of ownership over the asset’s life. The lessee may even have to guarantee all or part of an asset’s residual value at the end of the lease.

**Pros and Cons of Leasing**

**Financial flexibility.** A lease can generally be negotiated faster than a commercial loan and requires a less thorough credit assessment since the lessor owns the asset and can reclaim it quickly for non-payment. A down payment is not required (called 100% financing) which allows a company to save precious working capital although security deposits and advanced lease payments may be required. A lease normally has a fixed interest rate providing greater certainty to the lessee and fewer lending conditions and collateral requirements compared to a loan. The lessor also has greater flexibility to adjust lease payments to better match a company’s cash flow needs using stepped, seasonal, or decreasing payments. If the lessee already owns an asset, they can sell it to a lessor and then rent it back to generate needed cash flows for operations in a sale-leaseback agreement. This financial flexibility leads to higher lease payments because of greater risk for the lessor but the lessee may decide it is worth the cost.

**Operational flexibility.**  Short-term operating leases can greatly simplify a lessee’s operations. Lessors can take responsibility for buying, installing, maintaining, disposing, and replacing a lessee’s equipment on an ongoing basis in exchange for regular lease payments. If equipment obsolescence becomes an issue, the lessor absorbs the risk, and the lessee simply waits till the end of the short-term agreement and replaces its equipment with the latest, most efficient models available. Some leases even allow the lessees to return assets early if they are not needed or if newer technology is required. Other leases base lease payments on usage such as miles flown rather than charging a fixed amount which essentially turns a fixed cost, the lease payment, into a variable cost which will be invaluable during a business downturn. The improved service provided by leases is costly and will lead to higher lease payments, but the lessee may feel it is worth the expense.

**Lessor expertise.** Many lessors specialize in leasing certain types of assets like airplanes or mining and forestry equipment. This expertise allows them to buy assets from competing vendors and re-sell them at the end of the lease for the best possible price. They can also more accurately estimate residual values reducing the risk of the agreement. Any savings this expertise generates can be shared with the lessee through lower lease payments.

**Lending restrictions.** Lessees can circumvent commercial loan conditions that limit the amount of new capital spending or bank borrowing a company can do by leasing an asset instead of buying it. A lease is not a loan and the lessee does not own the asset, but most lenders understand this ploy and place limitations on new lease agreements as well. Internally, companies may introduce moratoriums on the purchase of new assets, but junior managers may try to circumvent these rules by leasing instead of buying. Again, corporate controllers can usually recognize this deception.

**Tax savings.** An organization with a zero or low marginal tax rate such as a non-profit or company experiencing losses can lease assets from a lessor with a higher marginal tax rate. The lessor owns the asset and realizes greater tax savings by being able to deduct depreciation and receiving any tax credits. These tax savings can be shared with the lessee through lower lease payments in what is called a tax-orientated lease. In a leveraged lease, the tax savings are even higher as the established lessor can borrow more heavily than the smaller lessee to finance the asset due to their stronger credit position. The lessor’s lender also files a lien on the property and may require that the lessee make all lease payments directly to them to minimize risk.

**Cost.** Leases are generally more expensive than buying due to their financial flexibility and a higher level of service, but not always. Sometimes low-cost leases are used by equipment manufacturers and dealers as a way of passing on savings or providing sales incentives without reducing list prices and possibly instigating a price war with their competitors.

**Real estate.**  Leasing real estate (i.e. land and building) has unique problems that may cause a potential lessee to purchase the asset instead. These include:

* Loss of any appreciation on a leased asset over the term of the lease.
* Limited ability to make improvements to a leased asset.
* Breaking a lease or subletting may be difficult if the business must move.
* Lease renewals may be uncertain and expensive if the lessor has alternative uses for the property.
* Lessor may increase lease payments dramatically when the lease is renewed especially if the lessee’s business has been successful.
* Owned assets are typically better maintained than ones that are leased which adds to their residual values and lowers the cost of financing.

**Contractual disputes.** Lessors stress the convenience of leasing, but they do not always mention the strict rules relating to how much an asset can be used like maximum mileage, the over usage charges, that the lessee is responsible for any damages to the asset based on the lessor’s assessment, or that the lease likely cannot be cancelled early. A lessee needs to be familiar with their obligations under a lease agreement to avoid penalties and extra fees.

**Accounting for Leases**

Another advantage of leasing is that it can be used to make a lessee’s financial performance appear better compared to a competitor who may be purchasing its assets. Consider a simple balance sheet:

**Exhibit 1: A Balance Sheet**

|  |  |
| --- | --- |
| **Assets** | **Liabilities** |
| **Equity** |

When a company leases an asset instead of buying it using a commercial loan, the asset and corresponding loan do not appear on their balance sheet which is called off-balance sheet financing. As a result, the total assets and liabilities are lower while equity is mainly unaffected. These changes have a significant effect on some of the financial ratios that analysts use to evaluate a company’s performance or that lenders use as loan conditions.

**Total asset turnover (.** This ratio measures how efficiently a company utilizes its assets. By leasing instead of buying, total assets fall but sales are unchanged causing the ratio to rise. This makes the lessee appear more efficient.

**Debt-to-total-assets ratio ().** This ratio measures how dependent a company is on borrowing to finance its operations. By leasing instead of buying, both total liabilities and total assets fall. When the numerator and denominator of a ratio that is below 1.0 fall by the same amount, the ratio falls. This makes the lessee appear less dependent on debt.

**Rate of return on assets ().** This ratio measures the profitability of a company. By leasing instead of buying, total assets will fall and net income normally increases causing the ratio to rise. This makes the lessee appear more profitable. Net income increases because in the early years of a lease, lease expense is lower than the interest and depreciation expense a company would have accrued if it had purchased an asset.

Before January 1, 2019, to prevent this manipulation of the lessee’s financial statements, IFRS required that all leases be capitalized if the risks and rewards of ownership had passed from the lessor to the lessee. This means that the lessee is in reality the owner of the asset so the asset and corresponding loan should be included on the lessee’s balance sheet. The following factors were considered when determining if the risks and rewards of ownership had passed:

* Lessee assumes ownership of the asset at the end of the lease or the lease has a bargain purchase option.
* Present value of the future lease payments substantially equals the value of the leased asset.
* Lease term is for a major part of the asset’s economic life.
* Lease involves a highly specialized asset that can only be used by the lessee.
* Lessee is responsible for any gains/losses on the residual value.
* Lessee can extend the lease at a rent that is substantially below market value.
* Losses from cancelling the lease are borne by the lessee.

The problem with this approach is that these factors were easy to circumvent. Lessees intentionally structured their lease agreements so the risks and rewards of ownership did not pass and the manipulation continued. Professional analysts and bank lending officers knew of this problem and adjusted financial statements and loan conditions to compensate, but the average user did not have that expertise. IFRS 16 – Leases recognizes this problem, and effective January 1, 2019, requires that all leases be capitalized unless the lease term is less than 12 months, or the asset is of low value.

To capitalize a lease, the lessee determines the present value of all future lease payments. A lease payment is equivalent to a loan payment when capitalizing a lease, so taking the present value strips these blended equal monthly payments of their interest leaving the principal portion of the loan only. As leases do not have a down payment, this amount is equal to both the value of the asset and the liability. The asset is classified as a fixed asset on the balance sheet and is depreciated over the lease term. The portion of the liability due within the year is classified as a current liability while the remainder is classified as long-term debt.

The interest rate used to determine the present value is the implicit rate in the lease or the lessee’s incremental borrowing rate if the implicit rate is not available. The implicit rate in the lease is the interest rate that equates the value of the asset today with the future lease payments and the estimated residual value of the asset. The incremental borrowing rate is the interest rate a lessee would pay if it purchased the asset and financed it with a commercial loan with similar security.

**Calculating Lease Payments**

There are three types of companies that act as lessors. Financial institutions like banks or credit unions offer leases to businesses along with their other commercial lending services. Vendor (also called sales or captive) financing companies lease out the equipment produced by manufacturers like Boeing or General Electric. These financing companies are usually major profit centers within these manufacturers. Finally, independent leasing companies specialize in leasing and work with lessees to identify their equipment needs, help them get the best possible price from competing equipment vendors, and then provide lease financing.

To calculate a lease payment, lessors use the formula:

Value of asset – Present value of CCA tax shield = Present value of after-tax lease payments + Present value of residual value

It equates what a lessor is investing (left-hand side) in a lease to what it is getting back (right-hand side). The value of the asset is its current fair value plus any initial leasing costs such as legal fees, transportation, or installation. The lessor, who is the owner of the asset, can claim depreciation or capital cost allowance (CCA) on the asset which reduces its investment. These tax savings are equal to:

Present value of CCA tax shield = (Investment) (Marginal tax rate) () ()

The lease payment is calculated based on an estimate of the asset’s residual value and a required rate of return (RRR) that reflects the risk level of the lessee. The actual lease payment charged by the lessor may be different than what is calculated due to competitive forces. In this case, the formula can be used to calculate the implicit interest rate in the lease which is the rate of return they are earning. It can also be used to determine how a bargain purchase option would affect the lease payment. A bargain purchase option allows the lessee to buy the asset at the end of the lease at a below-market price.

**Lease or Buy Decision**

Before entering into a lease agreement, a lessee should compare the incremental after-tax cash flows of leasing versus buying an asset on a present value basis to determine which form of financing has the lowest cost. As leases are substitutes for commercial loans and other forms of debt, the appropriate discount rate is the after-tax cost of debt. This rate can be varied depending on the uncertainty of specific cash flows especially residual values at the end of the lease which is difficult to estimate and are a major source of risk in leasing agreements. Buying is usually the better option on a net present value basis, but all the other pros and cons of leasing need to be carefully considered before making a final decision. Again, the benefits of leasing may be worth the added costs.

**Tax Law**

Governments lose significant tax revenues when companies with low marginal tax rates lease assets from companies with higher marginal tax rates and share in the tax savings. To limit these losses, the “specified leasing property rules” in the Income Tax Act (ITA) were introduced that divide all assets into either exempt or non-exempt categories. A lessor of exempt assets can deduct full CCA, but a lessor of non-exempt assets is limited to the lower of 1) CCA or 2) the principal a lessor receives if a lease is treated as a loan equal to the fair value of the leased asset.

The principal is much lower than CCA which eliminates the tax incentive for leasing non-exempt assets. The full lease payment a lessor receives is recognized as taxable income, but if the deduction is limited to the principal portion of the payment, the net of these two amounts are equivalent to the interest portion of the loan payment. This is what the lessor would recognize if they treated the lease as a loan, which is the intention of the government. The interest rate used to calculate the principal is the prescribed rate relating to “pertinent loans or indebtedness” which is regularly published by the Bank of Canada.

The lessee can also elect under the ITA to be treated as the owner of a non-exempt asset for tax purposes allowing them to deduct both interest and CCA. The intention of the federal government is for lessees to account for a lease as the owner while the lessor is the financier. This is consistent with recent changes to IFRS, which may lead to further harmonization of tax and accounting treatments of leases in the future. These rules eliminate the tax savings that can be realized by leasing non-exempt assets, but the other leasing advantages such as financing flexibility may still cause companies to select this financing option.

**1.3 | Corporate Bond Financing**

**Bonds versus Commercial Loans**

Financing a business with corporate bonds is similar to using commercial loans. Interest is paid regularly at a fixed or variable rate along with bond sinking or purchase fund payments that help keep the balance of the loan below the declining value of any pledged collateral. All terms and conditions are outlined in a lending agreement called a bond indenture or deed of trust which is enforced by an independent third party, usually a trust company, who protects the interests of bondholders. Trustees carefully monitor the issuer and distribute all interest and principal payments as received.

Bonds and commercial loans exist together because of the different advantages they offer to both issuers and investors. Bonds are preferred over commercial loans because they:

* Enable businesses to by-pass financial institutions (i.e. the middleman) and borrow directly from investors thus lowering their cost of borrowing.
* Trade publicly providing greater market liquidity to investors who will accept lower interest rates.
* Have a less restrictive monitoring process and fewer lending covenants.
* Provide funding for extended periods of up to 30 years as bondholders are longer-term investors.

Commercial loans are preferred over bonds because they:

* Can be arranged quickly as they do not go through the public placement process and are originated using the lender’s extensive branch banking system.
* Have lower up-front issuance costs that small issuers can absorb more easily.
* Can customize repayment provisions to meet a firm’s unique cash flow needs.
* Are easier to modify than bond indentures if an issuer wants to make changes.
* Do not require a bond rating.
* Avoid the detailed financial disclosures required in a public placement.

**Public and Private Placements**

A public company attempting to raise a large amount of long-term (i.e. 5+ years) debt typically issues bonds using a public placement as the size of the issue justifies the high up-front costs. The public placement process for issuing bonds is similar to the process for equity securities described in Section 1.3 Equity Financing.

Securities regulators realize that the formal public placement process is not always needed to protect investors. If securities are sold directly to a limited number of institutional investors and high-net-worth individuals, regulators feel these investors are sophisticated enough to deal directly with issuers. They also believe that issuances involving business insiders and their family, friends, and business associates require less scrutiny. To help companies raise debt financing more easily, regulators exempt them from having to file a prospectus in several situations. They can use a private or direct placement to sell exempt securities directly to specific investors with minimal paperwork and little or no government supervision. In British Columbia, the exemptions include:

**Family, close friends, and close business associates.** Securities can be issued in any amount with no formal disclosure to the person who controls a business or a director or senior officer of the company and their family members, close friends, and close business associates. Family members include a spouse, parent, grandparent, brother, sister, or child of a person who controls a business or a director or senior officer. Close friends and business associates are people who have known the business owner, director, or senior officer long enough to assess their capabilities and trustworthiness.

**Employee, director, officer, and consultant.** Securities can be issued in any amount with no formal disclosures to employees, directors, officers, and consultants as long as the investment is not a requirement of their employment, appointment, or engagement.

**Accredited investor.** Securities can be issued in any amount with no formal disclosure to accredited investors. They include institutional investors and high-net-worth individuals with over CAD 1,000,000 in financial assets (i.e. cash and securities minus any loans); who earned CAD 200,000 yearly or more (or CAD 300,000 yearly or more including their spouse) in the past two years and who expect to earn that in the current year; or who have at least CAD 5,000,000 in net assets. High-net-worth investors must sign a risk acknowledge form which clearly outlines the risky nature of exempt investments and includes a confirmation by the issuer that the investor qualifies as an accredited investor.

**CAD 150,000.** Securities worth over CAD 150,000 can be issued to any non-individual investor (i.e. an institutional investor) with no formal disclosure to the investor.

**Private issuer.** Securities can be issued in any amount with no formal disclosure to investors by private issuers under several conditions. Private issuers must have fewer than 50 shareholders consisting of only the person who controls the company, and its directors, and officers; their family members, close friends, and close business associates; current security holders and their family members; and accredited investors. Private issuers must restrict the sale of their shares so they can only be sold with the permission of the company’s board of directors.

**Start-up crowdfunding**. Securities can be issued to a maximum of CAD 250,000 per issue with no more than two issues per year. Each investor can contribute up to CAD 1,500 or CAD 5,000 if the investment is made through a registered dealer. Upon completion, each successful distribution is reported to the securities regulator. Section 1.3 Equity Financing provides a detailed description of crowdfunding

**Offering memorandum.** Securities can be issued in any amount to any investor regardless of their relationship with the issuer, their net worth, or the amount of securities they have purchased. Regulators require that investors sign a risk acknowledgment form that clearly outlines the risky nature of exempt investments. Issuers must also provide investors with an Offering Memorandum (OM) which is a simplified prospectus. It includes a description of the issue; the issuer and its business; how the funds will be used; special features of the security including any resale limitations; risk factors that may affect the success of the business; rights of investors to cancel the security purchase; their rights in case of a misrepresentation in the OM; and unaudited interim and audited annual financial statements. The OM must also be signed by the CEO, CFO, directors, and any share promoter. All OMs are submitted to the securities regulator upon completion of the issue, but they are not read or approved by them.

Private placements offer several advantages compared to public placements. These include negotiating financing more quickly; lower issuance costs; being more receptive to smaller, higher-risk issues; being able to hand-pick compatible investors with the desired competencies; diversification of funding sources; greater customization of repayment schedules and loan conditions; no bond rating requirement; and more privacy including no public disclosure of company information.

Exempt securities issued in private placements are much less liquid than those issued in a public placement which leads to higher interest costs. Also, private placements are generally for shorter periods and smaller amounts compared to public placements. They have higher lending standards and stricter loan conditions and are more closely monitored by lenders. This is mainly because private placements have traditionally been used by SMEs who have higher risk profiles. Private placements provide SMEs with the long-term (i.e. 5+ years) debt that commercial banks cannot supply because of the shorter timeframe (i.e. <5 years) of their funding sources. SMEs are usually not able to secure financing through a public placement because of their limited size, so private placements fill this gap.

The private placement industry is becoming more sophisticated and the sizes of placements are increasing. New institutions are forming such as TSX Private Markets that brings together issuers and investors in the private placement market and then provides them with an active secondary market to trade securities enhancing their liquidity. As a result, private placements are increasingly being used by large public companies as well as SMEs to raise needed debt and equity capital.

**Bond Provisions**

Although bond financing is generally less restrictive than commercial lending, a bond indenture is still a complex legal document containing the terms of the loan and numerous other provisions relating to covenants, call options, conversion features, sinking or purchase funds, credit ratings, collateral, subordination, and guarantees.

**Interest Rates and Currency**

Bonds typically require semi-annual interest payments at a fixed rate over the life of the security. Some bonds have floating or adjustable rates equal to an interest rate index such as the prime rate, banker’s acceptance rate, commercial paper rate, or London Interbank Offering Rate (LIBOR) plus a spread that reflects the risk of the issue. Interest rates are reset daily, weekly, monthly, quarterly, semi-annually, or annually depending on when the interest rate index is re-calculated. Adjustable-rate bonds are popular if issuers expect interest rates to fall, but investors will prefer to lock into fixed-rate bonds in this scenario.

Instead of issuing bonds domestically, companies can raise funds in other countries to either finance their operations in that country or repatriate funds for domestic use. Foreign bonds are sold in another country in that country’s currency and are regulated by that government. Companies may decide to raise funds this way because of lower interest rates and a less restrictive regulatory environment. Since interest and principal payments are made in the foreign country’s currency, companies can also use these transactions as part of a natural currency hedging strategy.

Eurobonds are a more flexible alternative to foreign bonds. Eurobonds can be sold in any country but must be denoted in a currency other than the currency of that country. These bonds are named according to their face currency. For example, Eurodollar bonds are denoted in USD but could be sold in any country other than the U.S. Eurobonds give issuers the flexibility to sell bonds in many countries and denote them in whatever currency they need for hedging or other purposes. The name Eurobond is confusing as these bonds are not related to Europe, the European Union, or the Euro currency.

**Covenants**

A company is in default of its bond indenture if it violates any term or condition. The main reason for default is non-payment of interest and principal, but the violation of one of the many bond covenants is also grounds for demanding immediate payment. Borrowers are often given a specified period called a “cure” period to attempt to rectify the violations before payment is required. The lender may also have the option to waive default in exchange for the payment of a fee or modifications to the bond indenture. Some typical covenants include:

**Exhibit 2: Typical Covenants**

|  |  |
| --- | --- |
| **Negative Pledge Clause** | Company cannot pledge any assets to another lender if it gives the current bondholders less protection. |
| **Acceleration Clause** | If the issuer defaults on specific terms or conditions, all interest, and principal payments are immediately payable. |
| **Cross Default** | A default on any lending agreement is considered a default on all lending agreements. |
| **Maintenance Test** | Certain liquidity ratios such as the current ratio or cash flow coverage ratio must be maintained at a specified level when reported or the loan is in default. |
| **Incurrence Test** | Limits are placed on borrowing as measured by different leverage ratios such as the debt ratio and long-term debt to total capitalization ratio. Ratio maximums may be lowered over time to encourage the company to reduce its borrowing. |
| **Limitations on Mergers** | Leverage ratios requirements must be met post-merger to prevent over-leveraging the company in a take-over. Debt holders cannot have a weaker claim after the merger. |
| **Limitation on Restricted Payments** | Restricted payments to redeem subordinated debt, repurchase equity, or provide dividends are limited to protect the bondholders. Investments in subsidiaries that are not subject to the loan covenants are also limited.  Restricted payments are any payments that take funds out of a business that could be used to pay the obligations of the bondholders and thus puts bondholders in a weaker position. |
| **Limitation on Asset Sales** | All pledged collateral must be properly maintained, and any asset sales must be for cash and used to pay down debt or buy replacement assets. This prevents risky diversification and ensures the asset base to support the debt is maintained. |
| **Limitation on Sale/Leaseback Agreements** | These transactions are limited as it reduces the collateral available to bondholders and burdens companies with additional fixed charges. |
| **Limitation on Sale of Stock in Subsidiaries** | Company cannot sell additional shares of its subsidiaries. This protects the asset base available to the bondholders of the parent by preventing a change of control of the subsidiary. |
| **Limitation on Guarantees by Restricted Subsidiaries** | Subsidiaries cannot provide guarantees to other companies to reduce the support they can provide to the parent. |
| **Limitations on Transactions with Affiliates** | Transactions with affiliates must be at market value and cannot be used to make restricted payments. Trustee approval may be required for all transactions. |
| **Change in Control** | Bondholders have the right to sell their bonds at a premium to the company if there is a change in control. Change in control can be measured by percentage ownership (50 percent or more), board member replacement, or “rating triggers.” Rating triggers means if the bond rating falls below investment grade it is considered a change in control. |
| **Material Adverse Change** | Default occurs if there is a change in any law or regulation affecting the business, loss of a major customer, or other material event affecting the business. |
| **Line of Business Test** | Company is not allowed to enter new a new line of business. Owners may not have the expertise to operate the new business or it may be in a riskier industry. |
| **Fall Away Event** | Certain covenants will not be enforced if the company can improve its credit rating over the life of the debt agreement. |
| **Provision of Financial Statements** | Audited financial statements must be provided regularly. |

**Call Options and Conversion Features**

**Callable Bonds.** Most bonds are callable at a premium above par (i.e. 104) which is equal to up to one year’s interest, but this call premium falls as the bond matures and reaches par value (i.e. 100) at maturity. Issuers can call all or part of a bond issue on specified dates through the trustee. If less than the full issue is being bought back, bonds are purchased either randomly or on a pro-rata basis. A call option allows issuers to reduce their use of financial leverage; re-finance at a lower interest rate if interest rates in the economy have fallen; re-finance at a lower rate if the company’s credit rating has improved; or replace debt that has strict lending conditions or conditions they are about to be violated.

Issuers should not call a bond just because current market interest rates have fallen below the bond’s coupon rate. They must compare potential interest savings with the call premium and issuance costs that would be incurred replacing the debt. Also, it is difficult to call a bond and immediately replace it, so interest costs during an overlap period when both bond issues are outstanding should be included in the analysis. These costs should be compared on an after-tax, present value basis using a discount rate equal to the cost of the new debt since this rate most accurately measures the risk level of the relevant cash flows.

Because calling a bond is inconvenient for investors and usually results in them receiving a lower interest rate when they re-invest, they will demand a higher coupon rate and may try to negotiate call protection using a deferred call. This prevents issuers from buying back their bonds for any reason for a specified period at the beginning of the bond’s life. A weaker defense is refund protection where issuers can buy back bonds for any reason except to refinance at a lower interest rate.

Another type of call protection that is much more beneficial to bondholders is a Canada Plus Call. With this type of call option, a call price is not set at the beginning of the bond’s life, instead, the issuer has the option to buy back bonds at a call price equal to the greater of the 1) bond’s par value or 2) value of the bond using a discount rate equal to the rate on a Government of Canada bond of the same maturity plus a premium. The premium is contained in the bond indenture and approximates the average spread between the issuer’s interest rate and the rate on Government of Canada bonds of the same maturity. This process forces companies to buy back bonds at an amount that approximates their current market value, which fairly compensates bondholders for the higher interest rates they are being forced to give up and eliminates the interest savings an issuer can realize by refinancing. As a result, few bonds with a Canada Plus Call feature are repurchased unless reducing financial leverage or eliminating restrictive lending covenants are important to the issuer.

The risk of bondholders having their bonds called early is referred to as call risk. This risk increases the coupon rate issuers must pay although the amount varies with the call protection provided and future interest rate expectations. Retractable bonds or puttable bonds are the opposite of callable bonds. Bondholders can also force the issuer to buy their back bonds at par value on a specified date if interest rates rise. Another option is extendable bonds which allow investors to extend the life of their bonds if the coupon rate is above the market interest rate when the bonds mature. To encourage investors to extend their bonds, issuers are frequently offered a higher coupon rate in the second term. Both retractable and extendable bonds benefit the bondholder so the issuer pays a lower coupon rate.

An alternate method for removing bonds from the balance sheet is the defeasance of debt. Companies establish an escrow fund controlled by a third party that contains sufficient funds in the form of government securities to pay the interest and principal on the bond as it comes due. Because payment is guaranteed by a third party, the bond and the corresponding escrow funds can be removed from the balance sheet lowering the debt ratio.

**Convertible Bonds.** Some bond issues are also convertible into an issuer’s common shares at a specified conversion ratio such as 5-to-1 which means each CAD 1,000 bond can be exchanged for five shares at a conversion price of CAD 20. If the company implements a stock split or reverse stock split, the conversion ratio is adjusted. Most conversions are at the discretion of the investor, although some can be mandatory or at the discretion of the company. Convertible bonds are usually callable, so issuers can force a bond conversion by announcing they will exercise their call option.

Conversion options are commonly used with subordinated bonds or mezzanine financing to better compensate these high-risk investors. If a company is successful and its share price rises, investors will realize a sizeable profit on conversion. If the company continues to struggle, then investors will still receive bond interest and rank ahead of equity holders if the company fails and is forced to liquidate. The conversion feature also serves as an “equity kicker” or “sweetener” which reduces the coupon rate and allows companies to issue bonds with fewer restrictive covenants. In Canada, convertible bonds can trade on the Toronto Stock Exchange as they are hybrid securities with an equity component. If the share price is well below the conversion price, the conversion is unlikely to occur so the convertible bonds will trade like a regular debt instrument.

Instead of conversion options, issuers can also lower bond coupon rates by issuing warrants which allow investors to benefit from a rising share price. Warrants have the additional advantage of being detachable which means they can be sold separately on a public exchange like a stock option. They also provide issuers with new capital unlike the conversion of an existing bond. The opportunity cost of conversion options and warrants can be quite high for issuers if their company is successful and the share greatly appreciates. Convertible bond and warrant holders will be able to buy equity well below the market price which is detrimental to existing shareholders.

**Bond Sinking and Purchase Funds**

Under a bond indenture, a portion of a bond issue may have to be bought back each year to ensure that its depreciating collateral is worth more than the outstanding obligation. If the sinking fund payment is not made, the bond is in default which can lead to bankruptcy.

Companies can make bond sinking fund payments in several ways:

**Option 1** Buyback bonds of equivalent value on the open market.

**Option 2**  Buyback bonds of equivalent value on a random or pro-rata basis among existing bondholders at par value or a special sinking fund call price that usually starts at the issuance price but moves to par value by maturity.

**Option 3** Make a cash payment to the bond trustee who invests the funds and uses the proceeds to retire the bond issue at maturity.

Businesses normally choose either Option 1 or 2 depending on whether the current market price or the sinking fund call price is the lowest. Option 3 is not popular because the sinking fund and the liability must both remain on the issuer’s balance sheet negatively affecting key financial ratios. Sinking fund purchases have the added benefit of increasing the bond’s market liquidity reducing interest costs for the issuer.

Sinking fund payments can be of equal value or modified to accommodate a business’s cash flow needs. They can start low and end high and may include a large balloon payment at the end of the bond’s life. Payments may be deferrable for several years or a doubling option may allow the issuer to buy back twice the prescribed amount if they want to further reduce their use of financial leverage or to replace bonds that have high interest rates.

A purchase fund is similar to a sinking fund except that issuers only repurchase bonds when the price is below a certain level which is usually the issuance price. The bonds purchased each year will vary considerably using this system, but investors prefer it because they are not forced to sell bonds that are trading at a premium. Like sinking funds, purchase funds improve the bond’s market liquidity and lower interest costs.

Companies can also ensure that the value of the collateral remains higher than the loan’s balance by using serial or installment bonds instead of term bonds that mature on a specific date and have sinking or purchase fund requirements. Serial bonds are divided into different maturities with shorter maturities having lower coupon rates than longer maturities. Each maturity represents a portion of the bond’s principal that is paid off over its life. For example, a CAD 100,000 bond could be divided into 10 maturities of CAD 10,000 which are payable in each of the next ten years.

**Credit Ratings**

A credit rating is a “forward-looking opinion of the creditworthiness” of a particular debt issue or a company. When determining a credit rating for an issue, the rating agency evaluates the company’s “capacity and willingness to meet its financial commitments as they come due.” This also includes an assessment of currency risk if the obligation is in another currency; any collateral pledged; subordinations and any preferences in bankruptcy; and third-party guarantees or other credit enhancements. Senior obligations have higher credit ratings as do issues with greater collateral and better guarantees. When determining a credit rating for a company only their “capacity and willingness” to meet their obligations is considered. In general, firms with higher, more stable profits and lower debt ratios have higher credit ratings.

An up-to-date credit rating is typically required to issue bonds and many other debt obligations. The rating is used to determine the appropriate coupon rate but is also included in some bond covenants. For example, an issuer may have to meet more demanding ratio requirements or repay a bond early if its credit rating falls below a specified level.

The issuer and not the bondholders pay the rating agency for its credit assessment. Canadian companies are served by four major rating agencies including DBRS, Standards & Poor Global Ratings, Moody’s Investment Services, and Fitch Ratings. DBRS was the only Canadian firm until recently when it was purchased by Morningstar a U.S.-based financial services firm. Credit ratings are often referred to as bond ratings, but they apply to many different types of debt obligations issued by both the private and public sectors. Common rating categories include:

Corporates

Insurance companies

Public finance

Sovereign countries

Structured finance

Asset-backed securities (ABS)

Collateralized mortgage obligations (CMO)

Collateralized debt obligations (CDO)

Collateralized bond obligations (CBO)

Collateralized loan obligations (CLO)

Collateralized commercial real estate obligations (CRE CDOs)

Rating agencies provide rating scales for both short-term obligations (i.e. under a year) and long-term obligations (i.e. over a year). These scales vary by rating agency but they are all similar. The long-term credit rating scale at S&P is:

**Exhibit 3: S&P Long-term Credit Ratings**

|  |  |
| --- | --- |
| **Category** | **Definition** |
| **AAA** | An obligation rated ‘AAA’ has the highest rating assigned by S&P Global Ratings. The obligor’s capacity to meet its financial commitments on the obligation is extremely strong. |
| **AA** | An obligation rated ‘AA’ differs from the highest-rated obligations only to a small degree. The obligor’s capacity to meet its financial commitments on the obligation is very strong. |
| **A** | An obligation rated ‘A’ is somewhat more susceptible to the adverse effects of changes in circumstance and economic conditions than obligations in higher-rated categories. However, the obligor’s capacity to meet its financial commitments on the obligation is still strong. |
| **BBB** | An obligation rated ‘BBB’ exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to weaken the obligor’s capacity to meet its financial commitments on the obligation. |
| **BB, B, CCC, CC, and C** | Obligations rated ‘BB’, ‘CCC’, ‘CC’, and ‘C’ are regarded as having significant speculative characteristics. ‘BB’ indicates the least degree of speculation and ‘C’ the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposure to adverse conditions. |
| **BB** | An obligation rated ‘BB’ is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor’s inadequate capacity to meet its financial commitments on the obligation. |
| **B** | An obligation rated ‘B’ is more vulnerable to nonpayment than obligations rated ‘BB’, but the obligor currently has the capacity to meet its financial commitments on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor’s capacity to meet its financial commitments on the obligation. |
| **CCC** | An obligation rated ‘CCC’ is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation. |
| **CC** | An obligation rated ‘CC’ is currently highly vulnerable to nonpayment. The ‘CC’ rating is used when a default has not yet occurred but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default. |
| **C** | An obligation rated ‘C’ is currently highly vulnerable to nonpayment, and the obligation is expected to have lower relative seniority or lower ultimate recovery compared with obligations that are rated higher. |
| **D** | An obligation rated ‘D’ is in default or in breach of an imputed promise. For non-hybrid capital instruments, the ‘D’ rating category is used when payments on an obligation are not made on the date due, unless S&P Global Ratings believes that such payments will be made within five business days in the absence of a stated grace period or within the earlier of the stated grace period or 30 calendar days. The ‘D’ rating also will be used upon the filing of a bankruptcy petition or the taking of similar action and where default on an obligation is a virtual certainty, for example, due to automatic stay provisions. An obligation’s rating is lowered to ‘D’ if it is subject to a distressed exchange offer. |
| Ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories. | |

Source: S&P Global Ratings

Bonds rated from AAA to BBB are classified as investment grade while bonds rated below BBB are called non-investment grade, high-yield, or “junk” bonds. High-yield bonds are normally issued to finance distressed firms or leveraged buyouts of other companies. “Fallen angels” are bonds that were investment grade when first issued, but then fell to “junk” status due to a company’s deteriorating performance. “Rising stars” were high-yield bonds when first issued, but then rose to investment grade as the company became more successful. Non-investment grade bonds have much higher default rates than investment-grade bonds, so many institutional investors are precluded from investing in them to protect against high losses. Other institutional investors do not have this limitation and find the higher yields more than compensate for the greater risk.

Rating agencies also provide warning systems for potential credit rating changes. S&P places companies on a CreditWatch® if there has been a recent economic or political event; short-term material change in the performance of an issue or issuer; or a change in S&P’s rating procedures that may affect the rating. With CreditWatch®, a “positive” designation means a rating may be raised; “negative” means it may be lowered; and “developing” means it may be raised, lowered, or affirmed.

S&P also provides longer-term rating outlooks for the next six months to two years based on changes in general economic and business conditions and a particular business’s fundamentals. For rating outlooks, one new designation is added to the CreditWatch scale which is “stable” meaning a rating is not likely to change.

Credit rating agencies were major contributors to the financial crisis beginning in 2007. They had difficulty rating the many new structured finance products like collateralized-debt obligations, which led to risk being greatly underestimated, an over-investment in real estate, and a housing bubble. This was made worse by a conflict of interest where bond issuers and not investors pay for ratings making it less likely companies would receive a negative review.

The eventual collapse of the housing market would have caused many financial institutions to fail if it were not for government intervention. The USD 800 billion Trouble Asset Relied Program (TARP) was needed, although nearly all of the funds were eventually repaid. Markets and the real economy have only now recovered from this crisis after nearly a decade of low-interest rates orchestrated through “quantitative easing” by central banks globally. Quantitative easing occurs when central banks purchase government bonds to expand the money supply and lower interest rates to promote increase lending and greater economic activity.

Credit rating agencies have been improving their rating systems, so this crisis is not repeated. Major steps include better disclosure of the rating methods, procedures, criteria, and assumptions used; greater use of scenario analysis or “stress tests” centering on factors that could cause ratings to change; and improved rating methods for structure finance products. Credit rating companies only provide an opinion concerning a company’s creditworthiness, so legally they cannot be held accountable for their errors unless fraud or negligence is proven.

**Collateral, Subordination, and Guarantees**

**Collateral.** A bond may be either secured by collateral or unsecured. Investors in unsecured bonds depend on the “promise and good credit” of the issuer and must wait until the claims of secured creditors have been satisfied before making their claims. Unsecured bonds with lives of under 10 years are also referred to as medium- or intermediate-term notes, while those with lives of 10 years or greater are called debentures. The terminology bond and debenture are sometimes used interchangeably, so users should always ensure what is meant.

The collateral consists of claims on specific physical assets (land, plant, equipment, inventory) or financial assets (receivables, marketable securities) or blanket claims on entire asset groups. Collateral should be properly appraised and carefully monitored over the term of the loan. A title search will assure that the borrower owns the asset and that they have not pledged it to another creditor. A lien against the asset should be properly registered with the government so the lender’s claim is valid and enforceable. The borrower should be required to carry adequate insurance and properly protect and maintain the assets in their possession.

Some bonds have unique names depending on their specific collateral arrangement:

**Mortgage bonds.** Secured by specific real estate and other real property such as equipment. There may be several mortgages for the same property, but a first-mortgage bond or senior mortgage bond must be paid before a second-mortgage bond or junior mortgage bond.

**Equipment trust certificates.** Secured by the ongoing equipment purchases of transportation companies to finance assets such as trucks, shipping containers, airplanes, and railway cars. The trustee holds the title to the collateral until the bond is fully paid and then transfers the collateral to the issuer.

**Collateral trust bonds.** Secured by marketable securities such as stocks or bonds. These bonds are normally issued by parent companies who do not have any collateral of their own but do own shares or bonds in their subsidiaries that do have real assets. These marketable securities are transferred to the trustee and are held until the bond is fully paid.

Pledging high-quality collateral to secure a bond will increase the issue’s credit rating, lower its coupon rate, make the bond more marketable to potential investors especially in the secondary market, and provide higher recovery rates if the issuer defaults. Complying with collateral requirements can be costly for both the issuer and lender. The issuer will also have less financial flexibility since the collateral cannot be pledged to support other loans in the future.

Unsecured bonds are generally sold by issuers who are financially strong and will only realize a minimal reduction in their borrowing costs by pledging collateral; have already pledged all of their collateral; or have mostly intangible assets that are not generally accepted as collateral due to their lack of physical substance.

**Subordination.** To provide additional protection, some bonds, notes, or debentures are designated as senior which means they must be paid in full before any other junior or subordinate obligations. Subordinate notes or debentures are common in mezzanine financing where companies have pledged all of their collateral to existing creditors and their bond indentures stipulate that any new borrowing must not weaken current bondholders’ claims. Income bonds are also subordinate to other obligations. With an income bond, the company agrees to pay the bond’s principal, but the coupon is only paid if the company has sufficient income. Missed interest payments may be either cumulative or non-cumulative, but cannot be used to force a company into bankruptcy. These types of bonds are suitable for mature companies with variable sales and high fixed costs which causes earnings to fluctuate or start-up companies with low initial profits. They are also useful for companies that are either in bankruptcy or attempting to reorganize as their cash flows are limited.

**Guarantees.** A company may require a third-party guarantee to comply with a covenant in a bond indenture or use it as credit enhancement to reduce its borrowing costs. Guarantees usually come from a parent corporation; a government organization promoting economic growth; financial institutions through a back-up line of credit or standby letter of credit; or a bond insurer.

Bond insurers are well-capitalized companies with AAA credit ratings who can reduce the cost of borrowing for a company with a lower credit rating by guaranteeing its debt in exchange for an insurance premium. Municipal Bond Insurance Association (MBIA) and Ambac Financial Group are the major public providers of bond insurance. Regulators refer to these companies as financial guaranty insurance companies or monoline insurers and only allow them to provide this one type of insurance to make regulation easier and the industry safer.

Mismanagement at the bond issuers played a major role in the financial crisis beginning in 2007. Until 1990, only U.S. municipal bonds were insured. Profits were high as very few of these bonds ever defaulted. In the 1990s, monolines began to diversify into other types of financial guarantees to grow their business. By 2006, monolines were guaranteeing over USD 3.3 trillion in loans but supported this with only USD 34 billion in equity so were very highly leveraged. Monolines became very involved in ensuring collateralized debt obligations especially those in the real estate industry. With the collapse of the U.S. housing market in 2007 and 2008, the credit ratings of the monolines fell dramatically as they were undercapitalized. Guarantor’s credit ratings fell below their clients, so they could no longer offer new guarantees. Regulators intervened and required bond insurers to recapitalize to raise their credit ratings, limit their guarantees to only the safest investments, and better diversify their risks.

In addition to guarantees, parent corporations, governments, and third parties such as accounting firms sometimes provide comfort letters to lenders. In these letters, they describe the actions they will take on behalf of the borrower if it experiences financial difficulties or state that the borrower can meet its loan obligations. These letters are only opinions and are not legally enforceable.

**1.4 | Equity Financing**

**Self-Funding**

New ventures have limited access to start-up capital. Commercial banks and credit unions may provide some debt financing, but they are very hesitant to lend to new businesses because of their inexperience and lack of a financial track record. These lenders will impose strict loan conditions and substantial collateral requirements to compensate for the higher risk. A company is limited in how much of its operations it can finance with debt, so considerable equity is also needed. Small businesses cannot access the public equity markets like major corporations, so owners have no choice but to use their personal assets and connections to raise capital. These may include their savings including RRSP and TFSA accounts; re-mortgaging a primary residence; selling personal property such as a cottage or boat; borrowing “patient money” or “love money” from family and friends; using credit card debt despite the exorbitant interest rates; and possibly swapping shares in a new business for legal, accounting and other business services provided by local business professionals.

**Crowdfunding**

Crowdfunding allows start-ups or small businesses to raise modest amounts of capital through small contributions from many people using the Internet and other social media platforms. The three main crowdfunding models are:

**Donor-based.** Used by individuals or small organizations to raise funds for business start-ups, medical bills, family expenses, charitable causes, and accident or disaster relief. Donors receive nothing in return for their contribution but personal satisfaction.

**Rewards-based.** Provides entrepreneurs with funds for business start-ups or product development. In exchange for their financing, contributors receive a reward such as a free product or can pre-purchase products at a reduced price. This not only provides companies with capital but also allows them to test market new products before committing to them. Any success can also be used to attract more conventional sources of financing such as commercial loans. Numerous web-based crowdfunding portals provide easy access to this type of financing. All-or-nothing campaigns do not release funds unless the project’s stated fundraising goal is met within a specified time frame. If unsuccessful, contributions are returned, and no commission is levied by the portal. Keep-it-all campaigns allow entrepreneurs to keep whatever is raised after paying the portal’s commission. There is no guarantee that contributors will receive the rewards or pre-purchased products promised and the crowding funding portal is not liable. Fraud is limited though because of the close relationships entrepreneurs usually develop with their contributors through the crowdfunding portal and social media.

**Securities-based.** Regulators oversee securities-based crowdfunding to protect investors, but they do not apply the same rigorous standards used for larger public placements completed through registered investment dealers. Preparing a prospectus and financial statements can be very costly for a start-up or small business, so regulators in most provinces provide an exemption that allows them to raise funds without this documentation. British Columbia, Saskatchewan, Manitoba, Quebec, New Brunswick, and Nova Scotia have joined together to offer a standard set of crowdfunding rules. Ontario and Alberta have established similar but separate systems.

Crowdfunding portals are also exempt from registering with regulators as investment dealers although registered dealers can operate crowdfunding portals. Those operated by registered dealers can make investment recommendations to clients and charge them for their advice. Other portals only provide basic information about each issue and cannot charge investors any fees. All portals can screen potential issuers to protect the portal’s reputation and increase their returns.

Using a portal, companies post an Offering Document which contains information about the business, the securities being offered, how the funds are being used, the risks involved, and how successful the company’s previous crowdfunding distributions have been. This information must be kept up-to-date and the Offering Document is submitted to regulators in the province where the issuer is located once the distribution is complete. Regulators do not review or approve the Offering Document so investors should be very cautious and thoroughly research the company before investing. All portals must provide warnings on their websites about crowdfunding’s unique risks and investors must confirm that they have read the Offering Document before they can invest.

In British Columbia businesses can raise a maximum of CAD 250,000 per distribution with no more than two distributions per year that cannot run concurrently. Distributions last for up to 90 days and each investor can contribute up to CAD 1,500 or CAD 5,000 if the investment is made through a registered dealer and the investment is deemed suitable by the dealer. The portal collects all funds and releases them to the company if its fundraising goal is met. If the goal is not met or an issuer withdraws its offer, contributions are returned to the investors with no deductions. Contributions can also be withdrawn by investors for any reason within 48 hours or when changes are made to the Offering Document. Again, portals must refund these amounts with no deductions. When a distribution is complete, the securities are issued and investors are provided with a description of the securities, their price, the quantity received, and any fees paid to the portal by the issuer. Securities can include common and preferred shares, debt instruments such as bonds, limited partnership units, and convertible securities such as warrants. Each successful distribution is reported to regulators.

Crowdfunding is a simple way for start-ups and small businesses to raise capital, but smaller companies must carefully consider whether they are capable and willing to deal with so many shareholders. Minimum contribution rules can be used to reduce the number of investors.

**Private Equity**

Private equity funds are pools of investment capital that do not trade publicly and are set-up as limited partnerships with one or more general partners managing the fund and a large number of limited partners providing the remaining capital.

Being a limited partner means an investor’s liability is restricted to their original investment as long as they do not become actively involved in the management of the business. Limited partners are sophisticated, long-term investors with large amounts of capital who are willing to accept considerable risk to earn high returns. They typically include institutional investors such as pension plans, life insurance companies, and trusts as well as endowment funds and high-net-worth individuals. Limited partners may select their funds themselves, hire a “gatekeeper” with more expertise to select funds for them, or adopt a fund of funds approach where they invest in a mutual fund that in turn invests in different private equity funds.

General partners are the technical experts who manage private equity funds. They receive a percentage of the fund’s profits called a carried interest plus expenses. Private equity funds specialize in four areas. Venture capital provides financing to start-up companies while mezzanine financing is high-risk, unsecured lending. Distressed capital invests in financially troubled or bankrupt companies to profit from their eventual turnaround. Leveraged buyouts take control of firms to realize operational and financial synergies and then re-sell them at a sizable profit. Venture capital, including angels, and mezzanine finance are discussed in this module. Leveraged buyouts are covered in the module Mergers & Acquisitions and Corporate Restructuring and distressed capital is examined in the module Bankruptcy, Liquidation, and Reorganization.

**Angels, Incubators, Accelerators**

Angels are high-net-worth individuals such as doctors, lawyers, retired executives, or business owners who provide seed capital to new start-ups in their early stages to generate high returns and enjoy the thrills of entrepreneurship. In many communities, angel investor groups are formed so entrepreneurs can sell their ideas equipped with a business plan and a slick “elevator pitch.” Members can invest individually or co-invest with other angels to diversify their portfolios of companies. Funds provided are early-stage investments and are typically under CAD 1 million. In addition to funding, angels can also provide valuable business experience and contacts and may become active on the company’s board of directors.

The National Angel Capital Organization (NACO) is the coordinating body for angels and business incubators and accelerators in Canada. It hosts conferences where angels from across the country gather to network, promote co-investment opportunities, and listen to experts in the field. Professional development workshops are also provided to help angels increase their returns. NACO works with different levels of government to expand the angel financing network in Canada through additional financial support and to certify angels so they can participate in government-sponsored angel programs aimed at new Canadians. For example, under the Start-up Visa Program, foreign entrepreneurs may be approved for a visa if they can secure CAD 75,000 in funding from an angel investors group, CAD 200,000 from a venture capital fund, or are accepted into a business incubator program. This replaces the Immigrant Investor program where experienced applicants could receive a visa if they invested a specified amount of capital in Canada. Currently, NACO is comprised of 45 regional angel investment groups and 40 incubators and accelerators.

Business incubators provide early-stage companies with an array of services including mentorship; advisory boards; networking; business plan development; seed capital; management training including business etiquette and presentation skills; office space; legal services relating to intellectual property, incorporation, governance, and regulatory compliance; accounting and information technology services; marketing and market research; links to additional funding sources including angels, venture capitalists, and commercial lenders; and management team recruitment. Admission to an incubator is usually competitive and only candidates with innovative ideas and strong business plans are accepted. Participants may work out of a central facility provided by the incubator or operate virtually from their own facilities or a remote location. Incubators may specialize in an industry such as technology, biotechnology, or health care or support a mixture of companies.

The goal of an incubator is to develop businesses that can operate on their own. This may take a few months or several years depending on the business’s development time and the owner’s expertise. Programs generally require that start-ups leave once they achieve certain sales or staffing goals. Most incubators are established by governments, universities, other non-profit organizations that do not take equity. But some for-profit companies such as venture capitalists do exchange their support and investment for an ownership stake in the company.

Business accelerators are an alternative to business incubators for start-ups who are further along in the development process but still need help securing financing. These programs operate on a cohort basis and candidates are thoroughly vetted before being selected. Just being allowed into an accelerator program attests to the quality of a start-up and makes it much easier to secure angel financing. Accelerators are considerably shorter than incubators and clients leave the program when it is complete. Seed programs last two to four months and help businesses quickly sort out their operational and strategic problems in a boot-camp style atmosphere before arranging for entrepreneurs to pitch their business plans to potential investors. Second-stage programs last longer, usually up to six months, and focus on even more mature start-ups providing a greater level of service. The main goal of an accelerator is to secure angel financing for its clients and they usually take an equity position in the company as well.

**Venture Capital**

Venture capitalists (VCs) provide financing to new business start-ups, particularly technology companies when regular funding sources are not available due to the borrower’s lack of collateral, management expertise, or a financial track record. Venture capital (VC) is expensive as VCs must receive high returns, usually 20%-25%, to be fairly compensated for the high probability of business failure. The general rule is only 20% of VC investments succeed.

To increase the chances of success, VCs become heavily involved in a company’s operations serving on the board of directors; providing valuable business advice; using their industry contacts to develop a strong supplier/customer network; and recruiting new professional managers to help inexperienced founders grow the business. A start-up company should ensure that VCs are a good personal fit for their organization and have the drive, industry experience, business contacts, and funding needed to build a successful venture. Checking the references of VCs is critical to determine if they attend board meetings regularly, have useful industry contacts, can provide additional funding if needed, and react appropriately when new ventures experience problems. Given the difficulty in finding enough VC, a company may have to compromise its standards.

Venture capital is paid out in stages or rounds over a company’s life but only if it is successful at each stage. Not distributing all the funding at once reduces the VC’s risk and provides businesses with a greater incentive to succeed. The stages include:

**Exhibit 4: Stages of Venture Capital Financing**

|  |  |
| --- | --- |
| Seed financing | Researching a new business concept |
| First stage | Concept development |
| Second stage | Developing a prototype |
| Third stage | Production of a product or service |
| Fourth stage | Rapid expansion |

Angels provide seed and first-stage financing while VCs typically invest in second-, third-, and fourth-stage companies. Some VCs specialize by geographic region, industry, or financing stage while others are generalists who invest in a variety of projects.

If a venture is successful, ownership passes from one group of VCs to another as the company goes through each stage of financing. VCs provide additional capital in each stage, so their total ownership stake in the company increases and the founder’s share declines over time. The dilemma for the founder is to retain control of their company while still raising the needed capital. VCs are long-term investors, but in three to seven years depending on the stage of their investment, they will want to realize a return. Common exit strategies for VCs include:

* Have the founder and other managers buyout VCs if they lose faith in the project.
* Liquidate the company if it is unsuccessful.
* Sell to new VCs who are responsible for the next stage of financing.
* Take the company public in an initial public offering.
* Arrange an acquisition by a company that wants the new business concept or technology – this is the most common exit strategy.

In exchange for their cash investment, VCs receive a large equity stake of up to 40% in the new venture in the form of common shares, convertible preferred shares, or convertible debt. Preferred shares are normally issued so VCs can convert them into common equity if the company is successful while still providing them with preference over other investors if the business fails and must be liquidated. Preferred shares are also used because intercorporate dividends paid by the company to the VCs are not taxable in Canada. Issuing convertible debt gives VCs higher preference if the company is liquidated, but start-ups do not normally need the interest deduction as they are not yet profitable, so this type of security is not typically issued.

Private equity firms specializing in VC can be organized in one of two ways:

**Private limited partnership funds.** These funds are fixed in amount and established for periods of approximately 10 years. VCs serve as the fund’s general partners and limited partners provide the remaining capital. They invest in several new ventures or join syndicates with other VCs to mitigate their risks and pool their expertise. It may take a few years for a fund to find suitable companies to invest in, so it will make “capital calls” to its limited partners when funds are needed. Some capital can also be kept in reserve in case a venture needs emergency funding later. VC is very attractive due to its high potential returns, but the limited partners need to be patient as these investments are relatively illiquid for up to ten years depending on the stage of financing.

**Corporate venture capital.** These groups are established as separate business units within technology companies or financial institutions that provide the needed funding. Technology firms use them to develop new products or cost-saving ideas that they can employ in their own operations and they will buy out the start-up if it is successful. Financial institutions offer them to provide their clients with more investment choices.

VCs only invest in a very small percentage of the companies they examine. Before investing, VCs do a very thorough due diligence review of the new venture like a commercial lender does with a potential borrower although the focus is more on the technical and business merits of the new product or service and its market potential. Once VCs decide to invest, they negotiate a term sheet that outlines the terms and conditions of the financing agreement that is later incorporated into a formal shareholder agreement. VCs are very demanding, and the detailed term sheet covers all possible contingencies. Typical information may include:

* Who are the company and VCs?
* How much will be invested? When will it be invested? What ownership percentage do VCs receive for their investment?
* What can the funds be used for?
* What types of securities will VCs receive? Common shares, convertible preferred shares, or convertible debt?
* What dividend or interest payments must be made on these securities?
* What are the securities specific voting and conversion rights?
* What preference will these securities have if the company is liquidated? Has any specific collateral been pledged to secure these investors?
* What actions can VCs take if the company defaults on the agreement?
* How will VCs be compensated for their work and expenses?
* What are the representations and warranties made by the company?
* What is the composition of the board of directors? How are the members elected? How many board seats do VCs receive? How many senior managers can VCs appoint?
* What are the board committees? Does it have an audit committee? Does it have a compensation committee?
* How often will board meetings occur? What constitutes a quorum?
* How are major decisions approved? Does a supermajority voting provision apply? Do VCs have veto rights?
* What financial information must be provided to VCs? When is it provided? Will it be audited?
* Are there any restrictions on the sale of shares that help protect the VCs? These may include:

**Right of first refusal**. If any shareholder receives an offer to sell their shares to a third party, the VCs have the right to enter into that agreement first.

**Piggy-back rights**. If any shareholder receives an offer to sell their shares to a third party, the VCs have the option to sell their shares to that third party at the same price as well.

**Drag-along rights**. If VCs who are majority shareholders receive an offer to sell their shares to a third party, they can force a minority shareholder to also sell its shares at the same price so the buyout can go through.

**Pre-emptive rights**. VCs have the right to maintain their ownership percentage when new shares are issued to prevent dilution of their voting position.

* What exit strategies are available to VCs?
* What performance milestones must be met relating to sales, product development, etc.? What are the penalties for not meeting these goals?
* What insurance coverage must be maintained? Fire? Product liability?
* What commitments do key employees make to remain with the company? What happens if they leave early? Are their non-compete agreements with the company if they do leave?

In Canada, the federal and provincial governments actively support the venture capital industry to promote employment, economic development, and diversification. Some governments are directly involved through the formation of their own venture capital firms while others choose to rely on the expertise of the private sector by making limited partnership investments in private venture capital firms and by providing venture capital investors with generous tax credits. For example, the federal government’s Business Development Bank of Canada supplies venture capital directly to new start-ups. In British Columbia, the B.C. Renaissance Capital Fund invests in different private venture capital firms focusing on technology. The British Columbia government has also simplified the process for establishing private Venture Capital Corporations (VCC) under the Small Business Venture Capital Act. Under the act, if VCCs raise at least CAD 50,000 and invest for at least five years in companies that pay 75% or more of their wages and salaries to B.C. employees, corporate and individual investors will receive a 30% tax credit. Tax credits for institutional investments in VCCs are unlimited and they can be carried forward a maximum of four years if necessary. Individual investors are limited to a CAD 60,000 investment each year, but the tax credit is refundable immediately regardless of taxable income. To simplify the process further, the act allows venture capitalists to invest directly in Eligible Business Corporations (EBC) without establishing a VCC and still receive the 30% tax credit. EBCs are B.C. registered companies with fewer than 100 employees that have over 80% of their assets and 75% of their wages and salaries located in the province.

Besides tax credits for venture capital, the federal government provides a Scientific Research and Expenses Development (SRED) Investment Tax Credit equal to 35% of the first CAD 3,000,000 of qualified research expenditures and 15% of additional expenses for Canadian Controlled Private Corporations (CCPC). Other companies receive 15% of qualified expenditures. This is usually supplemented by an additional provincial tax credit. For CCPC, 100% of the tax credit on the first CAD 3,000,000 and 40% on the remaining expenditures is refundable immediately which is a major advantage for cash-starved small businesses. The remaining federal and provincial investment tax credits are subject to normal loss carryback and carryforward rules.

The federal government also offers a 15% Investment Tax Credit for investments by Designated Businesses in Qualified Property which includes new buildings, machinery, and equipment. Some provinces offer additional investment tax credits. These tax credits are subject to normal loss carryback and carryforward rules.

**Franchising**

Franchising is a business expansion strategy commonly employed in the fast food, retail, personal services, and hotel industries but it is also used in manufacturing and distribution. A franchisor develops a business model complete with operating procedures, intellectual property such as special recipes, and a recognized brand. Instead of growing the business themselves, they license it to franchisees who operate one unit (called single-unit franchising) or several units in a specified geographical area (called multi-unit franchising). The franchisor may take full responsibility for developing the outlet including site selection; purchasing or leasing the site; building the facility or completing all leasehold improvements; and stocking the outlet before passing it over to the franchisee (called turnkey franchising). The franchisor can also involve the franchisee more in site development (called semi-turnkey financing). In return for this assistance, the franchisee generally pays a large initial fee; ongoing fees for services such as training or advertising; and a percentage of its gross sales. Franchisees may also have to buy all their inputs from the franchisor at a profit. Franchises are established for a set period but can be terminated early due to operational or quality issues which are monitored carefully by the franchisor to ensure the success of the business.

Franchising has important financial advantages for both the franchisor and franchisee. These include:

**Franchisor**

* Raise start-up capital through the initial fee without losing control of the business.
* Faster domestic and international expansion by pushing large investments in fixed assets, working capital, and operating expenses onto the franchisee.
* Increase profitability through the franchisee’s strong local management.
* Reduce business risk by having the franchisee assume most of the fixed costs.

**Franchisee**

* Negotiate bank financing more easily by using the franchisor’s established name and the higher success rate of franchised businesses.

**Retained Earnings**

Research indicates that established companies avoid issuing equity and instead rely on retained earnings to fund their growth. This occurs for several reasons:

* Issuance costs for seasoned equity offerings by larger public companies are high but are even higher for IPOs.
* Issuers experience considerable losses due to underpricing of IPOs as underwriters try to ensure the success of a new issue by setting the offer price at a level that is well below the share’s fair market value. The low offer price also allows underwriters to reward their preferred clients for past business.
* Equity issuances signal to the market that a share is overvalued so investors bid down the share price as they feel the firm has better information and would only sell new shares if the current market price exceeds its fair value.
* Equity issuances signal to the market that a company has insufficient cash or is over leveraged and needs additional funds so investors bid the share price down.
* Underpricing and share price declines caused by issuing equity hurt existing shareholders resulting in greater opposition to current management and lower payouts on their executive stock option plans.
* Changes in the balance of power on the board of directors resulting from new share issuances may put management positions in jeopardy.

Companies manage their sustainable growth rates to ensure they have enough retained earnings to finance future growth opportunities. If retained earnings are insufficient, many companies choose to limit their growth or over-borrow instead of issuing shares.

**Common or Preferred Shares**

If a company decides to issue new shares because of a lack of retained earnings, it must choose between either common or preferred shares. These securities have very different characteristics from the issuing company’s perspective.

Common shares:

* Entitle the holder to receive all residual profits of the business.
* Are not obligated to pay dividends if funds are needed internally.
* Can vote in board elections and major decisions such as the approval of a corporate take-over.
* May assign their voting rights (called a proxy) to management or another shareholder group who is opposing management on key issues.
* Can be divided into multiple share classes with different voting rights so a shareholder group such as the company’s founder can maintain control.

Multiple share classes with different voting rights can consist of non-voting shares; restricted voting shares that limit the number of shares in a class that can be voted; or subordinate voting shares that receive only one vote per share while multiple voting shares receive more than one vote per share. These shares receive the same dividend as voting shares, are treated the same if the company is liquidated, and may have coattail provisions allowing them to be converted into voting shares so they can participate in major corporate decisions.

Non-voting, restricted, or subordinate voting shares trade at a significant discount to voting or multiple voting shares because of their limited voting rights. Many countries do not permit these types of shares as they treat most investors unfairly and reduce economic efficiency by enabling a company’s founder to retain control even when they do not have the skills to manage the business properly. Despite serious reservations, regulators in Canada do allow varying voting rights so more Canadian firms can remain independent and not be acquired by larger multi-national firms. Independent companies tend to keep their high-paying head office and research and development jobs in Canada and help protect Canadian economic sovereignty.

Preferred shares have:

* No voting rights so there is no potential loss of control for common shareholders.
* No dilution of EPS since preferred shareholders are not owners and only provide financing in exchange for a regular dividend.
* Preference over common shareholders if the company is liquidated which includes the share’s stated or par value, current year’s dividend, and any dividends in arrears.
* Fixed dividends; adjustable or floating rate dividends based on a benchmark rate such as LIBOR; or participating dividends.
* Ability to delay the payment of dividends indefinitely without being forced into bankruptcy.
* Conversion features that allow investors to convert their shares into common shares to take advantage of rising equity prices.
* Redemption features that force the company to buyback investors’ shares at their request if interest rates rise.
* Call features so companies can re-finance shares if interest rates fall.
* Term or limited life features that require regular sinking or purchase fund payments to retire shares over a specified period.

Fixed preferred share dividends can be expressed as a dollar amount per share or percentage of a share’s stated or par value. Some preferred shares are participating which means they receive an additional dividend if the common share dividend is above a specified level or in certain circumstances such as a corporate take-over, but the majority are non-participating. Preferred dividend payments can be delayed indefinitely but these dividends are nearly always cumulative which means dividends in arrears must be paid in full before any common share dividends can be distributed. Also, preferred shareholders can usually vote like common shareholders if their dividends are in arrears, so companies have a strong incentive to pay these dividends on time.

The primary reason to issue preferred shares instead of common shares seems to be to maintain control since preferred shareholders cannot vote. This can also be achieved by issuing non-voting, restricted, or subordinate voting common shares, so there must be another motive. Preferred shares are actually considered an alternative to debt financing as they have many of the same features as bonds including:

* No voting rights.
* A fixed or adjustable-rate dividend that is usually always paid.
* Conversion, redemption, and call features.
* Limited terms with sinking or purchase fund requirements.
* Preference over common shareholders in liquidation.
* Preferred share ratings are provided by the same bond rating services.

Preferred shares are used instead of bonds when companies have an excessive amount of debt or cyclical cash flows and are concerned about being able to pay their fixed debt obligations in an economic downturn. Preferred shares give companies the flexibility to defer their dividend payments instead of declaring bankruptcy for non-payment like with bonds. This added safety is reflected in the company’s debt ratio as preferred shares are normally classified as equity and not debt. Preferred shares also have the added advantage of usually not requiring sinking or purchase fund payments or collateral which is important to companies experiencing liquidity problems.

Preferred share financing is usually more expensive than debt financing because it is subordinate in liquidation and therefore riskier; issuance costs are higher since riskier investments are more difficult to sell; and dividends are not tax-deductible by companies like interest. For firms with unstable cash flows though, the safety provided by preferred shares may be worth the higher costs. Issuers should be careful when deciding between issuing debt or preferred shares as sometimes preferred shares are the most cost-effective option. Young or high-growth companies or those experiencing financial distress cannot take advantage of the deductibility of interest making the cost differential between debt and preferred shares much smaller or non-existent. A large percentage of preferred shares are sold using private placements which greatly reduces issuance costs. Finally, intercorporate dividends between Canadian Controlled Private Corporations are not taxable which reduces the required return on preferred shares.

Some companies try to understate their use of financial leverage by classifying certain financial instruments that are liabilities as equities. Under International Financial Reporting Standards, regardless of what a financial instrument is called, it is classified as equity if it 1) has no contractual obligation to deliver cash or other financial assets or 2) can be settled with the issuer’s equity instruments. Preferred shares are classified as equity if the dividend and any sinking or purchase fund payments can be delayed indefinitely meaning they are a safer source of financing.

**Going Public**

The decision to go public is an important one that has many lasting consequences for a company and its shareholders, directors, and officers. The major advantages and disadvantages include:

**Advantages**

**Higher share price.** Investors will pay more for publicly-traded securities because they are liquid, accurately valued, and easier to use as collateral when applying for a loan or in other business dealings. The value of a private company will rise significantly if it goes public as investors will no longer demand a liquidity discount.

**Financial flexibility.** Public companies can raise debt and equity financing more easily due to the larger size of the public market and its greater accessibility. New securities like convertible debt, warrants, or stock options that require a publicly-traded share that is liquid and accurately valued can now be issued. Government policies have made the private placement of debt and equity easier, but it is still difficult to raise adequate capital this way. Many financial institutions are restricted or prohibited from investing in exempt securities in private companies because of their higher risk and lack of liquidity. Minority investors in private firms also worry about being treated unfairly by controlling shareholders and not having regular access to reliable financial information.

**Lower cost of financing.** Investors will accept lower returns on publicly-traded securities due to their greater liquidity which reduces the cost of capital. Financial institutions are also more likely to lend to companies with access to the public equity markets since shares can be more quickly issued to refinance problem loans.

**Personal financial planning.** By going public, a company’s founder can more easily diversify their personal investment holdings by selling a portion of a business while still retaining control. Eventually, they may decide to exit the business entirely as part of their estate planning.

**Facilitates mergers and acquisitions.** Companies can more aggressively pursue take-overs. Take-over bids often include both a cash and stock component. Public firms can offer shares, but private companies will likely have to make all-cash offers. Private companies could offer their own shares, but this is not wise as they trade at a significant liquidity discount. Companies are also more likely to be targets of lucrative take-over bids if their shares trade publicly as the market already provides an accurate valuation.

**Corporate creditability and visibility.** Free publicity received through press releases, media coverage, stock quotations, earnings announcements, analyst research reports, prospectuses, annual reports, and other public disclosures helps attract new customers, suppliers, employees, creditors, and equity investors. Ironically, public companies have better access to the private placement market because of their enhanced public profile.

**Motivation.** A publicly-traded share invigorates a company and serves as an important gauge of its ongoing performance. Highly qualified employees can be attracted and retained using stock-based compensation plans such as stock options or performance shares. Publicly-traded shares are more effective in these types of plans because they are liquid and accurately valued, and can be easily used as collateral when borrowing the funds needed to exercise the stock options.

**Disadvantages**

**Compliance costs.** Going public is expensive with stock exchange listing payments; share registrar and transfer expenditures; investment banking fees; higher accounting, auditing, and legal costs; and the expense of holding annual shareholder meetings. Public companies must establish a proper corporate governance system composed of a professional board of directors and sub-committees that operate independently of management. Regulators and stock exchanges require continuous disclosures of key information including unaudited interim financial reports, audited annual reports, annual information forms, management information circulars, notices of shareholder meetings and voting results, prospectuses, insider trading reports, proxy solicitations, change of auditor notices, take-over bid circulars, issuer bid circulars, changes in percentage ownership, material change reports relating to past disclosures, and numerous news releases. Companies are held accountable for any errors or misrepresentations in these filings which can be costly. Meeting these disclosures requirements is especially burdensome for smaller corporations whose lower sales may not yet justify these high fixed costs.

**Communications.**  Most public companies have an investor relations department that acts as a liaison with potential investors, shareholders, equity analysts, and members of the financial media. The department ensures these groups are well informed and tries to present the company favorably to ensure continued access to capital at an affordable rate. CFOs must devote considerable time to investor relations which is a major distraction from their other duties.

**Disclosure of information.**  Public companies are required to disclosure important operational and financial information that they may not want to share with their competitors, governments, or other groups. Financial results, executive compensation, corporate governance practices, and director and management performance reviews are some of the information that must be disclosed.

**Market scrutiny.** Public companies are heavily scrutinized by investors, so corporate directors and officers must be proactive in preventing instances of insider trading, self-dealing, and nepotism. Regulators require directors and officers to file insider trading reports to detect any misuse of material non-public information, so companies need to introduce their own strict rules backed up by a thorough training program. Self-dealings such as shareholder loans or lucrative contracts with other corporations in which insiders have an ownership stake need to be banned. Excessive pay and employment benefits such as overly generous stock options grants or the use of lavish apartments or corporate jets must be restricted. Hiring or awarding consulting contracts to friends or family members should be forbidden. Any of these abuses can become a major issue in the media or at the annual shareholder meeting causing serious embarrassment to the company and a decline in its share price.

**Lack of marketability.** Many small public corporations do not have sufficient trading volume to justify coverage by equity analysts resulting in reduced market liquidity and a lower share price. The full benefits of going public may not be realized immediately.

**Control.** By going public to access capital, a company’s founder may eventually lose voting control (i.e. over 50% ownership) of their business. As a result, the company’s directors and officers may become pre-occupied with proxy fights involving disgruntled shareholders and take-over bids from unwanted suitors. This pressure may eventually lead to insiders taking the company private again in a management buyout. “Going private” transactions also occur because management wants to avoid the high cost of public disclosure, curtail embarrassing market scrutiny, hide poor corporate performance, or adopt a strategy that favors long-term over short-term earnings. Public markets are reputed for severely punishing companies for short-term declines in earnings and dividends instead of allowing them to focus on longer-term goals.

Before deciding to go public, a company should ask itself several questions:

* Is it a market leader that can attract the interest of underwriters and investors?
* Does it have a strong record of profitability and growth?
* Are a strong business and financial plan in place? Does it have a history of meeting and exceeding its financial projections?
* Does it have a debt-to-equity ratio that adheres to industry averages? Does it have access to temporary and permanent debt financing on an ongoing basis?
* Are the funds raised being used to finance profitable growth opportunities or to pay off debt or existing shareholders?
* Does it have the commitment and depth of management to operate publicly?
* Are its financial reporting and internal control systems sufficient to meet the disclosure requirements?
* Will its corporate governance system be adequate?
* Is it ready to endure market scrutiny and any control issues?

If a company answers “yes” to these questions, they should seriously consider going public with the help of a team of qualified lawyers, accountants, and investment bankers. These professionals will guide them through the process culminating in regulators approving a final prospectus that allows their shares to trade on a public stock exchange. In Canada, initial public offerings (IPOs) take place on either the Toronto Stock Exchange (TSX) or the TSX Venture Exchange (TSXV). The TSX is aimed at established businesses who are experienced in public markets while the TSX Venture provides early-stage and small businesses with access to venture capital in the CAD 500,000 to CAD 2 million range.

To trade on the TSXV, companies must meet specific listing requirements that are tailored to the needs of small businesses. Companies are classified into five sectors including energy, mining, technology and innovation, diversified industries, and real estate and each has different listing requirements. These requirements relate to earnings, cash flows, net tangible assets, working capital, cash on hand, stage of business development, management experience, governance structure, market capitalization, and the number of publicly traded shares. In the diversified industries sector, for example, companies are classified accordingly:

**Exhibit 5: Example of Listing Requirements**

|  |  |  |
| --- | --- | --- |
|  | **Net Tangible Assets** | **Pre-tax Earnings** |
| TSXV Tier 1 | CAD 500,000 | CAD 50,000 |
| TSXV Tier 2 | CAD 1 million | CAD 100,000 |
| TSX | CAD 7.5 million | CAD 200,000 |

As companies grow, they can graduate from TSXV Tier 1 to Tier 2 and eventually the TSX. Each step increases their market profile, share liquidity, and access to capital. Most TSXV listed companies are Tier 1, and it is considered a major achievement for a company to be promoted to Tier 2. TSXV provides mentoring programs to help newly listed companies advance. Each year the TSX selects the TSXV 50 which is the top ten performing companies from each of the five sectors.Approximately 20% of S&P/TSX Composite Index members are graduates of the TSXV. The TSXV also maintains a separate trading board called NEX where company’s who have fallen below their listing requirements can continue to trade while they attempt to “refinance, reactivate, or reinvent” themselves to eventually re-apply to the TSXV.

**Public Equity Placements**

Potential investors in public equity placements include sophisticated institutional or high net-worth investors as well as members of the general public. Regulators closely monitor the public issuance process to protect these less experienced investors and maintain the public’s confidence in the financial markets. These issuances can involve either established companies whose shares already trade publicly (also called a seasoned, secondary, or follow-on offering) or businesses selling shares publicly for the first time in an IPO.

A public equity placement is complex, so companies usually retain one or more investment bankers or underwriters to help navigate the process. They prepare a preliminary prospectus or “red herring” followed by a final prospectus that are both approved by regulators and contain important financial information about the business and stock transaction. All potential investors must receive a copy of the final prospectus and if important facts are omitted or misrepresented, issuers and their underwriters can be fined by regulators or sued by the investors affected.

As the preliminary prospectus is reviewed, underwriters attempt to determine the appropriate volume and offering price for the issue by taking out advertisements called “tombstone” ads, conducting investor presentations or “roadshows” in major financial centres, or contacting institutional clients and retail brokers directly. The process of determining investor interest in the offer is referred to as “book building.” If demand is greater than expected, the issue is said to be oversubscribed. The limited supply of shares is allocated among interested investors or the issuance price can be increased to reduced demand. If demand is less than expected, the underwriter will reduce the issuance price or withdraw the offer.

To streamline public equity placements, companies whose shares already trade on a public stock exchange can issue new securities using a Short-Form Prospectus Distribution (SFPD). Issuers circulate a basic prospectus to potential investors describing the type of security, amount of the distribution, and issuance price. Disclosure is limited because public companies already provide extensive information in other filings such as their consolidated financial statements. Regulators also permit a “shelf” registration, where once a prospectus is approved, companies have up to 25 days to sell the shares so they can better time equity markets. Canada and the U.S have a Multi-Jurisdictional Disclosure System (MJDS) where firms can issue shares concurrently in both countries using the same documentation. Many large domestic firms cross-list their shares in the U.S. as well as Canada to access lower-cost capital, reduce issuance costs, and make their stock more marketable. Finally, regulators host the System for Electronic Documents and Retrieval (SEDAR) which is a central electronic depository for all consolidated financial statements, prospectuses, and other corporate information issued by public companies in Canada.

Once the final prospectus is approved and the volume and offering price are set, the issuer and underwriter agree on a spread which is the difference between the offering price and what the company receives. The spread is the underwriter’s profit and is subject to varying levels of risk depending on the underwriting method used. There are four options:

**Firm commitment.** An underwriter buys the entire issue from the company at an agreed-upon price. The company is not exposed to any risk, but the underwriter’s spread can fall and even become negative if the share price declines substantially. Because of this risk, parties may negotiate a market out clause which allows the underwriter to withdraw the issue.

**Best efforts.** An underwriter agrees to sell shares at the offering price but can return any unsold shares. The company risks not raising all the capital it needs. The underwriter earns the agreed-upon spread but does not sell the volume of shares expected. Best efforts underwriting is used by small issuers who are not well recognized and during periods of market uncertainty when risks are higher.

**Bought deal.** An underwriter agrees to buy the entire issue at a set price and then quickly sells it to a small group of institutional investors. The spread is smaller because of lower issuance costs due to the limited number of investors involved and the speed of the transaction. If the deal is executed quickly, the underwriter is not exposed to the risk of falling equity prices.

**Dutch auction.** An offering price is not established, and the underwriter sells shares using a competitive bidding process. Interested investors submit bids indicating the number of shares they want to buy and at what price. The lowest price which results in the entire issue being sold is accepted by the underwriter and is paid by all successful bidders. This system encourages potential investors to place higher, more competitive bids knowing they will receive the lowest price.

Instead of taking responsibility for selling the entire issue themselves, an underwriter can become the lead manager and recruit a syndicate or banking group made up of other underwriters to help sell the issue and share any risks. If additional help is needed, a larger selling group can be recruited that focuses on retail investors. The number of shares allocated to each syndicate member varies with their size and prestige. When many underwriters are involved this is referred to as broad syndication while a limited distribution or sole distribution includes a few or only one member. Broad syndications provide the issuer with the greatest control over the distribution process and the most market exposure resulting in the highest share price. Transaction costs are higher though, and the process is slower, so a limited or sole distribution may be the better option. Regardless, issuers should recruit the most reputable underwriters who have the specialized financial knowledge and industry contacts needed to sell the desired volume of securities at the best price possible while charging a reasonable spread.

For firm commitment and best efforts underwriting, syndicate members agree not to sell shares for less than the offering price during the selling period. The syndicate’s lead manager may buy shares during this period to support the market price and keep it above the offering price. If demand is strong, syndicate members may have an overallotment option that allows them to receive more shares than they were originally allocated to satisfy client demand. For firm commitment underwriting, once the selling period is over and the syndicated is dissolved, members can sell their shares at the current market price or wait till prices possibly improve. If best efforts underwriting is used, the unsold shares are returned to the issuer.

To promote the integrity of the financial markets, issuers and underwriters respect a “quiet period” when an IPO is being sold. During this time, issuers limit corporate disclosures to routine financial information. This focuses investors more on the company’s final prospectus when making investment decisions and discourages issuers and underwriters from trying to influence investors by making exaggerated performance claims or issuing strong buy recommendations. Most IPOs also have “lockup” agreements where insiders such as the issuing company’s founder or managers are unable to sell their shares for approximately six months to support the share price and demonstrate their continued commitment to the business. Eventually, insiders will sell all or a portion of their shares to diversify their holdings or to redeploy capital to other projects which put downward pressure on the share price.

New equity is generally issued in large amounts all at once by established underwriters. Some companies do use “dribble out” equity programs where funds are raised in smaller quantities over time depending on market conditions. Companies can issue equity more cheaply this way by avoiding high underwriting fees.

When timing a public equity issue, companies should be careful to:

* Issue shares during bull markets when prices are likely overvalued and avoid bear markets when they are likely undervalued.
* Avoid selling shares when there is a lot of competition from other issuances that will lower demand.
* Sell shares with a high dividend yield just before the ex-dividend date so investors who want high dividends can earn the best possible return.
* Avoid selling shares when a company’s stock options are about to expire as option-related transactions can materially affect the share price.

**Private Equity Placements**

New equity is raised using private placements in the same way that debt securities are sold privately as outlined in Section 1.2 Corporate Bond Financing. As with debt, equity private placements are employed by both private and public companies. Approximately 40% of all equity issued on the TSX and TSV is sold initially using private placements.

**Dividend Reinvestment Plans and Stock Purchase Plans**

Some companies offer dividend reinvestment plans (DRIPs) so shareholders can reinvest their dividends if they do not want them by buying additional shares in the company. Many DRIPs also offer a stock purchase plan (SPP) or optional cash purchase (OCP) feature that allows shareholders to buy additional shares without reference to the size of their dividend although a limit may be placed on the number of shares that can be purchased this way. Shares issued under a DRIP are usually new equity, but if the company does not need the additional capital, they sometimes buy existing shares in the open market to meet shareholder demand.

DRIPs offer several advantages:

* Companies do not incur issuance costs when raising new equity capital because the shares are sold directly to investors. Equity issuance costs average 7% to 8% of the fund raised in Canada, but these expenses are much higher for the smaller issues of startup or growth companies.
* Shareholders may be able to purchase additional stock at a discount since they are buying directly from the company who can pass along some of their savings. Shareholders also save on trading costs by not having to purchase the shares through a stockbroker. DRIPs are especially attractive to small investors as they do not have to buy shares through the exchanges in the standard board lot size of 100 shares to receive the lowest commission and they may also be allowed to buy fractional shares.
* Management can build a more diverse and loyal investor clientele that is less likely to sell their shares during a market downturn resulting in a more stable share price.
* Investors are forced to cost average their share purchases over time. Cost average means shareholders buy shares regularly throughout the normal up-and-down movements of the stock market, and thus they do not risk buying all their shares during a market peak when they are likely overvalued.

One disadvantage of a DRIP is the dividends re-invested are still taxable even though shareholders receive no cash.

**Rights Offerings**

Rights offerings are one of the most popular ways for large corporations to raise equity in Canada. Issuance costs are low because companies are selling directly to existing shareholders and do not have to find new buyers. Pre-emptive rights may be required in a firm’s articles of incorporation or by securities regulators so existing shareholders can maintain the same percentage ownership (i.e. no dilution).

With pre-emptive rights, each common share is awarded one right and the company specifies how many rights are needed to buy one share which depends on the amount of equity the company wants to raise and the subscription price set. Shares trade either on-rights (the shareholder receives the rights) or ex-rights (the shareholder does not receive the rights) effective the holder of record date. These rights can be used to either buy shares or sold separately if the shareholder does not want to invest further in the company. The value of a right is:

Theoretical value of a right =

Rights preserve the value of a shareholder’s investment regardless of whether they participate in the new equity issue or not.

**Limited Partnerships**

Besides VC, limited partnerships are a popular way to raise equity capital for high-risk investments like resource projects where there is a strong likelihood of significant losses for a considerable period before any profits are realized. Due to the high risk of such businesses, debt financing is difficult to attain.

Unlike corporations, governments allow profits and losses and tax credits of limited partnerships to flow directly through to the partners each year. In the early years of the investment, when losses are high, the investor’s tax savings are significant, which greatly reduces the project’s risk. The investors are limited partners, so their liability is also limited to their original investment if they do not become actively involved in the management of the business further reducing their risk.

Limited partnerships were once subject to considerable abuse. Many generated tax losses above the investor’s original contribution and were promoted as “tax shelters” and not as investments in legitimate business ventures. In response, the Canada Revenue Agency introduced “at-risk” rules which limit loss deductions in limited partnerships to the capital the partners have invested. Also, the General Anti-Avoidance Rule in the Income Tax Act disallows any transaction whose sole purpose is to avoid taxation.

**Strategic Partnerships: Joint Ventures and Strategic Alliances**

A joint venture is when two or more companies establish a new legal entity to pursue a business project. This may include developing and selling new products or services, selling existing products in new markets, or engaging in activities such as research and development. The joint venture can be established for a set period or be permanent. Partners share in the risk and rewards of ownership based on their contributions.

The advantages of a joint venture include:

* + Access the financial resources of larger partners.
  + Acquire needed tangible and intangible assets such as store locations, management skills, or technology.
  + Attract well-known partners who bring more creditability to the project from the perspective of lenders, suppliers, and customers.
  + Avoid unnecessary cost duplication and increase economies of scale.
  + Limit industry competition resulting in higher prices.
  + Faster market penetration compared to growing organically.
  + Gain entry to international markets where governments may limit foreign investment without a local partner.
  + Acquire key competencies that can be used in other areas of the business.
  + Share risks when projects are complex and require large capital investments.
  + Reduce risk by establishing a separate business entity that operates on a non-recourse basis.
  + Easier exit from projects as the other partners are usually willing buyers at a reasonable price.

Strategic alliances are like joint ventures except no new legal entity is established and the relationship is usually shorter. Alliances typically relate to:

**Operations.** Partners share the cost of new production facilities to take advantage of economies of scale; produce certain components only; or outsource production completely to another partner who has greater expertise or idle domestic or international capacity.

**Licensing.** A partner licenses their products for manufacture and sale in another region of the country or internationally. This may help start-up companies raise needed capital so they can focus on their home market while still exploiting the product’s full potential abroad. They may also continue to manufacture their products, but licence a partner to manage promotion, sales, and distribution. Cross-licensing occurs when partners agree to license each other’s products to expand their product line and increase the utilization of existing production, sales, and distribution facilities.

**Technology development.** Partners may share high research costs to reduce risk and allow each partner to focus on their strengths such as engineering or product design.

Like with operating leases before IFRS 16 – Leases became effective in January 2019, companies sometimes use joint ventures to keep certain assets and liabilities off the balance sheet to improve their financial ratios and perceived performance. If a company owns 50% or more of a joint venture that business unit must be consolidated meaning its assets and liabilities are included on the parent company’s balance sheet. But if ownership falls below 50%, only the net value of the investment is shown as an asset understating both assets and liabilities. This is another example of off-balance sheet financing.

**Employee Stock Ownership Plans**

Employee stock ownership plans (ESOP) allow employees to acquire shares in their employer. There are two types of ESOPs including limited person plans that are open to key upper management personnel only and broad-based plans where all employees can participate. Limited persons plans are discussed in the module on Corporate Governance and Executive Compensation.

With broad-based plans, an employee receives shares either as a reward in a profit-sharing plan or by purchasing them voluntarily through payroll deductions. Broad-based plans offer companies several advantages:

* + Attract and retain more capable personnel.
  + Motivate workers to be more productive and provide better customer service and product quality.
  + Encourage employees to make more constructive suggestions on how to improve operations.
  + Reduce employee absenteeism, turnover, and wastage of supplies and materials.
  + Encourage labour-management harmony resulting in fewer grievances and work stoppages.
  + Raise additional capital at a lower cost by selling shares directly to employees and sharing the savings with them to encourage greater plan participation.
  + Conserve funds by awarding shares through a profit-sharing plan instead of paying wages or salaries and still receiving an income tax deduction for the value of the shares distributed.
  + Provide a strong take-over defense as employees typically support management fearing potential layoffs.
  + Increase the liquidity of a company’s stock resulting in a higher share price.
  + Create a market price for shares in privately-held companies that are difficult to value since they do not trade publicly.
  + Prepare a private company to go public by establishing a market price for its shares.
  + Allow owners of smaller corporations to diversify their wealth by selling a portion of their business to their employees while still maintaining control.
  + Allows owners to sell their business to their employees as part of a business succession strategy.
  + Venture capitalist and commercial lenders look favorably upon companies with significant employee ownership due to greater worker commitment.

To be successful, ESOPs should include all employee groups, provide honest and frequent communication about the company’s performance, and allow employees an opportunity to become actively involved in the company through methods like autonomous work teams or seats on the board of directors. A regular dividend will help maintain employee commitment to an ESOP as will a buyback feature that allows anyone leaving the company to quickly liquidate their positions − this may be problematic if there is a major layoff. Limits should be placed on the number of shares individual employees can purchase to ensure their retirement portfolios are well diversified. Management should remind employees that equity investing is risky and that the company will struggle at times as its success is affected by economic cycles and geopolitical factors that are beyond its control. Finally, good ESOPs encourage employees to follow the company’s share price, but not to become fixated on short-term performance as long-term priorities such as capital expenditures, training, or research and development expenditures must take priority.

Governments provide tax incentives to encourage participation in ESOPs. In Canada, any share purchase discounts given by employers are treated as employment income and are tax at regular rates. Dividends are subject to the dividend tax credit and any capital gains are taxed at half the regular tax rate when realized. Shares can be held in a self-directed RRSP so taxation can be deferred. If the shares purchased are in a qualified small business (Canadian-controlled Private Corporation), employees are eligible for a lifetime capital gains exemption of approximately CAD 825,000 that will likely reduce the taxes paid on any capital gains to zero. Most provinces also provide tax credits to employees who invest in their company’s stock. In British Columbia, the Employee Investment Act provides a 20% tax credit with an annual limit of CAD 2,000. It also authorizes a special type of ESOP called a Succession ESOP where business owners can over time sell their entire business to their employees.

**1.5 | Government Financing**

**Business Development of Canada**

The Business Development Bank of Canada (BDC) is a federal crown corporation established to meet the financing needs of SMEs, who are the main drivers of employment in Canada. SMEs have long been underserved by the traditional banking system, which focuses on larger businesses and is generally quite risk-averse. BDC is more of a risk-taker providing:

* + Higher loan-to-asset value ratios.
  + Longer loan amortization periods.
  + More flexible repayment terms including payment holidays at the beginning of the loan, seasonally adjusted payments, progressive (stepped) payments, and cash flow-based repayment.
  + Unsecured loans for intangible assets and less restrictive collateral requirements generally.
  + More stable terms and conditions over the life of the loan with generous loan prepayment features.

BDC provides supplemental working capital loans for businesses that already have a line of credit with a private financial institution but have been refused additional funding. It provides term loans and mortgages as well as specialized equipment lines of credit so companies can purchase multiple pieces of equipment quickly without negotiating a new loan or making a down payment each time. Equipment lines of credit can also be used to consolidate existing equipment leases and loans to reduce interest rates and principal payments or convert from variable to fixed interest rates. BDC offers riskier loans to finance business start-ups, buyouts of existing businesses, purchases of franchises, or business transfers between family members.

Start-up or seed capital is available in combination with incubator or accelerator programs to aid in a firm’s initial development. Early-round venture capital funding through the BDC’s information technology, industrial and energy/clean technology, and healthcare funds is available. For SMEs who do not want to share ownership, mezzanine debt financing can also be negotiated.

BDC offers business advisory services to SMEs as a part of its lending process or as a standalone service. It has established a specialized “Growth Driver Program” that provides consulting to rapidly growing, mid-sized firms that have the potential to have a high impact on the economy. Specialized consulting services are also available for firms that are growing internationally.

**Export Development Corporation**

The Export Development Corporation (EDC) is a federal crown corporation established to promote domestic employment by providing businesses with export-related financing and insurance. International operations may be as simple as exporting domestically produced products or as complicated as establishing a foreign subsidiary to serve overseas markets.

Financing services offered by the EDC to promote exports include:

* + Direct loans to foreign customers to buy Canadian products.
  + Loans to foreign banks who lend to foreign customers. This is safer for the EDC as they are lending to a more established local institution.
  + Lines of credit and term loans to help finance the working capital and fixed asset needs of Canadian exporters both domestically and abroad.
  + Project financing for foreign ventures.

Losses that are insurable by the EDC can result from:

* Refusal to pay or bankruptcy by a foreign business or government.
* Contract cancellation or failure to honour agreements.
* Foreign government limitations on the conversion of local currency to hard currency or the transfer of funds out of the country.
* Foreign government moratoriums on debt repayment.
* Expropriation of assets by foreign governments or damages resulting from political unrest.
* Cancellation of government-issued import or export permits.

EDC also insures performance bonds issued by private insurance companies and financial institutions. When importers and exporters do not have an established relationship, the importer may require that the exporter purchase a performance bond to protect the importer from losses due to non-fulfillment of the agreement. By ensuring performance bonds, the EDC reduces exporters’ costs and limits the financial restrictions generally placed on them by the private insurance companies such as collateral requirements.

**Other Government Lending Programs**

The Canada Small Business Financing Loan (CSBFL) program is offered by the federal government in association with participating private lenders in Canada. SMEs with CAD 10 million or less in annual sales can borrow up to CAD 1,000,000. Loans must be approved by a private lender and the federal government guarantees 85% of their value. Funds must be used for the purchase of land, building, equipment, software, or leasehold improvements and not for working capital or to purchase a franchise. Bank service charges apply but interest rates are capped at 3.0% above the prime rate.

Numerous other federal, provincial, and local government groups and non-profit organizations offer lending programs aimed at specific industries such as agriculture or tourism, purposes such as R&D, or groups such as aboriginal peoples, women, immigrants, youth, or veterans. Assistance can take the form of loans, non-repayable grants, refundable or non-refundable tax credits, or subsidies for expenses such as wages or property taxes. All small businesses need to thoroughly research the programs available.

**1.6** | **Permanent Debt and Equity Financing at Canadian Companies**

Each company has a unique capital structure that is primarily determined by its level of business risk. To examine the sources of permanent debt and equity financing used, analysts should consult the investor relations or corporate information section of a company’s website. Here they provide important financial information for their stakeholders such as the consolidated financial statements, management discussion and analysis, annual information form, management information circular, and other disclosures. These documents can also be found on the System for Electronic Data Analysis and Retrieval (SEDAR) website sponsored by Canada’s securities regulators. In the U.S., similar reports are available on the company’s website or through the Electronic Data Gathering Analysis Retrieval (EDGAR) system hosted by the U.S. Securities Exchange Commission. Premium Brands Holdings (PBH) provides a practical example of how a company finances its operations.

**Premium Brands Holdings**

PBH is an acquirer of high-growth, premium-priced, specialty food manufacturers and distributors based in Vancouver, Canada. By selecting products that focus on quality, convenience, health, and lifestyle over price, PBH avoids intense price competition with its much larger national and international competitors yielding higher, more stable profit margins. PBH purchases innovative companies that already sell superior products and then helps them reach their full potential. These businesses continue to operate autonomously to encourage innovation, customer focus, faster response times, and to avoid bureaucratic decision making. PBH adds value by providing improved distribution, access to capital, risk diversification, lower-cost global purchasing, idea sharing between firms, and enhanced management services such as information systems.

PBH is growing rapidly with a 23.0% CAGR of sales from 2013 to 2018. It borrowed heavily to finance its expansion but maintained a stable long-term debt to total capitalization ratio of approximately 55.0% over this period. Nearly two-thirds of PBH’s permanent debt financing comes from an unsecured revolving term loan that requires no principal payments and matures in September 2022. This credit facility has a limit of CAD 984.5 million of which CAD 702.5 million is currently being used. The limit was increased by USD 150 in 2018 to help finance its U.S. expansion and the maturity date was extended. Interest is calculated quarterly and rates fluctuate from 0.25% to 1.25% over the bank prime rate or 1.25% to 2.25% over the banker’s acceptance rate. The exact rate is determined by the ratio of borrowing on this credit facility to cash flow from operations – the higher the ratio, the more interest PBH pays. Loan covenants require PBH to maintain a senior funded debt to adjusted EBITDA ratio ≤ 4.0 and an interest coverage ratio ≥ 4.0. At the end of 2018, these ratios were 2.6 and 11.1, so PBH is compliant. When calculating these ratios, senior funded debt excludes PBH’s subordinate debentures since they are convertible into common shares. Adjusted EBITDA includes a full year’s EBITDA for any new acquisitions. The interest coverage ratio only includes the combined income statements of certain subsidiaries. These rules make PBH’s ratios more representative of its true debt-paying ability.

PBH raises a small amount of permanent financing through a secured term loan, secured U.S. revenue bonds issued by a state industrial development group, an unsecured promissory note, and financial leases. But the remaining one-third of its permanent debt financing is from convertible debentures which are subordinate to the secured revolving term loan. PBH currently has three issues:

**Exhibit 6: Debenture Issues at PBH**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Issues** | **Amount** | **Issue**  **Date** | **Redemption**  **Date** | **Maturity**  **Date** | **Conversion**  **Price** |
| 4.65% debenture | CAD 84.5 million | April 12, 2016 | April 30, 2019 | April 30, 2021 | CAD 85.90 |
| 4.60% debenture | CAD 109.7 million | December 5, 2016 | December 31, 2019 | December 31, 2023 | CAD 107.25 |
| 4.65% debenture | CAD 166.0 million | April 10, 2018 | April 30, 2021 | April 30, 2025 | CAD 182.51 |

None of the debentures require any principal payments until maturity. Each debenture is redeemable by the company, but with the upswing in PBH’s share price nearly all debentures are expected to be converted into common shares by the holders first. PBH is one of the largest issuers of convertible debentures in Canada.

PBH is widely-held with no shareholder group controlling the company. As a result, it has only one class of common shares with no voting restrictions. Retained earnings are insufficient to finance PBH’s rapid growth, so it has increased the number of outstanding shares by approximately 60% since 2013 to raise capital. New shares are issued when debentures are converted and to pay previous owners directly for business acquisitions. A small number of shares are sold as part of PBH’s stock-based compensation plan, ESOP, and DRIP. The DRIP was recently discontinued as the additional equity was no longer needed due to PBH’s improved compliance with its loan covenants and continued use of convertible debentures. PBH pays a quarterly dividend of CAD 0.5250 which has more than doubled since 2013. For the first time in 2018, PBH issued a large amount of new equity directly to the public and received approval to implement a stock repurchase plan to buy 1.7 million common shares in 2019.

PBH has grown safely by maintaining a reasonable balance between debt and equity financing. It is willing to issue new shares because no ownership group is concerned about losing control. PBH is exceeding its ratio requirements by a significant margin, so it is planning a modest increase in its borrowing level. ROE fell in 2018 due to a large public share issuance and conversion of a debenture issue. As this equity is used to fund expansion in 2019, ROE should return to its previous level. Share prices fell at the end of 2018 due to a market correction but recovered to CAD 95.73 by July 1, 2019.

**Exhibit 7: Selected Financial Information at PBH**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **2018** | **2017** | **2016** | **2015** | **2014** | **2013** |
| Cash flow from operations (CAD millions) | 135.9 | 85.9 | 149.9 | 67.3 | 10.3 | (5.2) |
| Cash flow from investing (CAD millions) | (683.3) | (310.5) | (236.5) | (81.5) | (3.8) | (57.8) |
| Cash flow from financing (CAD millions) | 551.7 | 220.3 | 94.7 | 16.1 | (3.6) | 63.0 |
| Long-term debt to total capitalization ratio (%) | 57.1 | 56.0 | 49.0 | 50.1 | 65.5 | 53.6 |
| ROE (%) | 11.9 | 16.2 | 16.1 | 3.6 | 5.6 | 6.0 |
| Share price (CAD) | 73.43 | 104.25 | 66.73 | 39.16 | 21.89 | 19.36 |

PBH’s high growth is expected to continue but at a declining rate as it must look more to the competitive U.S. market for acquisitions as the number of companies in Canada that meet its investment criteria declines. By focusing on the premium-priced segment of the food industry, PBH’s sales are well protected from business cycle gyrations. Nearly all its debt matures by 2025, so it is exposed to rollover risk. Going forward, now that PBH has demonstrated the strength of its business strategy and gained greater respect in the financial markets, it should contemplate revising its sources of permanent debt and equity financing. Convertible bonds are expensive and are primarily used by high-risk borrowers, so possibly more traditional bonds, debentures, notes, term loans, and commercial mortgages with lower interest rates, longer laddered maturities, and regular principal payments can be issued using a combination of private and public placements. PBH has already started to sell new equity directly to the public reducing its reliance on expensive convertible debentures. Steps should also be taken to improve profitability in their family of companies to maximize retained earnings and reduce the size of equity issuances.