It's Time to Stop Thinking of the Financing Environment After the Global Financial Crisis as the *New* Normal (It's Just Normal)

by Desmond Lee & Michael Innes

Slow economic growth, weak metals prices and a little bit of REIT fatigue – all part of the current financing landscape in Canada. Although equity offerings did not keep pace with the brisk activity levels we saw in the United States, 2013 was a fairly typical year in Canada in terms of overall equity financing activity and was another strong year for debt offerings. Expect more of the same this year unless we see higher-than-expected economic growth.

Osler Comments *on It's Time to Stop Thinking of the Financing Environment After the Global Financial Crisis as the* New *Normal (It's Just Normal)*

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Equity Capital Markets

Canadian Equity Markets Up Overall, but Lag the United States

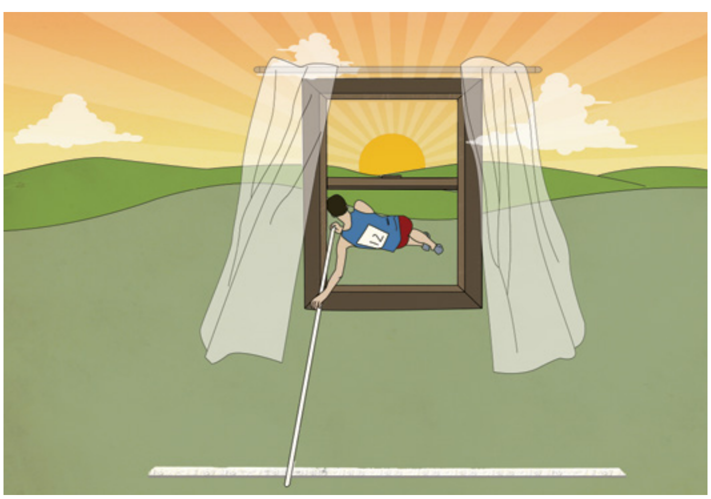
U.S. equities had a banner year thanks to favourable economic and market conditions, propelling both the S&P 500 and Dow Jones to all time highs in 2013. Strong equity market performance drove transaction activity in the U.S., which saw 222 IPOs completed in 2013 – the highest number since the height of the technology boom in 2000.

S&P Indices: Historical Daily Index Values (%)

Source: S&P Dow Jones Indices LLC, a part of McGraw Hill Financial. One-year return is as of December 31, 2013.

The underperformance of Canadian equities relative to U.S. equities became more pronounced in 2013, with the one-year return for the S&P 500 ending the year up close to 30% – almost triple the return of the S&P/TSX 60 and S&P/TSX composite indices over the same period and the highest single year return for the S&P 500 since 1997.

The Canadian IPO market did not benefit from the favourable market sentiment seen in the U.S. and did not come close to matching the strength of the U.S. IPO market, even on a relative basis. Nineteen IPOs were completed in Canada in 2013,[1] which was up over the 14 transactions completed in 2012 but still less than half the number in 2007. As in recent years, market conditions in Canada were inconsistent and remained challenging for many issuers. In some cases it was a buyer's market, with issuers having to entertain changes to price, offering size or deal terms in order for transactions to be completed. This, however, should be viewed as perfectly normal except perhaps during the middle of a bull market or frenzy for a particular product (such as income trusts in the early to mid-2000s or REITs in the past few years). It has become easy to blame the global financial crisis and the European and U.S. economic events that followed for what should be viewed as normal market risk.



For many smaller issuers, the keys to completion in difficult market conditions were flexibility, determination and an open mind. Once again we saw issuers deal with market risk by pursuing

1 Includes the IPO of Pattern Energy Group Inc., a Delaware corporation listed on the TSX.

alternatives to the conventional IPO that sought to split the processes of going public and capital raising. These strategies were used in a number of industry sectors, including real estate (PRO REIT), technology (ViXS Systems Inc.) and oil and gas (Caracal Energy Inc.).

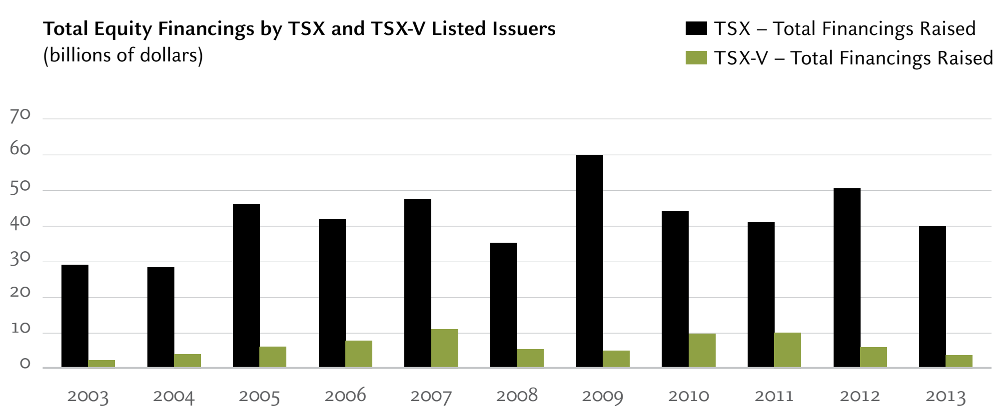
Equity Financing Down in 2013

Total equity financing activity in Canada was down in 2013 compared with 2012, although not as much as it may have seemed to issuers and their advisors. Equity offering proceeds decreased by about 23%, while equity transaction volumes fell by about 15% compared with 2012. This, combined with continued weakness in the mining sector and a substantial slowdown in equity offerings by REITs, made 2013 feel at best like a mixed year for equity financing activity in Canada, with a number of high-profile and well-received offerings taking place alongside many less-successful ones. On the positive side, we saw increased investor interest in industries outside the real estate, oil and gas, mining and energy sectors, with several successful IPOs and follow-on offerings by issuers in the technology, consumer and diversified industries.

Equity Financing Activity Consistent Over the Longer Term

Despite the perception that market conditions have been difficult since the onset of the global financial crisis, it is important to put the experience of the past few years in context. Looking back over a 10-year period, equity financing activity in Canada has been remarkably consistent.

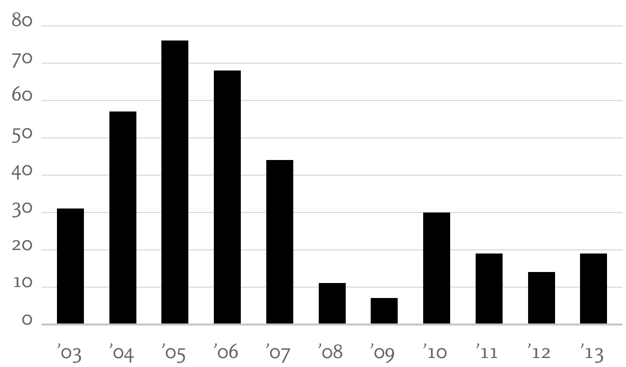
Total Equity Financings by TSX and TSX-V Listed Issuers
(billions of dollars)



Source: TMX Group Equity Financing Statistics. Includes proceeds from both IPOs and follow-on offerings, whether on a treasury or secondary basis.

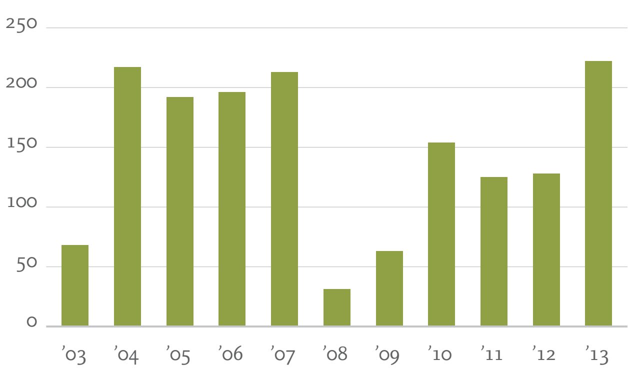
Total equity offering proceeds for TSX-listed companies from 2003 to 2013 averaged just over $40 billion per year and exceeded this average in seven of the last ten years. Even in the midst of the global financial crisis in 2008, total proceeds for TSX-listed companies were still above $35 billion. This was followed by a record-breaking year in 2009, where total proceeds reached $60 billion on the strength of high gold and commodity prices and capital raising activity by banks and other financial institutions. These data show that activity levels since 2008 compare favourably with those seen in the pre-crisis period.

Canadian Completed IPOs
(number of transactions)



Source: FPInfomart. Includes marketed IPOs over $10 million in offering size involving either a TSX or TSX-V listing. Excludes CPC transactions and investment funds.

U.S. Completed IPOs
(number of transactions)



Source: IPO investment firm Renaissance Capital (www.renaissancecapital.com). Excludes SPACs, closed-end funds and trusts.

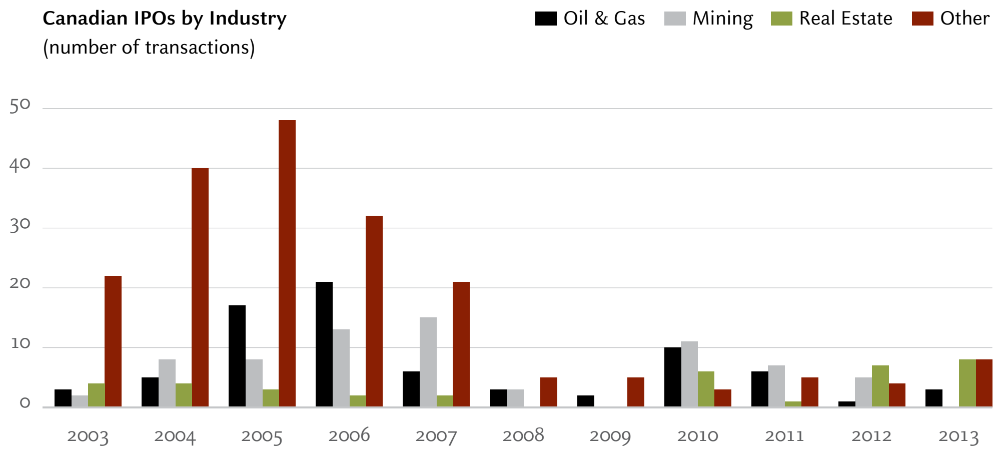
What is a Normal Market for IPOs in Canada?

Looking at Canadian IPOs over the same 10-year period, it would be easy to conclude that transaction volumes are significantly off compared with the years prior to the financial crisis. While this may be true, this overlooks the fact that the pre-crisis period saw IPO volumes that were well above historical averages in Canada due to the large number of income trust issuers coming to market at the time.

IPO volume in the U.S. prior to 2008 was fairly steady – hovering around 200 completed transactions per year – and then fell off significantly with the onset of the financial crisis in 2008. IPO activity then rebounded in the United States and may well have hit the 200 transaction mark in 2011 or 2012 were it not for the European economic crisis and the U.S. fiscal situation.

Why has IPO activity followed such a different pattern in Canada? We believe the main reason is due to the distorting effect of the income trust boom in the years leading up to the financial crisis. During this period, high transaction volumes were not an indicator of investor demand for IPOs so much as they were for tax-efficient, yield-driven products. The number of IPOs in Canada peaked in 2005 and then decreased with the Canadian federal government's announcement of the Specified Investment Flow-Through (SIFT) tax on income trusts in late 2006. Activity levels had already tapered off by the time of the onset of the financial crisis, suggesting that 2007 may be more indicative of actual IPO capacity in Canada than the prior years.

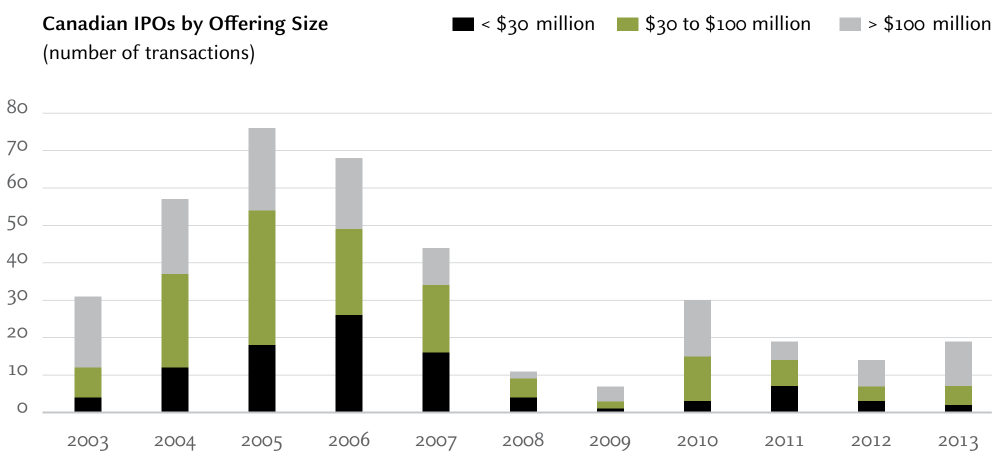
Canadian IPOs by Industry
(number of transactions)



Source: FPInfomart. Includes marketed IPOs over $10 million in offering size involving either a TSX or TSX-V listing. Excludes CPC transactions and investment funds.

Income trusts made up the bulk of IPOs by issuers in the "other" industry category during the 2003 to 2006 period. During the same period, there was a significant increase in small and mid-sized IPOs.

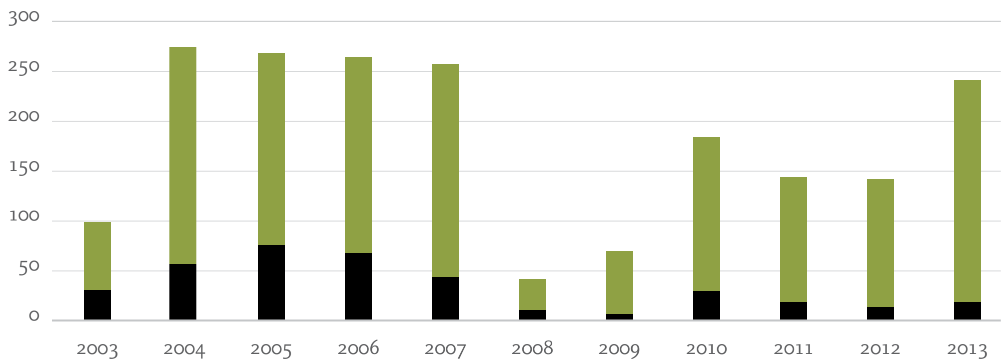
Canadian IPOs by Offering Size
(number of transactions)



Source: FPInfomart. Includes marketed IPOs over $10 million in offering size involving either a TSX or TSX-V listing. Excludes CPC transactions and investment funds.

We believe the past four years are a better indication of the natural demand for IPOs in Canada – a "normal" market, in other words – of around 20 transactions per year on average, or about one-tenth the number of completed U.S. IPOs in 2013. While we may someday see IPOs exceed the 44-transaction mark set in 2007, we think a number between 20 and 30 transactions per year is more realistic in the near term.

Canadian vs. U.S. Completed IPOs
(number of transactions)

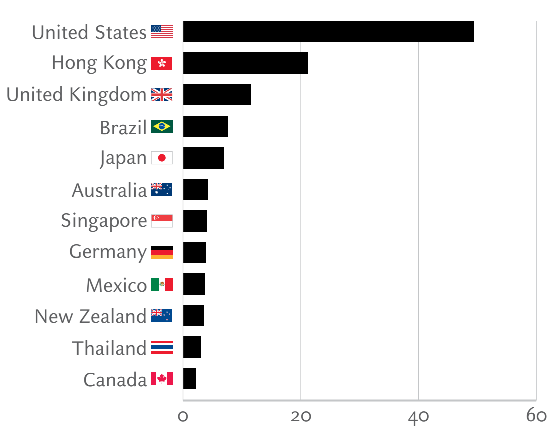


Sources: FPInfomart and IPO investment firm Renaissance Capital (www.renaissancecapital.com). Canadian transactions include marketed IPOs over $10 million in offering size involving either a TSX or TSX-V listing, and exclude CPC transactions and investment funds. U.S. transactions exclude SPACs, closed-end funds and trusts.

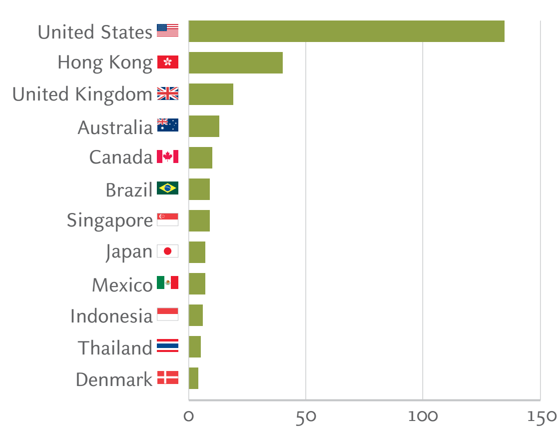
How Does Canada Compare as a Global IPO Market?

Relative to other markets, it is clear that Canada remains a mid-sized market, still largely dependent on mining and oil and gas issuers to drive IPO activity. In 2013, with no transactions by new mining issuers and only two by oil and gas issuers, Canada ranked 12th as a market measured by total IPO proceeds raised. Measured by deal count, Canada ranked 5th (behind the United States, Hong Kong, the United Kingdom and Australia), with transaction volume being approximately half that of the United Kingdom, a quarter that of Hong Kong and less than a tenth of total volume in the U.S.

Global IPO Race
(volume US$ billion)



Global IPO Race
(number of transactions)

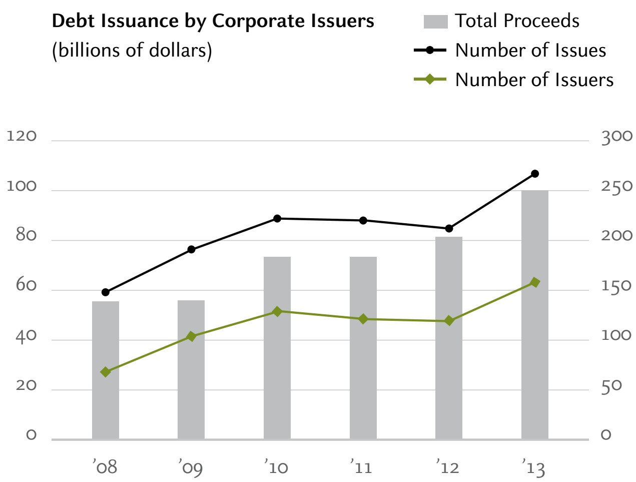


Source: IPO investment firm Renaissance Capital (www.renaissancecapital.com). Includes all IPOs that raise over US$100 million.

Outlook for 2014

We expect that activity levels in Canada will improve somewhat in 2014, although we do not expect a substantial increase in IPOs or follow-on transactions absent higher-than-expected economic growth or commodity prices. In addition to seeing some positive signs for an improving economy, we believe many issuers will be more accepting of current market prices and will return to the markets after having sat on the sidelines for all or part of 2013. This will be the case particularly for REITs and, potentially, issuers in the mining sector that may be running short on alternatives.

Debt Issuance by Corporate Issuers
(billions of dollars)



Source: FPInfomart. Excludes municipalities, governments, government agencies, asset-backed securities and mortgage bonds.

Debt Capital Markets

Low Interest Rate Environment Continues

The Canadian debt markets in 2013 carried on where they left off in 2012. A historically low-interest-rate environment, combined with a lessening of concerns over imminent rate hikes by central banks, led to very strong issuance volumes. As in previous years, market windows were erratic and opportunity-driven, but an increase in issuance volumes year over year confirmed that demand for credit remains strong.

Earlier in the year we saw a rush to issue over concern that the Bank of Canada and other central banks would raise benchmark interest rates, only to see another rush to issue once the fear of increased rates subsided.

High-Yield Opportunities

We saw opportunities for Canadian issuers of high-yield debt as investors continued to seek yield in a low-rate environment. Covenant patterns in Canada continue to evolve, but generally still follow those seen in the high-yield market in the U.S. We have also seen a willingness to use high-yield debt as part of acquisition financing. Examples include the high-yield financings launched by Western Energy Services Corp. and Canadian Energy Services & Technology Corp. in 2013 to take-out short term debt financing used to fund acquisitions. This is something that has not been seen much in the Canadian market so this is an encouraging sign for growth of this market.

REITs and Floating Rate Notes

Throughout 2013 we saw a number of REITs access the debt markets for the first time, such as Dundee REIT and Granite REIT. In addition to accessing the market, in the fall of 2013 a number of REITs issued floating rate notes (notes whose interest rate is not fixed through the term of the bond but which adjusts on pre-determined dates based on changes to one or more benchmark references) for the first time. Examples included Dundee REIT, Calloway REIT and Cominar REIT.

Consent Solicitations and Tender Offers

As we noted in 2012, consent solicitations have become a more popular mechanism for seeking modifications to the terms of debt securities. We continued to see increased consent solicitation activity through 2013, both for high yield and investment grade bonds. We also started to see consent solicitations tied together with tender offers for outstanding bonds, which is a distinctly American approach to dealing with bonds that are no longer favourable to the issuer. An example of this was the Livingston International Inc. offer to purchase and consent solicitation launched in March 2013 for its 10.125% Senior Unsecured Notes due November 9, 2015. Not all consent solicitations and tender offers have been successful so this reinforces the notion that issuers should carefully consider their covenants at the time of issuance to ensure they have the flexibility they believe they will need to operate their business going forward.

Outlook for 2014

Assuming benchmark interest rates remain stable and there is no intervening crisis of confidence on a macro economic scale, we expect to see a continued robust debt market in 2014. We expect issuers will seek to refinance their more expensive debt, replacing it with bonds bearing historically low coupons. In addition, so long as there remains uncertainty and volatility in the equity markets, the flow of capital out of the bond markets will not occur, leaving strong demand for credit generally.

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