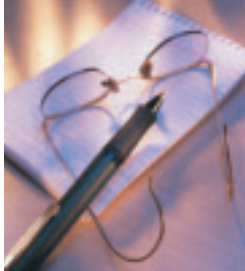


THEY'RE BACK...

Pension funds vying for BCE? It's déjà vu all over again.



BY LAURENCE BOOTH

In April 2007, Bell Canada Enterprises Inc. (BCE) announced that it was in non-exclusive talks with Kohlberg Kravis and Roberts (KKR), the Canada Pension Plan (CPP) and the Caisse de dépôt et placement du Québec. Subsequently, BCE has announced that it is also in talks with the U.S. private equity company, Cerberus Group, while the Ontario Teachers Pension Plan is also rumoured to be actively considering a bid in partnership with the U.S. private equity firm, Providence Equity Partners. Valued at close to CDN\$40 billion, buying Canada's biggest telephone company would be the biggest Canadian deal ever and one of the biggest in North America. So what is motivating the going private transaction of one of Canada's true icons?

To understand a possible BCE deal we have to contrast it with past innovations and excesses. So let's cycle back twenty years ago to the go-go years of the 1980s when leveraged buyouts (LBOs) were all the rage and see what we can learn. In Canada, People's Jewellers raised junk bond financing from Drexel and bought out the largest diamond store in the world: Zales. Closer to home Gerry Schwartz founded Onex and did Canada's first homegrown LBO with the buyout of American Can Canada from its U.S. parent. And, of course, the granddaddy of the era was the KKR-led 1988 buyout of RJR Nabisco for US\$25 billion.

So what did these leveraged buyouts have in common? Willis and Clark laid out the key factors: strong proven management; proven profitability; predictable cash flows; intrinsic financial strength; quality assets; distinctive market position; competitive strength; low technological risk; non-cyclical. The Willis and Clark factors were pretty much the same across most LBO shops and were the blueprint for a decade of highly levered transactions.¹

The motivation for these transactions was twofold. The

first was the use of large amounts of debt to reduce taxable income and corporate taxes—hence, the leverage in the LBO. By reducing corporate taxes, the aggregate amount of cash flows available to private investors is increased. In other words, LBOs maximized the use of debt tax shields and the fact that interest is tax-deductible. The second was the minimization of agency problems. In highly levered transactions, where management has a small stake in the equity, there is no incentive to undertake corporate empire building. Instead all cash flows are devoted to the survival of the firm and paying down debt, so that the firm could exit via an IPO or other transaction in five or so years' time. For some firms the minimization of these agency problems was a huge plus, particularly during the unwinding of the conglomerate mergers of the 1960s and, 70s.

These two objectives could be accomplished for firms that met the LBO criteria since, in essence, all the factors boiled down to one simple definition of low business risk coupled with minimal future capital expenditures. The low business risk was necessary to support the 60% senior and 30% mezzanine debt financing typical of LBO structures priced at 6.5 times EBIT. The low capital expenditure was then necessary to ensure that future cash flows could be used for debt reduction rather than for a necessary expansion or maintenance of the business.

An important feature of the prototypical LBO structure was that the debt was external debt, that is, debt owed to third parties, normally syndicated bank debt or junk bonds. Junk bonds by definition were non-investment grade debt issues (sub BBB-) with the twist added by Michael Milken that these were original-issue junk bonds, not fallen angels. However, as third-party debt, default on principal or interest payments would still trigger bankruptcy or reorganization. The key to LBOs was thus low business risk able to support large amounts of tax-deductible debt financing through a five-year forecast

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horizon. The fact that the debt was available was due to the innovation of Drexel and Michael Milken that made original-issue junk bonds a cheap source of financing. As always, it was this innovative twist that made LBOs the star of the, '80s.

LBOs peaked with the business cycle in 1989 with the RJR Nabisco LBO in 1988, the late cycle deal that never quite made it for KKR. Simply put, there was too much money chasing too few deals by the end of the 1980s, which made the RJR Nabisco deal expensive. The deal more or less coincided with the implosion of Drexel and Michael Milken's investigation for securities irregularities. As the economy slipped into recession, junk bond financing became more difficult to obtain and a new cycle started with new twists on old deals.

But as one vehicle dies, another is created, in this case for Canada it was the business trust market. The first oil and gas royalty trust was Enerplus Royalty Trust in 1986. However, fast-forward to the late 1990s and business trusts were developed to complement Oil and Gas royalty trusts and real estate investment trusts (REITS). So what have business trusts to do with LBOs? The key is that they are motivated by the same two basic principles of aligning the incentives of managers and investors and reducing taxes.

The basic structure of a business trust is that the trust owns both the debt and equity securities issued by an operating company. As a trust, organized similar to a mutual fund, these interest and dividend payments and any return of capital can be returned to the unit holders without any tax. A brief look at any income trust will show that the debt is often high-coupon and designed to reduce the taxes paid by the operating company. The result is that taxes are minimized similar to an LBO and with the flow-through of income to the retail market as a yield product, agency problems are again reduced.

Unlike an LBO, however, where the low business risk supported the external debt, in an income trust, the debt is held by the same party as the equity. In the event of any payment problems the debt holders are unlikely to enforce action against the equity holders, since they are the same

party. In this way the distress costs of excessive debt structure are removed while the tax reduction remains.

Income (business) trusts boomed in Canada and dominated IPOs from 2003 to 2006, but in October 2006 BCE announced that it was considering a conversion to an income trust. The Canada Revenue Agency could see Bell Canada's CDN\$0.8 billion of corporate income taxes disappearing, before even considering the implications for other large Canadian firms. On Halloween night the Minister of Finance announced a new distribution tax that would effectively tax income trusts the same as regular corporations in four years' time.

From LBO and private equity to income trusts to...you guessed it: if the advantages of tax and agency cost reduction are there to be had in higher valuations, then they will be realized in some way. Unlike the income trust market that was dominated by smaller firm IPOs, private equity deals have to be big. So whereas the typical income trust could not capture the attention of KKR, CPP and OTTP, BCE can.

So what is this cycle's twist on the LBO? Back in the 1980s OTTP and CPP and other public pension plans invested primarily in provincial bonds, while infrastructure assets were largely in government hands. Now these large public plans invest in public markets and have a voracious appetite for infrastructure assets with regulated returns that they can use to match their long-term inflation-indexed liabilities. OTTP was a potential investor when Ontario Hydro was on the block to be privatized in 2002, and now guess what it along with CPP and the Caisse is in for Bell Canada. A highly debt-structured deal for Bell Canada involving the participation of OTTP, CPP or the Caisse will result in similar tax losses to Ottawa as an income trust conversion. As financial "guru" Yogi Berra might have said, "Oh my god, it's déjà vu all over again." ■

ENDNOTES

1. John Willis and David Clark, "An introduction to mezzanine finance and private equity," *Continental Bank Journal of Applied Corporate Finance*, (Summer) 1989."