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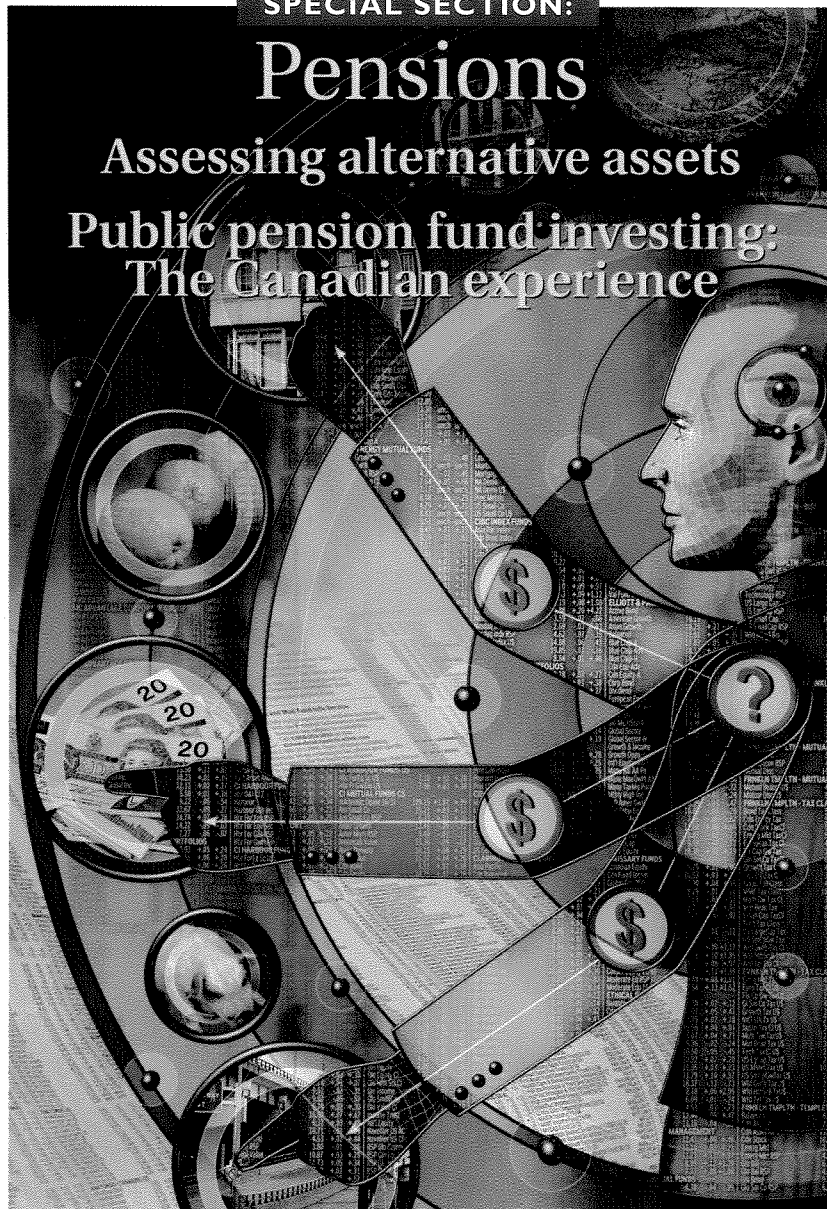
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# Debentures vs. MTNs

*What are the advantages and disadvantages of setting up a medium-term note program to raise debt funding in Canada rather than issuing debentures?*

By Ana Sainz

**T**HE MAJORITY OF CORPORATE PUBLIC DEBT ISSUED IN CANADA is raised through a medium-term note (MTN) program. How is an MTN program potentially a better vehicle for issuing debt over debentures? And which form of debenture?

MTNs are issued using a short-form prospectus while debentures can be issued via both short-form or long-form prospectus. To add to the confusion, the universal shelf (short-form) prospectus permits a corporation to combine the potential issuance of debt (convertible and non-convertible), warrants and equity securities all under one legal document. Assuming you have no need for further equity at this time, you will have to focus your consideration on the issuance of debt.

Typically, MTNs are senior debt with maturities of two years and longer. (Canadian banks issue their subordinated debt via MTN programs, as their senior debt is prospectus-exempt.) The longest corporate MTN issued in Canada had a maturity of 40 years. Interest paid on MTNs can be floating rate, fixed rate, or even linked to a number of indices.

To issue domestic public debt via a short-form prospectus, a corporation must be a reporting issuer in Canada for a period of 12 months. This means that the corporation has prepared and duly filed with one of the securities commissions such as the Ontario Securities Commission (OSC) all the following information:

- audited annual financial statements, with auditors' report;
- quarterly financial statements;

- annual information form;
- management discussion and analysis, and
- material change reports.

Although not technically required, most reporting issuers also file their full annual and quarterly reports.

This information must be filed on a continuous basis for as long as any of the public debt remains outstanding. The information is stored and available electronically on the OSC's System for Electronic Document Analysis and Retrieval (SEDAR).

Any form of public non-convertible debt requires a credit rating. The corporation should obtain credit ratings from at least two of the available agencies in Canada. A credit rating of BBB- equivalent or higher is considered investment-grade in Canada. The credit rating will generally apply to all debt issued by the company of similar ranking (senior, subordinated, etc). In addition, the credit-rating agency will rate each individual tranche when issued.

A short-form or shelf prospectus permits the issuer to put the legal document on the shelf for a period of 25 months. This means that, at any point during the 25 months, the corporation has the flexibility to issue from this

legal document already filed with the securities commission.

Figure One summarizes the paths the corporation may take. As mentioned, a short-form debt prospectus allows the corporation to issue a variety of debt securities over a 25-month period. The total dollar amount of potential issuance must be stated in the prospectus, but need not be split between the various forms of debt. The prospectus for an MTN program must also identify all the investment dealers that might act as the corporation's placement agents for the program. These investment dealers will need to sign a dealers' signature page in the MTN program shelf prospectus.

While the shelf prospectus describes each debt security, the actual issuance takes place by filing a prospectus supplement. The supplement contains all

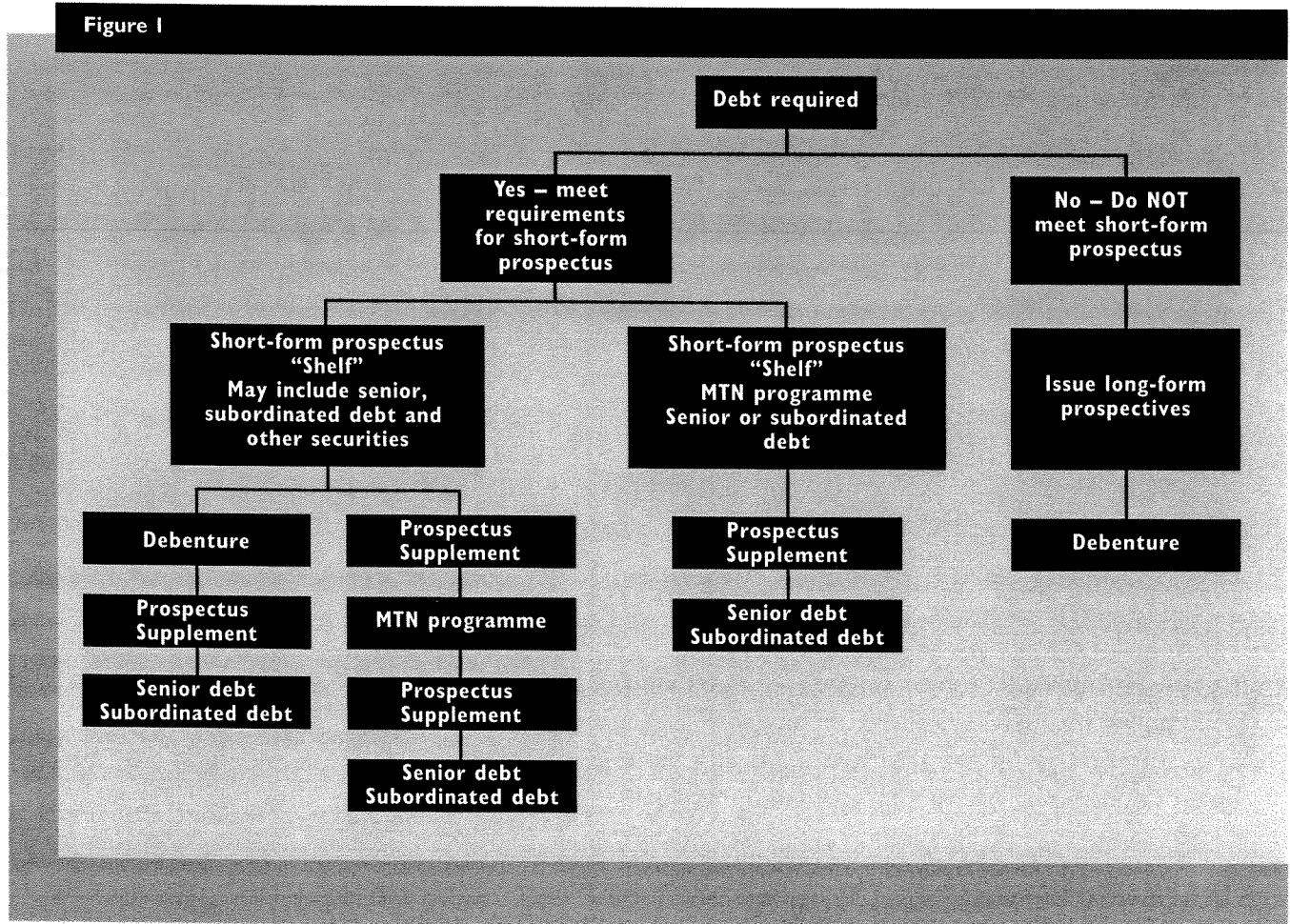
**Any form of public non-convertible debt requires a credit rating.**

the specific details of the debt being issued including maturity, price, coupon, yield, etc. The length of each supplement depends on the type of debt and how much detail was already included

in the shelf prospectus. To establish an MTN program from an existing shelf prospectus, a supplement for the entire program must be filed. If the MTN program is established through a supplement, the investment dealers still need to be identified and sign the supplement establishing the program.

For example, a shelf prospectus can be filed for \$750 million with a subsequent supplement carving out \$500 million of the \$750 million for an MTN

Figure 1



program. This leaves the corporation with the flexibility of using the remaining \$250 million for other type of debt. Alternatively, the shelf prospectus can be filed establishing the entire \$750 million as an MTN program without the supplemental step.

So why choose one over the other? It depends on the needs of the corporation and the message it may wish to send to the capital markets.

An MTN program signals several things to debt investors (your other stakeholders), which the corporation

should consider carefully. If it doesn't, the corporation's ability to issue debt, as well as the amount and cost of issuing debt, may be affected.

A debt shelf indicates that the corporation may consider issuing debt at some point over the next 25 months, has made the strategic decision to set up a shelf for flexibility and can optimize the debt issuance with respect to timing, appropriate size, maturity and all-in cost.

An MTN program tells the investor that, in addition to issuing debt strategically, the corporation is willing to entertain reverse inquiries. A reverse inquiry occurs when an investor contacts one of the investment dealers with a need for debt of a particular maturity, yield and credit rating. The investment dealer then contacts a suitable corporation to inquire

about its interest in issuing debt to meet the investor's need.

Institutional investors are greatly concerned with trading liquidity. The overall size of an MTN program, individual tranche sizes and the syndicate of investment dealers affect the overall trading liquidity of a corporation's debt. In all cases, bigger is better. A large-sized program with frequent good-sized tranches permits the investor to actively trade between the corporation's MTNs of differing maturities. A larger tranche size will encourage investment dealers to actively trade the issue (both buying and selling), as they will have the ability to sell short the debt and borrow back in the repurchase market. Small tranches and retail deals are considered less liquid.

An MTN program tells the investor that the corporation will be a frequent issuer into the market; that means a minimum of one issuance per year of at least \$100 million. The MTN program's total size should not be less than \$300 million.

**Placement agreement:** MTNs are issued through an agency agreement

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with the investment dealers. An agency agreement differs from an underwriting agreement as MTNs are placed on a best efforts basis. There are no guarantees that the MTNs will be sold to investors and, if they're not, the corporation may end up holding them.

Debentures are typically sold on a fully-marketed or bought basis. Bought deals are rare in the marketplace, as the investment dealers put up capital to buy all the debentures and then sell them to investors. Fees for bought deals are higher to compensate for the associated risk assumed by the dealers. Fees for a fully marketed deal vary with the credit rating of the corporation and the maturity of the debt issued but will usually fall in between agency fees and bought deal fees. A fully marketed deal includes intense marketing from senior management.

**Placement fees:** Since MTNs are placed on an agency basis the placement fees paid to the investment dealers is considerably less than a debenture. The lower fees are a direct response to the lower risk the dealers assume in an agency transaction. Table One compares the fees (based on \$100 face value) for an investment-grade-rated corporation. As you can see, the savings on placing institutionally \$100 million of 5-year MTNs over debentures is \$275,000.

**Investor base:** There are two main distribution channels available to the corporation – institutional investors such as pension funds, money managers, mutual funds, etc., and retail investors like you and me. Although technically retail deals can be issued from a debt shelf, they are generally issued via MTNs in smaller tranches of \$15 million to \$50 million.

Unlike the institutional MTN the placement fees for a retail debt deal vary with maturity of the note, the complexity of the note and the investment dealers' payment to the retail broker. In a retail deal, the corporation pays a higher placement fee, since a retail broker also receives his or her commission on selling the MTN to the likes of you and me. Fees can range from the ones noted above up to \$3 (per \$100 face value). Retail investors tend to focus their interest on corporations that are household names with high credit ratings.

Carving out a small piece (5%-10%) of an institutional deal for placement with retail investors is an excellent method of reaching both channels. In fact, institutional investors prefer this,

**Table One**

Maturity of debt	MTN (agency) (per \$100 face value)	Debenture (fully-marketed)
2 year	\$0.20	\$0.25
5 year	\$0.35	\$0.625
10 year	\$0.40	\$0.75
30 year	\$0.50	\$0.90

since retail investors do not typically trade around their debt holdings. Hence the price of the debt is thought to be more stable than a purely institutionally placed deal.

**Investment Dealers:** MTNs can be placed through a syndicate of investment dealers or through only one dealer. Generally, retail deals of less than \$50 million are placed through one or two investment dealers. Larger institutional transactions will require three to six investment dealers. MTNs are a great way to reward the investment dealers, as the placement fees do not use up the investment dealers' capital and are regarded as the one of the best types of business to procure. Each dealer's allocation should reflect its ability to make markets in the corporation's MTN. This means it has the ability and interest in actively trading all maturities of the debt outstanding. Keep in mind that this is also linked to the trading liquidity of the corporation's MTN, as discussed above.

In a debt issue there is generally a lead investment dealer followed by a tiered syndicate structure. The lead dealer is primarily responsible for assisting the corporation in the marketing and pricing of the deal and is the primary market-maker after issuance. With an MTN program, each dealer has the opportunity to present both institutional and retail deals to the corporation with the best combination of idea and cost winning the lead position for that tranche deal. Some larger corporations rotate lead positions while others stick to a format similar to a debt issue, with one consistent lead investment dealer.

**Marketing:** The corporation should be prepared to market the MTN program when it is established. This holds true even when a corporation has issued debt previously and/or has an existing MTN program. If the corporation sets up a debt shelf, the marketing should take place just prior to the issuance on the advice of the lead dealer.

MTNs are generally issued quickly into the market. For more frequent MTN issuers, the order book is typically open to investors for one to four hours before pricing so that the entire transaction is completed within one day. Other MTN order books may be open for one to two days depending on whether marketing is also occurring. Debt shelf issues are generally accompanied by two to four days of marketing with the order book open for one to three days before pricing.

Although both a debt shelf and an MTN program leave the corporation with debt outstanding, there are subtle differences that investors will infer from the corporation's choice of one over the other. In making the choice, the corporation should discuss the following items:

- Will the corporation be willing to entertain reverse inquiries?
- Is the corporation willing to commit to enhancing the trading liquidity of its debt through frequency/size of issuance and syndicate composition?
- Is the corporation comfortable with agency versus underwriting agreement for placement of debt and associated fees?
- Is the corporation's business easy to understand with a relatively high investment-grade credit rating?
- Is the corporation interested in tapping into the retail investor channel for smaller deals?
- Does the corporation feel it should spread its fees among a larger syndicate or does it feel more comfortable with one lead investment dealer?
- How much time does management have for marketing to investors?

Once the corporation has discussed these items, it can come to a well-considered decision on which type of debt issuance vehicle to use.

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