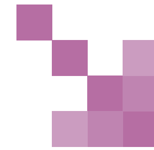
Canadian high dividend common share IPOs: a new path to liquidity for US businesses to meet investor demand for yield



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Stephen Pincus and Jon Northup, Goodmans LLP

On 17 May 2007, Northstar Healthcare Inc (Northstar) completed the first Canadian initial public offering (IPO) of high dividend common shares by a US business. Listed on the Toronto Stock Exchange, Northstar was formed to indirectly acquire and manage ambulatory surgery centres (that is, outpatient facilities) in the US, focusing initially on Houston and other metropolitan areas in Texas. At approximately Can$170 million (about US$174 million) (after full exercise of the over-allotment option (that is, the options given to the global co-ordinator of a bookbuilding exercise to acquire more shares to stabilise the market in the immediate post-offer period)), Northstar was the largest IPO in Canada during the first nine months of 2007. Investor interest in Northstar has continued since its IPO and as of 24 January 2006, its share price of Can$15.13 (about US$15.88) was approximately 25% above issue price (having traded as high as Can$19.83 (about US$20.80)) (*see box, The Northstar offering*).

Against this background, this chapter examines:

- The Canadian IPO market in 2007.
- The reasons for undertaking a Canadian IPO.
- The IPO process.
- Subsequent financing through bought deal offerings.
- Suitable businesses for high dividend common share offerings.
- The structure of such an offering.
- The outlook for Canadian IPOs.

THE NORTHSTAR OFFERING

Northstar, a Canadian corporation, issued dividend-paying common shares at Can$12.25 (about US$12.86) per common share. The Northstar shares initially paid a monthly dividend of Can$0.10 (about US$0.10) per share (Can$1.20 (about US$1.30) annually), which represented a 9.8% yield on the IPO value. The net proceeds of the offering were used to indirectly acquire a majority interest in two ambulatory surgery centres in Texas. The company also manages four other Texas-based facilities consisting of an ambulatory surgery centre and three pain management clinics. Northstar's stated objectives are, through selective acquisitions of additional ambulatory surgical centres and organic growth, to:

- Expand its asset base.
- Enhance its long-term value.
- Increase dividends.

The Northstar offering generated tremendous interest from both retail and institutional investors. The anticipated regular dividends appealed to those yield-oriented investors that had fuelled the growth of Canadian income funds. At the same time, the common share structure attracted many institutional investors that were not active investors in the income fund sector. The high level of interest in this structure reflects, in part, the recent lack of new supply in the Canadian capital markets.

THE CANADIAN IPO MARKET IN 2007

Despite strong equity values, Canadian IPO activity decreased significantly in 2007. According to a recent survey by PricewaterhouseCoopers (*Survey of Canadian IPO Capital Markets, January 2007 - September 2007, www.pwc.com/ca/eng/ins-sol/publications/ipo_1007.pdf*), the first nine months of 2007 saw just 63 IPOs with a total value of approximately Can$1.2 billion (about US$1.26 billion). During the same period in 2006, there were 95 IPOs with a total value of approximately Can$4.7 billion (about US$4.9 billion).

In recent years, the strength of the Canadian IPO market has been based on yield-oriented offerings, such as income funds. Canadian tax law changes announced on 31 October 2006 effectively destroyed the income fund IPO market (other than qualifying real estate investment trusts (REITs)) and temporarily cast uncertainty over the broader capital market (*see below, Why a Canadian IPO?, Investor interest*). In addition, since the 31 October announcement, more than 20 publicly traded income funds have been taken private (further reducing available supply). Several other significant Canadian public issuers (for example, BCE and Alcan) have also been or are in the process of being privatised.

With the growth of the income fund sector curtailed by tax law changes and a wave of privatisations, yield-oriented offerings continue to be in strong demand in Canada. To date there has been a scarcity of attractive IPOs of Canadian businesses to meet this demand. The high dividend common share structure provides a tax-efficient means for US businesses to fill this void. We can expect further US companies to follow the Northstar example and undertake IPOs on the Toronto Stock Exchange.

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WHY A CANADIAN IPO?

Private equity investors, owner-managers, employee stock ownership plans (ESOPs), and companies looking to monetise certain divisions may consider a Canadian IPO as a means of selling all or part of a US-based business or portfolio of assets. This path to liquidity may be attractive for a number of reasons, including:

- **Attractive valuations.** The demand for income-generating equities from an aging population at a time of low interest rates, combined with a shortage of such securities in the Canadian capital markets, allow appropriate cash flow producing businesses and assets to achieve favourable valuations.

- **Deal flexibility.** Canadian institutional and retail investors have been receptive to public issuers of a wide range of sizes. While there are many successful larger issuers, smaller and medium-sized issuers are also able to attract market interest and ongoing research coverage in Canada.

- **Speed of execution.** An IPO can generally be completed more quickly in Canada than a similar offering in the US.

- **Ease of ongoing access to capital.** Canadian bought deal offerings (*see below, Subsequent financings through bought deals*) allow issuers to return to the capital markets efficiently and quickly to fund future growth and acquisitions. In addition, most of the risk of marketing a bought deal offering is undertaken by the underwriters from the announcement of the transaction.

- **Monetisation of retained interest.** While sponsors are not required to retain an ongoing interest in the business after a Canadian IPO, if there is a retained interest the bought deal mechanism often allows sponsors to successfully and efficiently sell this down.

- **Flexibility for management.** Existing management can remain in place and be appropriately incentivised through a variety of compensation mechanisms, including:

  - long-term incentive plans;
  - stock option plans;
  - deferred/restricted stock unit plans;
  - stock appreciation rights plans.

  If desired, sponsors and/or management can retain control of the business through their retained interest.

Investor interest

Canadian institutional and retail investors have in recent years demonstrated a healthy appetite for income generating equity securities. A number of demographic, economic and market factors combined to stimulate this demand, including:

- An aging population.
- Low interest rates.
- Volatile equity markets after the "dot-com bubble" burst.

As a result, the Canadian income fund sector grew from 52 income funds with an aggregate market capitalisation of Can$20 billion (about US$21 billion) in 2000 to approximately 254 income funds with an aggregate market capitalisation of over Can$200 billion (about US$210 billion) at the end of October 2006. Despite this growth, observers have suggested that the Canadian market for yield-oriented securities remains proportionally smaller than the US market. In addition, the available supply of yield-oriented securities in Canada has actually been decreasing over the past year.

On 31 October 2006, the Department of Finance (Canada) announced a proposal to tax publicly listed income funds and partnerships (other than qualifying REITs) in the same way as corporations. The exclusion for qualifying REITs was intended to give relief to REITs with passive real estate investments.

Previously, Canadian income funds had generally been able to distribute pre-tax cash to their investors. While income funds that were publicly listed on 31 October 2006 are not subject to this new tax until 2011 (if they do not exceed certain equity growth limits intended to prevent their undue expansion), the tax proposals have effectively curtailed the continued growth of the Canadian income fund sector.

On 22 June 2007, the new tax on publicly listed income funds and partnerships was enacted. Other than a few REITs, there have been no IPOs or further conversions of Canadian public corporations to the income fund structure since the announcement of this new tax. Therefore, the number of new issuances for 2007 is predicted to hit a ten-year low. At the same time, an increasing number of existing income funds have been acquired or privatised, further reducing the supply of investment alternatives.

THE IPO PROCESS

If the decision is made to explore a Canadian IPO, experienced underwriters and professional advisers can bring a high dividend common share offering to market quickly and efficiently.

The process can be divided into three key phases:

- **Phase one.** Preparing the structure and the preliminary prospectus.

- **Phase two.** Clearing the prospectus, completing the documentation and marketing the offering.

- **Phase three.** Closing the offering and listing the shares.

While the length of the time required for phase one may vary depending on, among other things, the availability of information (including audited historical financial statements) and certain structural factors (*see below, Structure*), phases two and three generally take about five to seven weeks in total.

This is much shorter than the typical process in the US and significantly reduces execution risk. In certain circumstances, this may be further reduced by starting to market the offer immediately after filing the preliminary prospectus and before receiving the initial comments from the securities regulators. The price and size of the offering is set immediately before filing the final prospectus. The price reflects both the projected cash available for distribution and the investors' valuation of the underlying business.

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Generally, the prospectus must include three years of audited financial statements for the underlying business. The financial statements for the US business can be prepared in accordance with US generally accepted accounting principles if a note to the statements reconciles them to Canadian generally accepted accounting principles. Additional financial statements may be required for significant acquisitions undertaken by the target business.

SUBSEQUENT FINANCINGS THROUGH BOUGHT DEALS

After completing an IPO, Canadian bought deal offerings provide an efficient means for issuers to access future funding from the capital markets. A bought deal is a financing vehicle where the underwriters agree to purchase securities from the issuer as principal before the securities are marketed, with very few conditions attached. Consequently, underwriters take a great deal of market risk (for example, if the market price of the securities decreases, the underwriters can still be required to purchase securities from the issuer at a price greater than the market price of the securities).

Bought deals are advantageous to issuers for several reasons, including the:

- Certainty of the size of the proceeds that will be obtained (although issuers often pay for this certainty with a greater discount to market price than they might concede in a fully marketed offering).
- Reduced time to market. A bought deal is typically executed from inception to closing in about three weeks. Underwriters can pre-market the securities (before a prospectus is filed) for four business days before the filing of a preliminary prospectus if they have entered into a firm commitment to purchase the securities and issued a news release regarding the bought deal.

The bought deal mechanism provides sponsors and management holding a retained interest with an efficient and effective means of subsequently exiting their interests in the business.

SUITABLE BUSINESSES

The high dividend common share structure can be used for cash flow producing US-based businesses and assets in a wide variety of industries, including:

- Real estate.
- Energy.
- Infrastructure.
- Healthcare.
- Services.
- Manufacturing.
- Distribution.
- Retail.
- Media and entertainment.

The preferred candidates have:

- Strong or dominant positions in their respective markets.
- Predictable and sustainable cash flows.
- Potential for growth.

While potential for growth is certainly an advantage, a business with a low-growth profile may achieve a better valuation in a Canadian high dividend common share IPO than under alternative exit scenarios. Other factors that may affect valuations include ongoing maintenance capital requirements and the depth and experience of the management team.

STRUCTURE

High dividend common shares are issued by a Canadian corporation (Canco) and typically listed on the Toronto Stock Exchange. Canco is governed by the applicable corporate legislation of the federal or provincial jurisdiction of incorporation and, therefore, is not subject to the extensive governance issues debated in recent years in relation to income funds (which are trusts under Canadian law). A simplified summary of the structure underlying Canco is as follows:

- Canco establishes a US holding company (Holdco) and uses the net proceeds of the common share offering to acquire both:
  - common shares of Holdco; and
  - preferred securities of a US subsidiary of Holdco (Subco).
- Holdco agrees to repurchase the Subco preferred securities from Canco in ten to 12 years for their original issue price plus unpaid dividends.
- Subco uses the net proceeds to acquire an interest in the target business or assets.

This high dividend common share structure has been designed to maximize cash available to pay dividends to investors. Canco pays periodic (monthly) dividends to its public investors (retained interest holders in the US receive pro rata distributions from one of the underlying US entities). As dividends to the public are typically paid in Canadian dollars, Canco is expected to establish appropriate currency hedging arrangements.

The precise legal and tax structure of any particular high dividend common share IPO depends on a number of factors, including:

- **The legal form of the target business.** If the target business is to be acquired through an asset sale or if the target business is owned by a flow-through entity such as a limited liability company or a limited partnership, the transaction can be structured to allow Holdco to step-up its proportionate share of the target assets to fair market value. In addition to the US tax planning benefits arising from structuring of the repurchase obligation, this stepped-up tax cost basis generates additional tax shelter in the future. A similar step-up is not available if the target business is acquired in corporate form. However, other sources of tax shelter (such as tax losses and existing tax depreciation) may be available to reduce the target's tax liability.

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- **The retention of an interest by existing equity owners.** Existing equity owners can indirectly retain an interest in the target business through owning shares or other equity interests that are designed to be economically equivalent to the publicly issued high dividend common shares. In addition to receiving an equivalent yield, holders of the retained interest are typically entitled, at specified times, to certain liquidity rights in relation to the retained interest.

- **The leverage of the target business.** Depending on the existing leverage of the target business and market perception of acceptable debt levels, a high dividend common share IPO may involve leveraging or de-leveraging the target business. The target's third party debt obligations rank ahead of Holdco's obligations under the repurchase agreement in relation to the preferred securities of Subco. Existing senior credit facilities, if continued, must often be amended to ensure they are consistent with the proposed high dividend common share structure.

- **Available depreciation, amortisation and tax losses.** The high dividend common share structure's tax efficiency (and correspondingly the quantum of cash available for distribution) is enhanced if the target has significant inherent tax shelter to reduce taxable income.

- **Future growth and acquisition strategy.** Unlike other cross-border offering structures, the capital structure of a high dividend common share issuer is flexible and may generally adjust to meet the needs of the target business as it develops. The high dividend common share structure's robustness enables the issuer to consider the full spectrum of capital market alternatives as it pursues subsequent offerings and future acquisitions.

Taxing the business

Under the high dividend common share structure, Canco should not be subject to a material amount of Canadian tax. This is because the dividends received by Canco on the Holdco common shares and Subco preferred securities should generally be considered to have been paid out of non-taxable exempt surplus or pre-acquisition surplus of the underlying US entities (if such dividends are generated from active business activities in the US). The high dividend common share structure is not affected by recent Canadian tax proposals with respect to the elimination of certain "double-dip" structures.

In the US, Holdco's repurchase obligation in relation to the Subco's preferred securities is viewed as a financing transaction for US federal tax income purposes. Therefore, Subco's distributions on these preferred securities should be treated as deductible interest payments, which reduces or eliminates the US federal income tax payable. The US earnings stripping rules limit the permitted aggregate interest deduction to approximately 50% of the target's earnings before interest, taxes, depreciation and amortisation (EBITDA).

Currently, distributions paid by Subco to Canco on its preferred securities are subject to a 10% US withholding tax on interest payments. However, the fifth protocol to the Canada-US Income Tax Convention (Protocol), signed by the Canadian Finance Minister and US Treasury Secretary on 21 September 2007, eliminates withholding tax on cross-border interest payments between residents of Canada and residents of the US. For related parties, such as Holdco and Canco, the Protocol phases out withholding tax on cross-border interest payments over a three-year period: the withholding tax rate will be reduced to 7% during the first calendar year in which the Protocol becomes enacted (anticipated to be in 2008), reduced to 4% in the following calendar year, and eliminated completely in all subsequent years.

Dividends paid by Holdco to Canco continue to be subject to a 5% US withholding tax to the extent paid out of Holdco's earnings and profits (amounts in excess of earnings and profits are not subject to withholding tax).

Taxing investors

Distributions by Canco to its public investors consist of common share dividends from a Canadian public corporation. For many investors, such dividends are preferable on an after-tax basis to distributions from income funds and other similar investments. In particular, dividends paid to:

- Canadian taxable investors are eligible for the enhanced dividend tax credit. In this regard, Canco generally adopts a policy to designate all dividends as eligible dividends for Canadian tax purposes.

- US taxable investors are subject to a 15% Canadian withholding tax (which is generally creditable against the investor's US tax liability). In addition, these dividends should be qualified dividends for US federal income tax purposes (taxed at 15% in the US).

- US tax-exempt investors are not subject to Canadian withholding tax.

Unlike Canadian income funds, there are no tax limits restricting non-resident ownership of high dividend common shares.

THE FUTURE FOR CANADIAN IPOs

Over the past six years, numerous cross-border IPOs of income-oriented equity securities have been undertaken in Canada. The structures for these offerings have evolved from various types of trust to hybrid securities. The structure used in the Northstar IPO marks a departure from these earlier generations in that the public investors are issued conventional common shares. The high dividend common share structure appears to have been well received by the market. Its efficiency, flexibility and robustness enable it to adapt to numerous offering contexts and target businesses.

The increasing demand for income-generating equities and the reduction in the number of publicly traded income funds and other dividend paying public companies suggests that other US companies may follow the path forged by Northstar.

Sponsors and managers may wish to explore this unique way of selling all or part of a US-based business or portfolio of assets.

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