Business Boot Camp 2007

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Chairs

Kathryn L. Dykstra
Parlee McLaws LLP
Edmonton, Alberta

Al Stewart, CA
Daye & Company
Edmonton, Alberta

Panel

***Bill Daye*, FCA, TEP**
Daye & Company
Edmonton, Alberta

Kevin L. Lynch
Bennett Jones LLP
Edmonton, Alberta

Katherine A. MacRae
Parlee McLaws LLP
Edmonton, Alberta

Jason T. Marino
Bennett Jones LLP
Edmonton, Alberta

John W. McClure
Felesky Flynn LLP
Edmonton, Alberta

William (Bill) L. Mouris
Parlee McLaws LLP
Edmonton, Alberta

John D. Neilson, Q.C.
Barrister and Solicitor
Edmonton, Alberta

Jeffrey H. Selby
Parlee McLaws LLP
Calgary, Alberta

Karen Stanley
Corporate Paralegal/Supervisor
Parlee McLaws LLP
Edmonton, Alberta

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Capital Structures & Syndications

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For Presentation by: Jeffrey H. Selby
Parlee McLaws LLP
Calgary, Alberta

Capital Structures & Syndications

The essence of capitalism is the initial funding or capitalization of any venture. How capitalization occurs has been changing throughout time, but in the past 15-20 years significant pressure from a number of sources has caused a number of innovations to how we advise our clients on this issue. These sources may be said to include (without being exhaustive):

(a) legislative changes, particularly in banking regulation, Income Taxes, Securities, and Consumer Protection;

(b) institutional lending practices (such as the increasing importance of "up front" or processing and commitment fees) and attitudes (actual or perceived);

(c) lending rates (volatility);

(d) private demand for investment and limited returns on investment through traditional means; and,

(e) the extent of capital required.[1]

Traditionally (in the land developer's sense, particularly), a developer would use funds borrowed from an institutional lender "leveraging" as much as possible. The lender would hold its interest in the assets of the developer under mortgage, debenture (General Security Agreement) and/or similar security

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[1] capital requirements or the amount of investment required has been escalating in the development industry for several reasons. Not the least of these reasons are:

(a) decreasing capitalization rates: the value of development is based on the return. Demand for real estate (led particularly by Pension Funds) has lowered expectations of returns, dropping historic capitalization rates. The impact of each 1% drop in capitalization rate will increase the value of income producing property on an ever increasing basis; and,

(b) costs of development increase as demand for labour increase, and in Calgary a 40% increase in cost over the past 18 months would likely be considered as conservative.

and book its return through interest (and more recently "up front" or processing and commitment fees). Unfortunately, this type of capitalization through financing, tends to be somewhat difficult to obtain and subject to many costs and impediments to the developer. The institutional lenders, could react adversely to any significant leverage or economic change, and, accordingly, this could be considered a poor source of funding. Lenders depend upon their economic crystal ball and are restrained by internal guidelines and allocations, and may possibly not have a countrywide view of things (allegedly caused by the centralization of institutional management). For example, in the late 70's many traditional institutional mortgage lenders opted to get out of residential financing in favour of large commercial financings (believing that there were tremendous gains in divesting their mortgage administration departments) only to find out that, in harsher economic times commercial properties were more prone to be "let go" and losing large amounts of money on realization of the security. The obvious reaction? Go out and acquire a huge volume of residential mortgages (many of which were disposed of less than 5 years earlier) and stay away from any such large commercial ventures.[2]

Concurrently and increasingly, private investors have been interested in capitalizing development. This has been driven by the desire for greater returns, which were not found in other capital markets or from the newly rich investor (having "cashed out" on profits from oil and gas investment for example). These investors being accustomed to greater risk investment, see little difference in risk between the alternatives in other forms of investment and real estate, and a relatively good return on investment in real estate historically (particularly in Ontario, Alberta and B.C.). Unlike institutions, however, these investors often also want some "participation" in the ever - growing real estate market.

Like every product, to respond to this demand, a structure must be "concocted" to meet the interest of the capitalist investor. To this end we, as solicitors, have been charged with producing the product, which means we have to understand the structures and know the attendant issues that surround them.

Toward understanding any of the following concepts we must remember that the there can be very little difference between the terms of a loan (and the security granted for the loan) and a true equity position. It is quite common in small, tightly held corporations that the major shareholder(s) investment

[2] another lesson learned by these institutions was to diversify by limiting portfolio investments, and in periods of high capital demand, some lenders quickly met their annual lending limits, i.e. they had no more money to lend.