Canadian Structured Finance Newsletter

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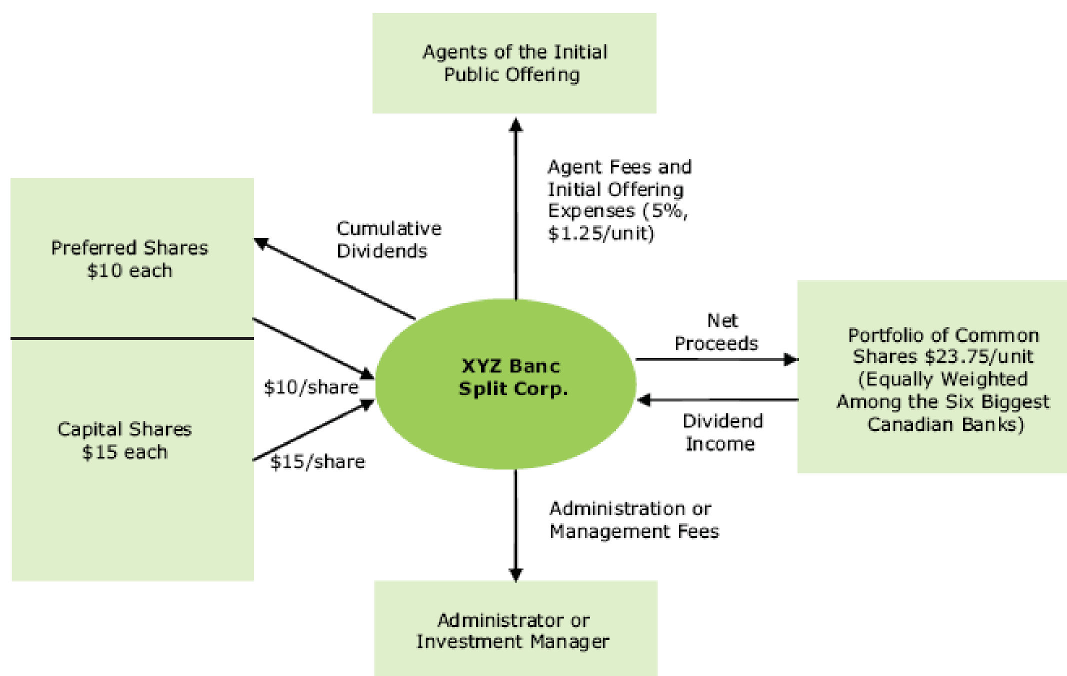
SPLIT SHARE STRUCTURES: THE BENEFIT OF SAVING FOR A RAINY DAY (OR YEAR!)

Split share companies and trusts[1] are created to redistribute the income and capital gains earned from common shares to separate groups of investors based on different levels of desired risk. The split share company obtains initial funding to purchase a portfolio of common shares by issuing an equal number of preferred shares and capital shares. The preferred shares rank in priority to the capital shares with respect to the payment of dividends and repayment of principal upon the termination date of the split share company. This priority ranking along with other structural enhancements allows DBRS to assign a rating to the preferred shares issued. The diagram below illustrates a typical split share structure.

Typical Split Share Structure



On August 27, 2009, DBRS published its updated methodology for rating Canadian split share companies and trusts. In the methodology, DBRS stresses that from the perspective of preferred shareholders, the stronger split share structures are those that distribute minimal income or capital gains to the capital shareholders until the termination date of the company.

A split share company is created as a long-term investment vehicle (normally with a predetermined lifespan of five to eight years). Any portfolio funds that are paid out to the capital shares prior to maturity lower the amount of asset coverage (or downside protection) available to the preferred shares. This means that if the portfolio suffers a subsequent large decline in value, there will be less protection before the preferred shareholders are in a first-dollar loss position. As a result, excessive capital share distributions increase the probability of negative rating action occurring at some point during the life of the split share company.

The benefit of maintaining capital gains in a split share portfolio is illustrated by examining historical price changes of common shares issued by Canadian banks, which have been the most frequent holdings of Canadian split share companies over the past decade. The chart below summarizes running one-year,

three-year, five-year and seven-year price data over the past twenty-five years, showing the average, minimum and 1st percentile[2] change in price. The returns below assume a portfolio equally weighted among Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and The Toronto-Dominion Bank.

Canadian Bank Capital Appreciation - 1985 to present

		1 yr	**3 yr**	**5 yr**	**7 yr**
Six bank portfolio	Average	11.7%	40.1%	78.8%	129.9%
(equally weighted)	1st percentile	-33.6%	-37.1%	-15.6%	7.9%
	Worst performance	-48.0%	-51.4%	-33.5%	-9.9%

On average, the price of an equally weighted portfolio of the six biggest Canadian banks has appreciated significantly over one-year, three-year, five-year and seven-year periods since 1985. Over short time periods, large declines have occurred, but the average and worst performance generally improves as the time period increases. Note that the worst five-year period (i.e., the worst possible price change if the portfolio was purchased for a five-year period at any point since 1985) was -33.5%. Over seven-year periods, the worst performance improves dramatically to -9.9%. Preferred shares rated by DBRS usually have initial protection levels of greater than 50%. These statistics demonstrate the robustness of preferred share protection for a typical split share company term of greater than five years.

It is important to note that past performance is not necessarily an indicator of future performance, but these statistics do demonstrate the low probability of a default on the preferred shares if capital share distributions are restricted to an amount that can be covered by excess dividend income. Assuming the portfolio is adequately diversified by the number of underlying entities, it would normally take a collapse of a particular industry (e.g., the dot-com bubble, U.S. and European banks in 2008) in which a portfolio is concentrated in order for a default on preferred shares to become likely. Furthermore, if such a collapse occurred with a long term to maturity remaining, a strong rebound over time in the underlying portfolio of equities could take the preferred shares out of a first-dollar loss position. This is a scenario that could potentially occur with certain split share companies that were exposed to global financial institutions over the past two years.

The negative impact from capital share distributions depends on the size of the regular and special distributions, as well as the threshold upon which distributions to the capital shares are suspended. In rating new split share transactions, DBRS may notch preferred share ratings lower based on these factors.

Over the past year, DBRS ratings assigned to preferred shares have experienced unprecedented volatility due to the equity market crash and subsequent rebound. Under such challenging market conditions, no distribution policy can save a split share company from experiencing some amount of ratings volatility. Nevertheless, if distributions to the capital shares are not excessive compared to company income, the generally conservative nature of split share structures and the low probability of large equity price declines over long periods of time should provide comfort to preferred shareholders.

This newsletter highlights some of the factors which are considered as part of DBRS's ratings analysis for preferred shares issued by split share companies. For a more complete list of rating factors, please refer to "Rating Canadian Split Share Companies and Trusts," published on August 27, 2009, and found under the Methodologies section of our website www.dbrs.com.

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[1] For the remainder of this newsletter, we will refer to split share companies. The same analysis and conclusions apply to split share trusts as well.

[2] The 1st percentile data refers to the point below which one percent of the total observations fall. This means that based on historical data of an equally weighted portfolio among the six biggest Canadian banks, the one-year change in price was lower than -33.6% one percent of the time.

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