



Those who cannot remember the past are condemned to repeat it. Santayana

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WINTER WARNING



Delusions of Grandeur

During the 1960's and 1970's, Bell Telephone (now Bell Canada) new debt issues were rated "AAA" in the corporate bond market and distributed through a syndicate of investment dealers according to their respective levels of placing power. A.E. Ames (taken over by Dominion Securities in 1981) was the lead underwriter for those issues, which enjoyed good liquidity / marketability in the secondary market because of the syndication method of distribution. Moreover, the responsible, prevailing borrower attitude towards credit ratings at that time was, not only to avoid a rating downgrade, (however small), but also, to strive for a rating upgrade, in order to lower the relative cost of capital in the future; for expansion, new plants, equipment etc.

During the 1980's, with the introduction of the "bought deal" concept, combined with the chartered bank takeover of Canada's largest investment dealers, liquidity in the secondary corporate bond market gradually deteriorated and it has never really recovered. I mention this background information as an eyewitness, having been Wood Gundy's (now CIBC Wood Gundy) head corporate bond trader and over-the-counter equity trader in Toronto from 1966 to 1974 and employed in the Canadian investment business for 49 years.

During those years in Toronto, I traded every type of corporate bond, including millions of dollars of Bell bonds, with institutional clients, retail investors and fellow investment dealers. I also covered the sinking fund accounts for our corporate borrowers, wherein, a fixed percentage of an issue had to be repurchased and retired by the issuer, during the life of the issue.

To illustrate how corporate attitudes and ethics have deteriorated over the years, one only need focus on the corporate bond market today, with specific reference to the recently aborted BCE leveraged buyout (LBO) Privatization Plan of Arrangement by a private equity consortium led by the Ontario Teachers' Private Capital, the private investment arm of the Ontario Teachers' Pension Plan. In June, 2007, when the announcement was made that the Teachers' consortium, which included U.S. based partners Providence Equity Partners Inc., Madison Dearborn Partners and Merrill Lynch Global Private Equity, would pay a cash price of \$42.75 (CAD) per share for BCE, this represented a premium of approximately 40% to the price where BCE shares were then trading. Indeed, the shares had languished in a narrow trading range between \$25 and \$34 for the previous 5 years. So, why did the Teachers not just sell its BCE holding, if it was unhappy with the stock's performance?

Any seasoned bond trader worth his salt could have told the Teachers that this LBO was doomed from the outset. The most formidable obstacle would be the sale of \$35 billion (CAD) of new BCE debt required to finance the deal; after outstanding Bell debt issues were downgraded by the rating agencies from A (Low) to BB (Low), basically, driving the long-term yields to double-digit levels. The most funds ever raised for an LBO with this rating was \$6.5 billion (U.S.), however, with very few institutional investors authorized to buy below investment grade corporates, my question was, who was going to buy the new bonds? Not surprisingly, several, high profile institutional Bell bondholders were so upset by the Teachers' proposal, that they issued a court challenge. On an unsolicited basis, I conveyed my opinion to the bondholder group that the Teachers' initiative was a clear breach of the existing trust indenture, as outlined in the relevant Bell prospectuses, and it required approval of the Trustee for the bondholders, in order to proceed. In any event, once the lawyers for both sides began grappling with the situation, the case took a few twists and turns through 3 levels of the court system, all the way to the Supreme Court of Canada, where the Teachers' lawyers were able to convince the Justices to rule in their favour.

In order to understand BCE's behavior, as the other major participant in this corporate soap opera, one must examine the composition of the 15-member BCE Board of Directors. In terms of their individual accomplishments in business over the decades, many have enviable, successful track records in their respective businesses. Basically, the board is comprised of 5 business executives, 3 lawyers, 2 bankers, 2 investment dealers / managers, 1 economist, 1 chartered accountant and 1 university professor. Indeed, several of these esteemed individuals have more letters of the alphabet behind their surnames, than in their surnames, which makes it all the more perplexing to understand the board's arrogant attitude toward this LBO proposition.

In the Governance Practices section of BCE's website, the company states "we want to remain a leader in corporate governance and ethical business conduct by maintaining best practices, transparency and accountability to our stakeholders. This includes a commitment to the highest standards of corporate governance, as BCE's board and management believe that good corporate governance practices tend to contribute to the creation and maintenance of shareholder value. On an ongoing basis, the Board reviews its structure, practices and composition, initiating changes to improve its effectiveness". If being a BCE board member means upholding the high ethical business standards mentioned above, then the current BCE Board of Directors has failed miserably. When a board of directors abrogates its corporate



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responsibility by willfully watching its company's credit rating sink to a level below investment grade (in BCE's case BB Low), in order that board members may personally profit from the sale of their common shares, this represents a classic situation of dereliction of duty. Similarly, when a board of directors breaches the trust indenture of a company bond issue (and whose own lawyers convince an ignorant Canadian court system to condone it), thereby, degrading the value and liquidity of existing bondholder portfolios, surely this represents an abrogation of board member fiduciary responsibility. BCE's high-powered board, particularly the 2 senior, experienced, career investment dealers / managers knew better, but rather, chose to become wolves of avarice; only to disappoint shareholders, bondholders and other stakeholders alike.

Earlier in this newsletter, I asked the question, so, why did the Teachers not just sell its BCE holding, if it was unhappy with the stock's performance? In the world of investment management, sometimes a corporate ego can experience a sudden spurt of growth, resulting in a corporate superiority complex. In short, I believe that the Teachers became a little too big for its breeches: as its website states "Outstanding Service Today ... Retirement Security Tomorrow." After all, did Teachers not have \$108.5 billion (CAD) in net assets and was it not the outright or part owner of many shopping centers across Canada, including, Sherway Gardens? Despite the ridiculous pronouncements from Michael Sabia (former CEO of BCE) in the summer of 2007, when he attempted to sell the idea to the public that the Teachers recognized "value and growth potential" in BCE stock even at \$42.75 (CAD) per share; the only possible way for the Teachers Consortium to have a hope of making money from that cost price, would be to break up the company and sell it off piecemeal. Indeed, the zeal and verve with which the Teachers relentlessly pursued the takeover, revealed the extent to which it believed that it was in the right and would be proven so. Of course, the December KPMG insolvency report finally decided the LBO's fate.

So, after wasting 18 months of time and millions of dollars on legal fees, both the BCE board of directors and the Teachers management have emerged from this experience with diminished reputations, as business ethics and corporate governance flew out the window. I will leave the hangover question of the \$1.2 billion (CAD) breakup fee to the jaundiced justice meted out by the Canadian court system. Perhaps now, the inventor of the talking machine and the man who gets my vote for the all-time greatest Canadian, Alexander Graham Bell (born in Scotland) can finally rest in peace.

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