

## Credit leases gain currency: Breakthrough financing well suited for public sector

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Stay tuned. That's the word from a number of corporate financiers -- plus a former federal finance minister -- who argue that credit leases can be a growth area in the financing of public sector projects.

"It makes less sense for some public sector entities to be in the real estate ownership business. They need to be focusing on their core business, which is delivering long term health care," said one investment banker.

Michael Wilson, the former federal finance minister, concurs.

Wilson, who is chairman of the Canadian Council for Public-Private Partnerships, believes that hospitals, for example, could raise a large amount of capital by selling off the land and buildings they own and then enter into a long term lease with the purchaser. The capital raised could be devoted to health care.

Investment bankers have been attracted to the idea of credit leases in light of the recent news that MaRS Development Trust -- a bankruptcy remote limited and special purpose entity -- plans to raise \$100-million to build and develop a research facility adjacent to the hospital complex in downtown Toronto. (The issue was priced last Friday.)

Once the facility -- MaRS stands for Medical and Research Sciences -- has been developed it will be leased to the University Health Network. That lease runs for 30 years and UHN has signed a lease known as a triple-net lease. That term means UHN -- the tenant -- has "no ability to abate rent or cancel the lease."

The breakthrough on the financing -- which should be completed by the end of the month -- is that the issuer was able to use the AA- credit rating of the University Health Network.

That entity raised \$281-million four years back. And MaRS could use that rating because of the strength of its lease with UHN. That lease calls for UHN to pay a mix of principal and interest starting on Aug. 1, 2005.

"MaRS is part of the evolution of structured finance," said one banker whose firm isn't involved in the MaRS deal.

"The credit lease technology can be used in a variety of situations, not just health care. [In theory] it can be used any time that a rated tenant occupies the vast majority of a building," he declares.

This banker argues the concept started a few years back with a \$400-million financing for the CBC Broadcast Centre. On that deal, the issuer used the credit rating of the federal government to sell the bonds. For certain investors there was another benefit: They didn't have to allocate capital against the bonds.

"But you don't have to have a government or government related entity involved to be able to do deals. There have been a number of private deals," said the banker, who argues a credit lease can secure "advance rates" which are comparable with what the issuer could secure from issuing a first mortgage bond. (Advance rates refer to the percentage of the value of a building that a lender will advance or finance.)

"If nothing else, credit lease technology will get you into the capital markets and at better spreads than you can get in the first mortgage market," said one banker. And that happens because "you are dealing with a rated counterparty."

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So what's involved in structuring a credit lease where the issuer uses the credit rating of the tenant to access the market on more favourable terms than it could do itself?

In short, lots of analysis is required. For instance:

- The structure of the lease.

A central part of the analysis has to focus on whether the lease is a real flow-through. "To the extent that there are outs in the lease," then it may not work, argued one banker, who has worked on deals where the term "hell or high water" has been used.

In essence, a hell or high water lease means that no matter what, the tenant is on the hook to make the

required payments. In the case of MaRS Development, the term triple-net is used.

As S&P said in its rating report: "The lease is a triple-net lease, and UHN is responsible for all costs relating to the property."

- The number of ratings accorded to the tenant.

One banker makes the case a rating from at least one Canadian and one U.S. rating agency would be required.

- The percentage of the building occupied by the lead tenant.

In an ideal situation, the lead tenant would occupy all the building. If that situation doesn't prevail, then a favourable situation would be for the lead tenant to occupy the bulk of the building.

Even if the lead rated tenant occupied a minority of the building, credit leases can still be done.

For that to happen, the lead rated tenant may enter into a "head lease, and subleases the rest of the space in the building," said one banker, noting that credit lease deals have been done for the head office of Bell Mobility, for the head office of TransCanada PipeLines and for Royal Bank of Canada's data centres. (In that case the issuer was Data Centres Trust.)

- Whether there is a mortgage on the building.

If one has been taken out by the special purpose vehicle, "the rating agencies take additional comfort," said one banker. "The mortgage gives the special purpose company the right, in certain circumstances, to step in and seize the building."