

Some recent innovative issues: Quadravest offers twist on split-share -- one issuer

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Innovation is alive and well in the new-issue business.

In the same week BMO Nesbitt Burns filed for a patent for a wrinkle it developed in an issue by Faircourt Asset Management, Toronto-based money manager Quadravest Capital Management announced plans to offer a product that features "a first of its kind" in Canada.

In BMO Nesbitt's case the innovation was the discovery of a way to deem distributions on a note as return of capital -- not regular income. With Quadravest, the breakthrough occurred in the structure of Prime Rate Plus Corp. where would-be-retail investors will be offered the choice of two floating-rate securities in a split-share structure. Before this deal, all split-share offerings featured at least two securities with a fixed rate of return.

In the issue by Prime Rate Plus Corp. investors are being offered the following:

- A preferred share expected to pay a monthly dividend at the annual rate of prime plus 75 basis points. Currently the prime rate is 4.25%. The issuer plans to pay a minimum rate of 5% and a maximum rate of 7% The preferred share has a term of 7 1/2 years;
- A Class A share, that also runs for 7 1/2 years, that will pay out an annual rate of prime plus 2%. The issuer has set a minimum rate of 5% and a maximum rate of 10%. At maturity, holders of the Class A shares will also receive a share of the growth after the preferred shareholders have been paid out.

The issuer will use the proceeds from the issue to invest in the common shares of the Big Six Canadian banks (20% can be invested in the assets in other financial companies).

Accordingly, the manager will enjoy all the perks that come with owning bank shares: capital gains and dividends. In the past year, the banks have generated a total return between 11.26% (Toronto-Dominion Bank) and 24.09% (National Bank), while all banks have hiked their dividend, paying at least 3%.

But the manager won't be adopting a "buy and hold"

strategy: It will write covered call options on all or some of the holdings in the portfolio. Such an approach means the manager will sell call options on stocks it owns and collect the option premium. There is one problem though, the manager risks losing ownership of the stocks on which it has sold call options.

However, under the terms of the offering the manager has lots of flexibility. For instance, it can buy cash covered put options (which have the effect of closing out call options already written) or it can write cash covered put options or buy puts. Covered call writing is a specialty of Quadravest which manages \$2-billion of assets in nine public mutual fund companies and four public mutual fund trusts.

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A few factors seem to be behind the decision to offer this product. One, it is different given that in the past investors have been offered fixed return securities.

Two, the product hopes to capture some of the likely growth in bank shares, particularly in a rising interest rate environment. Such an environment might generate additional price volatility -- a key ingredient in the pricing of options and the resulting income. In the past five years, according to the prospectus the 30-day volatility of the six bank stocks has varied from a low of 9.82% to a high of 42.18%.

"The manager believes this sector offers an attractive dividend yield, continued earnings growth, and has a strong history of capital appreciation," the prospectus said.

So why the minimum and maximum yield? Investors presumably want to know what they would receive in the worst case scenario, while the manager wants to know what it has to produce, again, in the worst case scenario. (The excess returns above the two stipulated maximums will flow to holders of the Class A shares.)

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The manager isn't doing it for nothing. Fees come in three forms: 20 basis points that's paid to the manager (Quadravest Inc.); an extra 65 basis points paid to

Quadravest; and a 50 basis points fee that is paid to the broker whose client buys the Class A shares. (No trailer fees are paid on the preferred shares.) As is the norm with Quadravest's offerings, the manager is entitled to a performance fee once a certain threshold has been reached.

Of course the underwriters aren't doing it for nothing either: they will receive a 3% fee for selling the preferred share and 6% for selling the Class A share. In all, the new issues fees amount to 4.8% of a \$25 unit with \$10 attaching to the preferred share and \$15 attaching to the Class A share.