Report to: General Committee – Finance & Admin.   Date Report Authored: Nov 14, 2016

SUBJECT: PowerStream Merger Update
PREPARED BY: Mark Visser, Manager, Financial Strategy & Investments

RECOMMENDATION:

1) THAT the report dated November 14, 2016 entitled "PowerStream Merger Update" be received;

2) THAT the City of Markham guarantee a Markham Enterprises Corporation loan for up to $47.3M to finance the equity contribution required for the closing of the MergeCo transaction;

3) THAT the Mayor and Clerk be authorized execute the required lending documents;

4) AND THAT staff be authorized and directed to do all things necessary to give effect to this resolution.

PURPOSE:
The purpose of this report is to provide an update on the PowerStream Merger and obtain Council approval to guarantee a loan to Markham Enterprises Corporation ("MEC") to fund MEC's equity contribution towards the merger.

BACKGROUND:
In November, 2015, Markham Council approved "the merger of PowerStream, Horizon and Enersource" as well as "the purchase of Hydro One Brampton Networks Inc. ("HOBNI")…(with) Horizon, Enersource and PowerStream as purchaser."

The entire transaction is expected to be finalized by the end of 2016, or early in 2017, and will result in a new company (currently titled "MergeCo").

It was resolved that the completion of the merger and the purchase of HOBNI be conditional on the following:

a. The terms of the Transaction being substantially as set out in the Merger Participation Agreement dated October 9, 2015, the Share Purchase Agreement dated October 8, 2015, the Unanimous Shareholders' Agreement dated October 9, 2015 and the draft PowerStream Solar Business Services and Indemnity Agreement dated October 5, 2015;

b. Amendments to the agreements in a form satisfactory to the Chief Administrative Officer as follows:

i. Unanimous shareholder approval required for mergers and acquisitions until 75% of the targeted synergy savings have been achieved;

ii. Extension of the term of the Shareholder promissory notes for 20 years from 2016 with right to extend for a further 20 years, at the interest rate approved by the Ontario Energy Board;
iii. Improvements to section 8.3 of the Unanimous Shareholders' Agreement to achieve clarity on the tax mitigation strategies for first and subsequent sales of shares in MergeCo that trigger departure and transfer taxes;

c. That a financial back stop be negotiated with one or more of the municipal partners participating in this Transaction, on terms satisfactory to the Chief Administrative Officer;

d. That the equity investment required to complete the merger and acquisition be no greater than $47.3M;

e. Approval of the Strategic Plan by the Board of Directors of Markham Enterprises Corporation ("MEC").

Furthermore, City staff were directed to work with MEC staff and other shareholders, to reduce the equity contribution required for the Transaction to occur, including but not limited to a formal, municipally led sale of 10% of MEC's shareholding in PowerStream with consideration for MergeCo's value, and that in the event that the sale was not successful, staff to report back with alternate funding options.

Of the above noted conditions, all have been satisfied with the exception of the approval of the Strategic Plan by the Board of Directors of MEC and the conditions associated with the funding of the equity injection.

OPTIONS/DISCUSSION:

<u>Strategic Plan</u>
MergeCo has completed a draft Strategic Plan that is currently being reviewed by each Shareholder. It is expected that the Strategic Plan will be finalized and approved by year end.

<u>Funding</u>
MEC's funding obligation on closing is approximately $43-47.3M related to the purchase of HOBNI.

In November, 2015, Council had directed City staff to "work with MEC staff and other shareholders, to reduce the equity contribution required for the Transaction to occur, including but not limited to a formal, municipally led sale of 10% of MEC"s shareholding in PowerStream with consideration for MergeCo's value" and "that a financial back stop be negotiated with one or more of the municipal partners participating in this Transaction" in order to ensure a minimum sale price.

On February 22nd and 29th, 2016, staff presented various options to the MEC Board on how to fund MEC's required equity injection for the MergeCo transaction. The MEC Board of

Directors resolved to no longer pursue selling 10% of PowerStream and to use debt or a combination of debt and equity to finance the closing of the MergeCo transaction. As a result of this decision, a financial backstop to ensure a minimum selling price was no longer required as a condition of closing.

The MEC Board, and Markham Council, previously approved a $17.1M equity injection into PowerStream for core business operations in 2013. Approximately $12.0M has already been transferred to PowerStream, leaving $5.1M remaining that could be used to partially fund the required equity injection. In addition, there are funds retained within MEC that could be used for the equity injection (less than $10M)

Regardless of whether the aforementioned funding sources are utilized, a source for the majority of the funding still needs to be determined. Two options are 1) fund the balance of the equity injection though City sources (i.e., the City's Life Cycle Replacement and Capital Reserve Fund); or 2) borrow some or all of the funds required for the equity injection (the estimated minimum borrowing amount would be $35M).

<u>1. City's Life Cycle Replacement and Capital Reserve Fund ("Life Cycle Reserve")</u>
The first option is to fund the required equity contribution through City Reserves, most appropriately, the City's Life Cycle Reserve as a) it has the largest balance, and b) PowerStream dividends are allocated to that Reserve.

As at September 30, the City's Life Cycle Reserve had a balance of $58.3M, comprised of $28.8M of cash (and other liquid investments) and $29.5M of receivables related to long term non-marketable investments/assets. Therefore, it is not recommended to use the Lifecycle Reserve as a funding source as it would leave the Reserve with a negative cash balance.

<u>2. Borrowing</u>
The second option is for MEC to borrow the necessary funds. The indicative rates provided by major Canadian financial institutions are below 2.5% for 10 year loans and less than 2.0% for 5 year loans, assuming the City would provide a guarantee. Preliminary quotes from one Schedule I bank indicate an approximate 200 basis point increase in lending rates if the City does not provide a guarantee.

Based on cashflow forecasts, $45-50M of additional dividends are expected to be paid by MergeCo to MEC in the first 10 years. These additional dividends can be used to service the principal and interest payments.

Borrowing is the preferred option for the following reasons:
1) Interest rates are at historic lows; and
2) There is a projected revenue stream (incremental dividends) that can service the principal and interest payments within 10 years

The PowerStream/MergeCo dividends are transferred to the City's Lifecycle Reserve on an annual basis to ensure there is a funding strategy for the replacement and rehabilitation of City assets for the next 25 years. Overall, the incremental MergeCo dividends (less the principal and interest payments associated with the equity injection) are expected to have a favourable impact to the LifeCycle Reserve.

FINANCIAL CONSIDERATIONS:
The current funding strategy is as follows:

1) $35.0M of borrowing
2) $5.1M from previously approved equity injection from City
3) $2.9M-7.2M from MEC (depending on closing adjustment amount)

This strategy provides a cost effective method of raising the funds required for the equity injection as well as leveraging some of the cash on hand in MEC, while still retaining some funds in MEC to finance future MergeCo or MDEI initiatives.

However, depending upon the interest rate environment at the time the loans are to be executed, it may be more attractive to borrow up to the full $47.3M and to determine the appropriate borrowing duration to best match principal and interest payments with the projected additional dividends. The MEC Board has delegated the authority to MEC staff to borrow up to the full $47.3M in order to potentially leverage historically low interest rates and maintain the opportunity to fund other initiatives.

FINANCIAL CONSIDERATIONS AND TEMPLATE:
The indicative rate differential between the City providing a guarantee is approximately 200 basis points. The financial savings associated with the City providing a guarantee, assuming a 200 basis point reduction for a $35.0 to $47.3M loan with a ten year term, is approximately $4.1 to 5.7M.

MEC staff will structure the loans to best match the principal and interest payments with the expected incremental dividends from MergeCo.

11/7/2016

X Joel Lustig

Joel Lustig
Treasurer

07/11/2016

X Trinela Cane

Trinela Cane
Commissioner, Corporate Services

ATTACHMENTS: None