

OVERVIEW OF FINANCING STRUCTURES

IN TRANSFER PRICING ANALYSIS

DRAFT

Table of Contents

List of Abbreviations	4
Section 1 Introduction	5
Section 2 Acquisition	6
2.1 Transaction structure	6
2.2 General comments.....	7
Section 3 Investment	8
3.1 Transaction structure	8
3.1.1 Private equity.....	8
3.1.2 Renewable energy.....	9
3.1.3 REITs	11
3.2 Debt structure.....	12
3.3 Terminology.....	13
3.3.1 Renewable energy.....	13
3.4 Comparing acquisition and investment financing structures.....	14
Section 4 Loan	17
4.1 Transaction structure	17
4.1.1 New loan	17
4.1.2 Loan refinancing / amendment.....	17
4.1.3 Loan transfer	18
4.1.4 Intercompany acquisition / restructuring.....	19
Section 5 Loss Utilization	21
5.1 Transaction structure	21
5.2 Project scope.....	22
Section 6 Leveraged Distribution	23
6.1 Transaction structure	23
Appendix A Tax Structures	24
A.1 Overview	24
A.2 Change in US regulations	24
A.3 Tax considerations	24
A.4 New US-Canada tax structures.....	25
Appendix B Low Rate Finco Structure	26
B.1 Transaction structure	26

Appendix C	Hybrid Debt Structure	27
	C.1 Transaction structure	27
Appendix D	Repo Debt Structure	29
	D.1 Transaction structure	29
	D.1.1 Example A (new 'double dip' Repo structure).....	29
	D.1.2 Example B	30
	D.1.3 Example C.....	31
Appendix E	Luxemburg MRPS Structure.....	33
Appendix F	Financial Models	34
	F.1 Acquisition model	34
	F.2 Investment cash flow model.....	36
	6.1.1 Private equity.....	37
	6.1.2 Renewable energy.....	38
	6.1.3 REITs	39
	F.3 Other models.....	39
	F.3.1 Loss utilization	39
	F.3.2 Leveraged distribution	40

DRAFT

List of Abbreviations

The following abbreviations and symbols are used in this guide:

Bloomberg	Bloomberg Professional Service
Capex	Capital expenditure
CFADS	Cash flows available for debt service
CFF	Cash flows from financing activities
CFO	Cash flows from operating activities
CRA	Credit rating analysis
D&A	Depreciation and amortization
DCA	Debt capacity assessment
DRB	Discount benchmarking analysis
FCF	Free cash flow
FFO	Funds from operations
FMV	Fair market value
FTA	Forward Transfer Agreement
GP	General partnership
IRB	Interest benchmarking analysis
ITC	Investment tax credit
LP	Limited partnership
M&A	Bloomberg's Merger & Acquisitions database
MRM	Moody's Rating Methodology
NPV	Net present valuation
OECD Guidelines	"BEPS Actions 8 – 10, Financial Transactions", a draft published in July – September 2018 for the purposes of public discussion
OEM	Original equipment manufacturers
PPA	Purchase power agreement

Section 1 Introduction

A disclaimer: my expertise in tax analysis is quite limited and these notes are made based on my experience as a transfer pricing practitioner. Therefore, certain interpretations of the transaction structure rationale from the tax perspective may be inaccurate or even incorrect. In a transfer pricing documentation our task is to provide as accurate description of the transaction and related facts as possible but the documentation does not discuss any tax implications of the transaction structure.

Financing transactions are implemented for multiple various business purposes including acquisition financing, investments, refinancing of existing debt, and other. Each business purpose and structure of a financing transaction has specific implications for the transfer pricing analysis that is performed to document the transaction. The objective of this guide is to provide a general overview of different transaction types depending on the business purpose of the transaction and its structure.

It can be observed that there are certain similarities between different types of transactions. We group broadly the transactions into the following pair: (i) acquisition and investment transactions; (ii) loan transactions issued for working capital or other needs of a company (which also includes refinancing and loan transfer transactions); and (iii) loss utilization and leveraged distribution transactions. While there is lots of similarity between the transactions in each pair, there are also some important differences which are discussed in the sections below.

The objective of this guide is to

- ▶ Present a schematic diagram and a description of the financing structure including the description of the facts relevant for the structure;¹
- ▶ Present at a high-level description of the structure impact on the financial statements of the borrowing entity.

¹ The description of the financing structure is typically included in the summary of facts section of a transfer pricing report. In addition, the summary of facts section also includes the description of the covered entities and a description of the covered transaction.

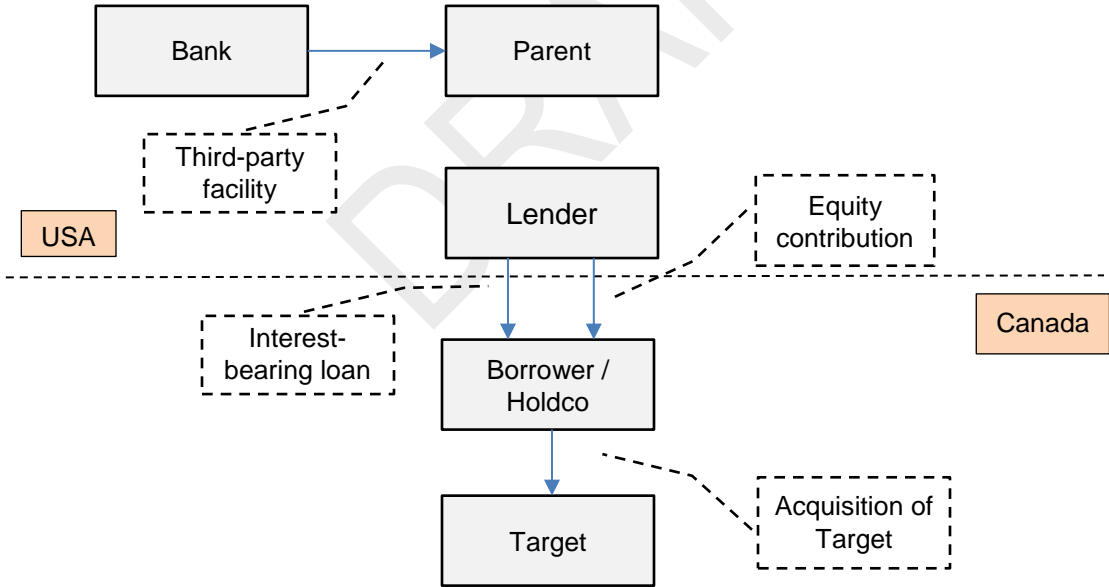
Section 2 Acquisition

Acquisition is one of the most standard transactions when a transfer pricing analysis is required to assess the respective financing structure. Potentially multiple structure scenarios are possible when a target is acquired by a company. Two such scenarios that will have a different impact on the transfer pricing analysis are the following:

- ▶ **Case A:** a target is acquired by a subsidiary that already has existing operations. The new target is consolidated with the existing operations of the subsidiary. The borrower is assessed in this case based on both the performance of the borrower and the target as well as on the financing structure that is out in place to acquire the target;
- ▶ **Case B:** a new holding company is created and capitalized for the purpose of acquiring the target. The target is the only material asset of the newly created company. The borrower is assessed in this case based on the target performance and takes into account the financing structure put in place to acquire the target.

2.1 Transaction structure

A typical structure of a loss utilization transaction is illustrated in the diagram below.



- ▶ On date XXX, the Parent announced its plans to acquire the Target for an approximate purchase price of \$XXX million (**Target Acquisition**);
- ▶ As part of Target Acquisition, a new holding company (Holdco) was created;
- ▶ The Parent group entered into a Facility agreement with the Bank to raise the funds for acquiring the Target;

- ▶ The proceeds from the Facility were used to capitalize Holdco through a combination of \$XXX million of equity contribution and \$XXX million intercompany term loan made by the Lender to the Borrower;²
- ▶ The proceeds received by the Borrower were used to finance the Target acquisition.

Some of the steps described above may be optional. For example, the Parent can use internal funds or an existing loan facility with the Bank to finance the acquisition.

2.2 General comments

In most cases both the debt capacity assessment (**DCA**) and interest rate benchmarking (**IRB**) analysis are required for the transfer pricing documentation of the transaction. The following elements of DCA and IRB analysis may be specific for the acquisition transaction.

1. The business purpose of the loan is an important factor in the DCA analysis that should be taken into account to ensure comparability of the Borrower and the companies included in the DCA sample. When companies make acquisitions, there is typically a significant impact on their debt capacity ratios. In practice we identify companies that made acquisitions in the past few years by following the steps below:
 - ▶ Search for companies with ratio of total assets to two-year average total assets greater than a certain threshold value (selected by default at 1.5). If there is more than 50% increase in a company's total assets over a one-year period, then most likely the change in the total assets is attributable to a new significant acquisition;
 - ▶ Review through the Bloomberg Merger & Acquisitions (M&A) database the acquisitions made by the identified companies and match the acquisition years to the years with material change in the company assets;
 - ▶ Review the impact of the acquisition on the DCA ratios.
2. If the Facility with the Bank is issued as part of the Target acquisition, the Facility can be viewed as a direct comparable transaction for the intercompany loan. The interest rate on the Facility, adjusted for any material differences with the loan, can be used as a reference value for the arm's length interest rate estimated for the intercompany loan.

² In some cases, the Borrower may also obtain the funds directly through the 3d-party Facility advances. The financial metrics of the Borrower in this case must be adjusted for both the change in the 3d-party and intercompany debt balances. In addition, the Borrower may use cash to finance the acquisition of the Target.

Section 3 Investment

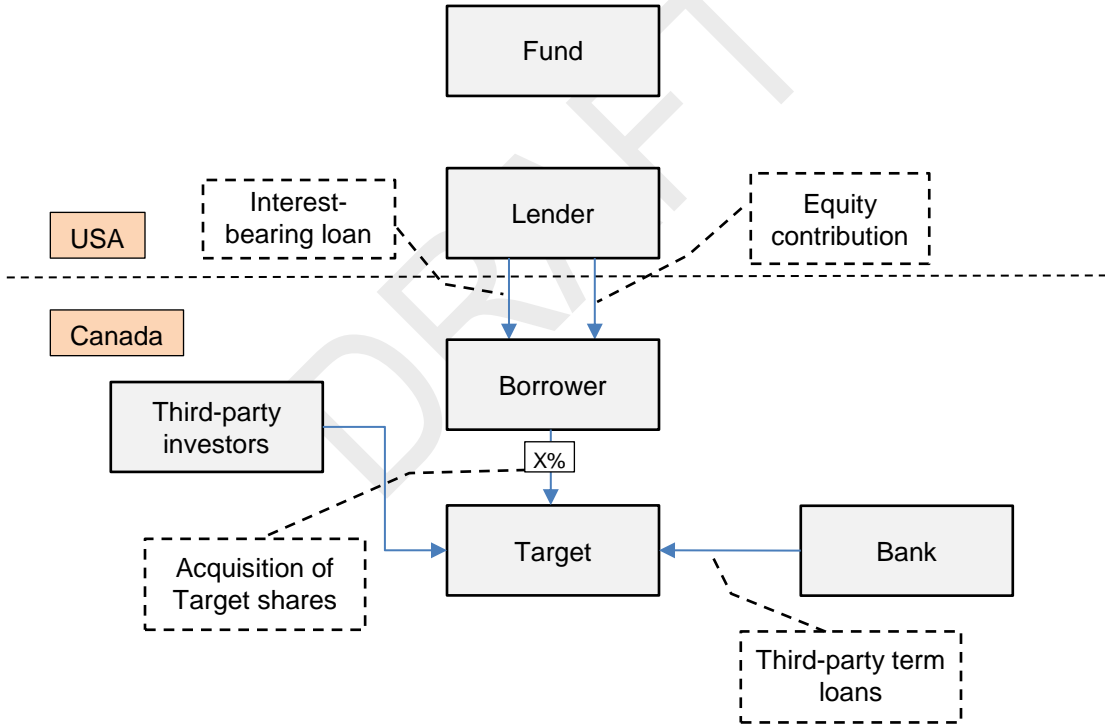
An investment structure is similar to the acquisition but there are typically some important conceptual differences. Investment structures are typically observed in REITs or renewable energy industries, when a REIT acquires new property or a pension or investment fund acquires a new renewable project.

3.1 Transaction structure

We present three different examples of financing structures: (i) private equity investment by an investment / pension fund; (ii) investment into a renewable energy project; and (iii) investment by a REITs company into new properties acquisition.

3.1.1 Private equity

Private equity investment represents a general type of investment transaction. In the transaction a fund acquires shares of an existing company. The structure is illustrated in the diagram below.

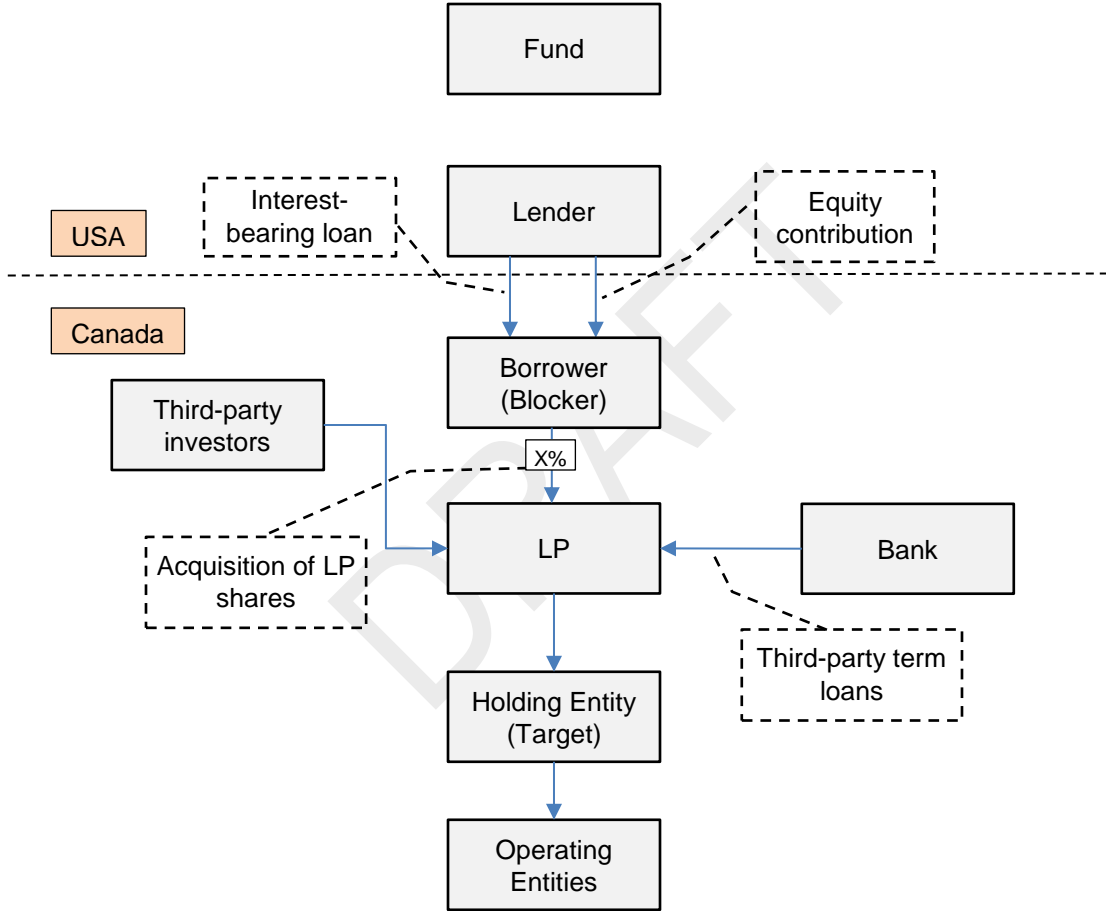


- ▶ In XXX, the Fund acquired a x.x% share stake in the Target for a total price of US\$XXX million. [Description of the target]. Remaining shareholders include [description of third-party investors];
- ▶ As part of Target acquisition, the Fund formed a new holding company, Borrower, and made a US\$ XXX capital contribution to the Borrower for the purpose of acquiring the shares of the Target.
- ▶ The remaining acquisition price was paid by the Borrower using the proceeds from the intercompany debt financing. The debt financing was in the form of a US\$ XXX million loan provided to the Borrower by the Lender.

In the investment structure, the Target effectively operates as a stand-alone entity. It often has shareholders other than the Borrower (in some cases the borrower may be a minority shareholder) and receives directly debt financing from third-party banks (which are not guaranteed by the Fund).

In some cases, the Borrower may have multiple private equity investments in different industry sectors and the Borrower acts effectively as a holding company. The credit rating and debt capacity analysis in this case is performed based on the rating methodology search for comparable entities which are classified as holding companies.

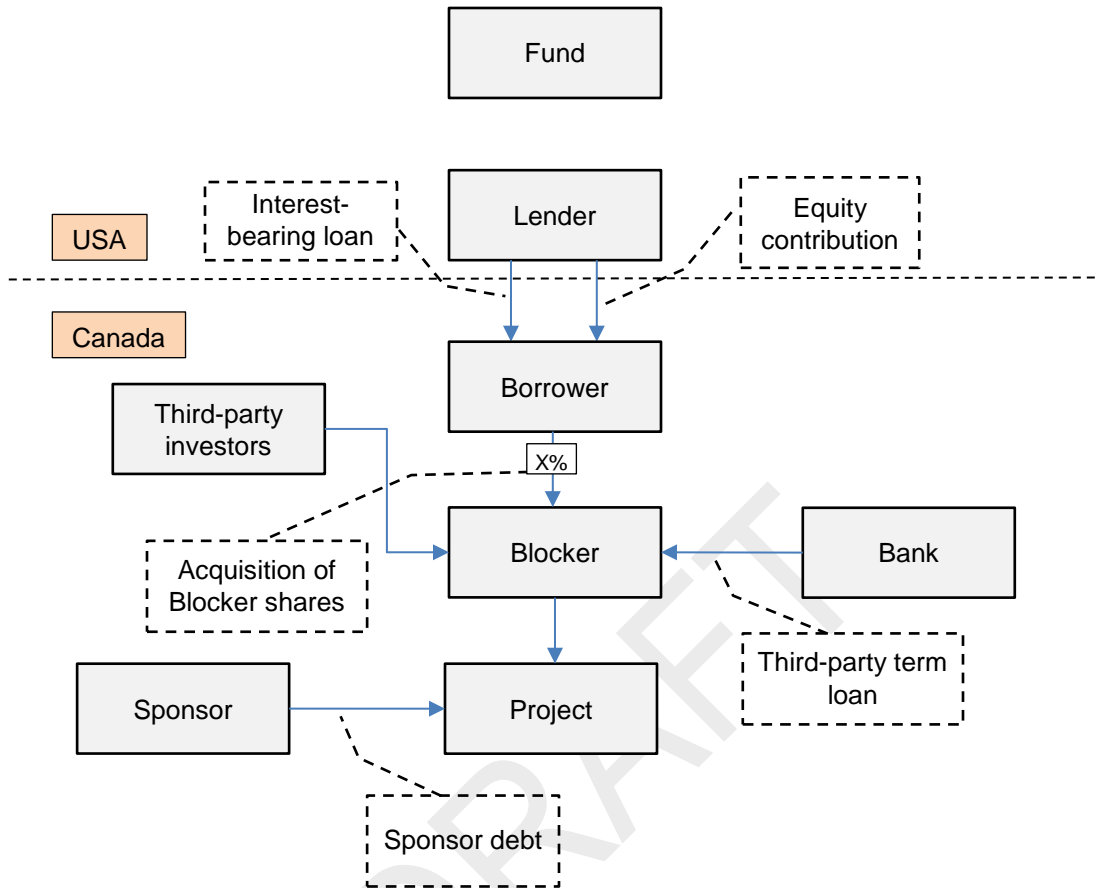
The structure above assumes that the Fund acquires 100% of the Target. Alternatively, the Target can be acquired by multiple investors in which case the structure looks as follows.



Under the structure, multiple investors form an LP which acquires 100% of the Target shares. Target is a holding company which owns 100% of the operating entities.

3.1.2 Renewable energy

A typical structure of an investment in a renewable project is illustrated in the diagram below.



► [Description of the Project]:

- X.X% of off-takers³ have A- to AAA credit rating and 15% have BBB- to BBB+ credit rating [provide the list of largest off-takers if available];
- Proven technology from leading original equipment manufacturers (**OEMs**) [Project Sponsor description];
- Portfolio: X windfarms; 1,268 turbines and X solar panel farms.
- In XXX, the Sponsor formed a new Blocker entity with the purpose of selling the Project to the investors. The total Project sale price of US\$XXX million was financed through the issue of USXXX million third-party debt to the Bank and equity contributions from the investors including equity contribution from the Borrower.⁴
- As of the project sale date, the Project had \$XXX million of outstanding debt financing provided by Sponsor at the project development stage. The debt bears a fixed interest rate of x.x% and is fully amortized in fiscal year FY20xx.
- The Sponsor continued to operate and manage the project after the project sale.

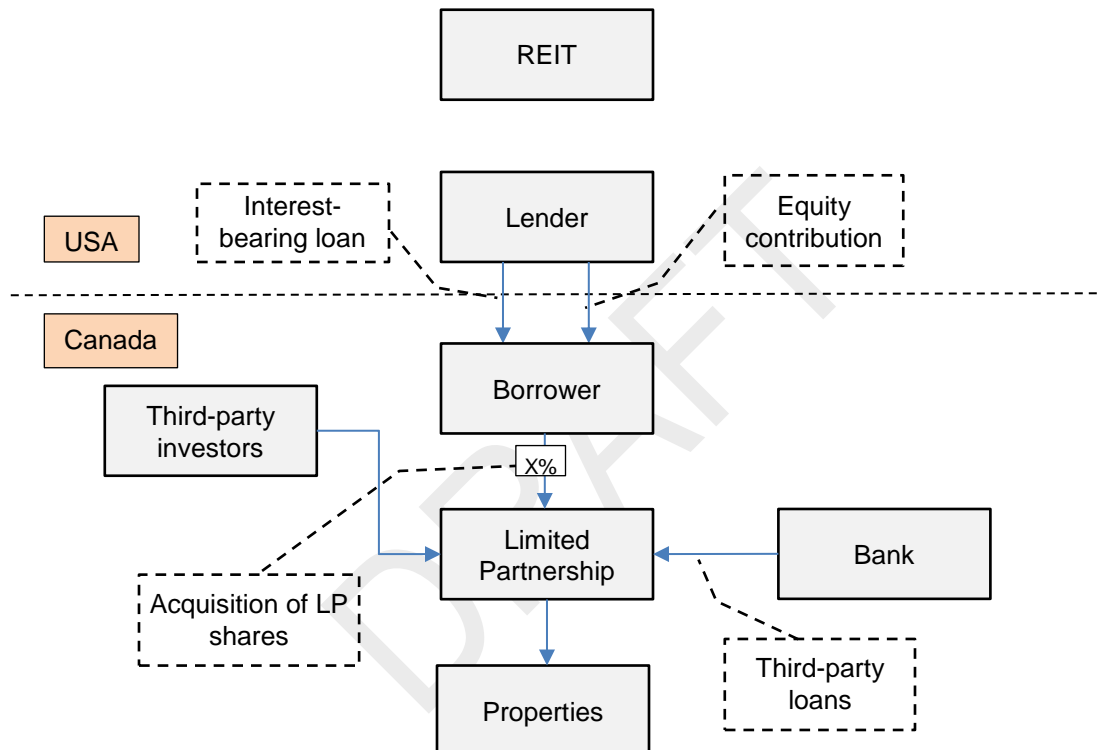
³ An offtake agreement entered between a producer and a buyer to buy/sell a certain amount of the future production. It is generally negotiated long before the construction of a facility to guarantee a market for the facility's future production and improve chances of getting financing for the installation concerned

⁴ In many cases, 3d-party investors obtain tax equity in return for the provided financing. After a certain period of time (typically 5-7 years), the Borrower has an option to buy the tax equity from the d-party investors.

- ▶ The Fund acquired a x.x% share stake in the Project for a total price of US\$XXX million;
- ▶ As part of Project acquisition, the Fund formed a new holding company, the Borrower. The acquisition price was paid by the Borrower using the proceeds from the US\$XXX million equity contribution from the Fund and US\$XXX million intercompany debt financing provided to the Borrower by the Lender.

3.1.3 REITs

A typical structure of an investment by a REITs company in the acquisition of new properties is illustrated in the diagram below.



- ▶ Borrower was formed in XXX for the purpose of acquiring X% ownership in the Properties;
- ▶ As part of Acquisition, a new LP was formed. LP is the only material asset of the Borrower. Therefore, for the purpose of this Report the Borrower was considered as an entity with Canadian risk;
- ▶ The acquisition of the Properties was financed through a combination of the equity contribution and the issuance of new third-party and intercompany debt. The relevant third-party and intercompany debt transactions are summarized below.
 - ▶ As part of the Properties Acquisition, the following third-party debt transactions were issued between the LP and the Bank: [list third-party loans];
 - ▶ As part of the Properties Acquisition, on XXX the Borrower signed the intercompany agreement (Note Agreement) with the Lender, which included the provision of the promissory note.

The investment structure is similar to the renewable project investment structure. The blocker entity is represented in this case by a limited partnership and the renewable energy project is represented by residential or commercial properties.

In some cases, the Borrower may be incorporated in the same tax jurisdiction as the Lender (US in the example above) but it will still be considered as a company with Canadian risk and therefore transfer pricing analysis will be required.

3.2 Debt structure

Investment in private equity is similar to acquisition and typically has a similar debt structure. A single term loan is issued for the acquisition purpose.

Investment in REITs or renewable energy project are often highly-leveraged structures, which is consistent with the patterns observed in the market. Due to high-leverage, the debt is often tranching into multiple issuances with different ranking. The purpose of tranching is to manage the risk of reassessment and recharacterization of debt into equity. Tranching provides a higher protection of the debt issuances with higher ranking against debt recharacterization. For example, if debt is issued in two tranches, the terms that describe the loan ranking can be specified as follows:

1. Loan A is subordinated to any senior third-party obligation of the borrower;
2. Loan B is subordinated to Loan A and to any senior third-party obligation of the borrower;

In the case of renewable project investments, the intercompany debt is typically issued not only for the acquisition purpose, but also for the purpose of financing the project's capital expenditures. As a result, two loans are typically issued. The two loans have different format which depends on the loan business purpose.

1. A term loan is issued for the purpose of acquiring the renewable energy project. The term of loan is either matched to the expected life of the project or the project disposition (sale) date;
2. A revolving loan facility is issued to finance the project capital expenditures. The revolving facility format is required to ensure flexibility to draw and repay the funds as needed. The term of the revolving facility is matched to the expected duration of the required capital expenditure funding. Pricing of the revolving facility requires to estimate and include a commitment fee in the revolver agreement. The commitment fee is applied to the undrawn facility balances.

Uncertainty in the project cash flows often requires including a pay-in-kind (PIK) provision in the loan agreement. The PIK provision allows to defer interest payments whenever there is an unexpected shortage in cash. In the presence of a PIK provisions, a loan becomes a hybrid debt which has both the features a debt and equity. Therefore, PIK provision creates a transfer pricing risk of debt recharacterization and should be recommended only if necessary. To mitigate the risk, the PIK term can be described in the loan agreement as a conditional PIK which is applied only if the project cash flow is not sufficient to pay the interest expense. The PIK provisional can not be used otherwise at the borrower's discretion.

PIK provision creates an additional risk exposure for the lender and is priced either through the credit rating adjustment or by specifying a PIK interest which is set at a premium compared to the loan cash interest.

3.3 Terminology

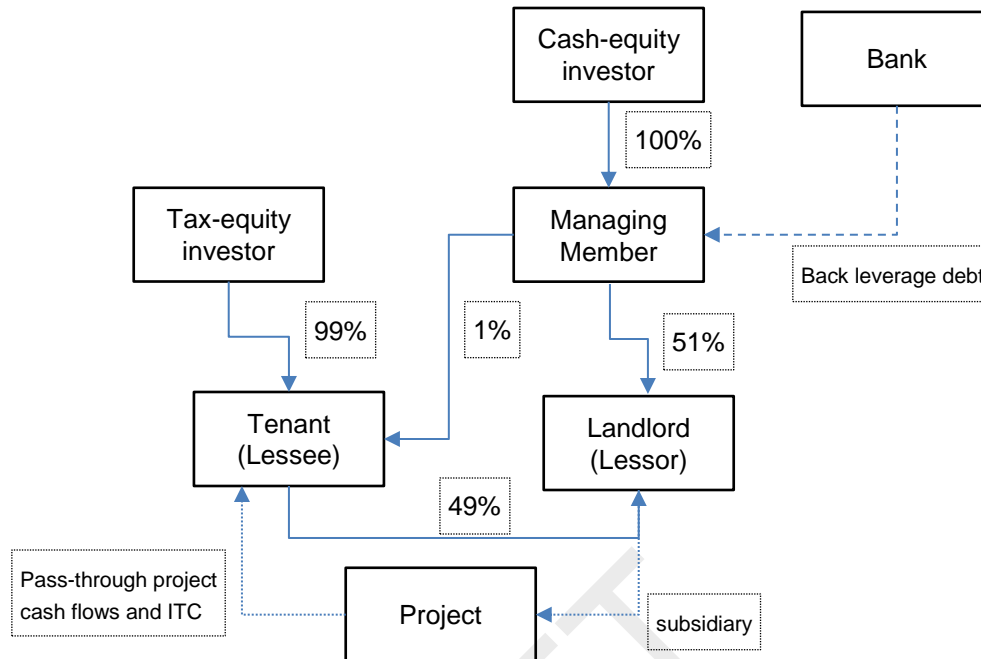
3.3.1 Renewable energy

The following terminology is used in the solar project finance.⁵

- ▶ *Cash Flow Waterfall and Distributions.* Cash flow waterfall model describes how the project revenues are used to pay project expenses and investor returns in a pre-determined priority. Many variations exist, but in general lenders permit cash flow to be applied as follows, on monthly or quarterly dates: first, to pay project operating expenses; second, to pay lender expenses not constituting debt service; third, to pay debt service (interest and scheduled principal payments); fourth, to fund any required cash reserves for the project, including reserves for debt service, maintenance expenses, and capital expenses; and fifth, to make distributions to the equity owners.
- ▶ *Back Leverage Debt.* Back leverage moves the debt from the project level up to a holding company level, above the tax equity investor level, such that the sole collateral securing the debt is the sponsor-side equity interests and the associated cash held by the holding company borrower. As a result of the high quality of the solar asset and the relatively low operating risk, the value of the sponsor-side cash flow streams in an operational solar facility can be significant enough to fully secure permanent debt for the project, even without project-level collateral.
- ▶ *Tax Equity Financing.* Tax equity financing is a structure of project finance unique to renewable energy project finance, owing its existence to the U.S. tax code, subject to the whim of federal politics and tax policy. As discussed more thoroughly in Chapter 8, the ITC permits an equity owner of a qualifying asset, including a solar power facility, to claim a tax credit equal to a percentage of the value of the asset's eligible basis. An owner may also be able to claim accelerated or bonus depreciation with respect to the asset's value. In combination, these benefits can offer a sizeable reduction to the federal tax liability of a solar project owner, allowing the owner to offset its taxable income from other unrelated sources but based on the value of the solar project.
- ▶ *Partnership Flip.*
- ▶ *Sale Leaseback.* In a sale-leaseback transaction, the sponsor sells the project to a tax equity investor. The tax equity investor then leases the project back from the investor for prepaid rent and periodic rental payments, which rental payments may be subject to a sponsor-level payment guaranty. The investor will be entitled to 100 percent of the tax benefits from the project while the sponsor will retain the right to use and operate the project and receive the revenue from its operation for a period of years, subject to paying a fixed rent payment.
- ▶ *Other leases.* In a **lease pass-through** transaction, the project company is often structured as a partnership, owned 49 percent by a tenant entity and 51 percent by the sponsor. The tenant is owned 99 percent by the tax equity investor and 1 percent by the sponsor. The project company leases the project to the tenant prior to the date the project is Placed in Service. The project company then elects to have the ITC, based on the appraised fair market value of the project, passed through to the tenant. The tenant partnership is structured as a partnership flip, where tax allocations and cash distributions will "flip" after a fixed period of time.

The structure of a lease pass-through transaction is illustrated below.

⁵ <https://www.stoel.com/legal-insights/special-reports/the-law-of-solar/project-finance-for-solar-projects>.



The structure changes after the Flip Date. The 99% and 1% ownership shares in the Tenant flip to 5% and 95%.

- ▶ **Cash Equity Financing.** The cash equity position shares the sponsor position and serves as permanent financing that can be used as an alternative or in addition to back leverage debt. From the perspective of the tax equity investor and lenders, a cash equity investor appears the same as a sponsor, and the tax equity investor will generally require guaranties from both the sponsor and the cash equity investor. However, this position is generally held by a pure financial investor that either does not have the desire or the necessary means to manage the ongoing operation of the project. The sponsor with the management role will be responsible for indemnifying the cash equity investor if a breach by the manager results in losses to the tax equity investor that are subject to guaranty payments or a cash flow sweep.
- ▶ **Cash sweep.** A Cash sweep, or Debt sweep, is the mandatory use of excess free cash flows to pay down outstanding debt rather than distribute it to shareholders. Firms always have the option to pay down debt with excess cash, but they do not always choose to do so.⁶

3.4 Comparing acquisition and investment financing structures

Acquisition and investment financing structures have lots of similarities but also have some conceptual differences summarized below.

1. Financial modelling.
 - ▶ In acquisition financing transaction, 100% ownership of the target is typically acquired. The financial statements of the target are consolidated with the financial statements of the borrower. The valuation model is represented by the (i) valuation of the target assets including intangibles, fixed assets, goodwill and other; (ii) repayment of existing target liabilities; (iii) projected income

⁶ https://en.wikipedia.org/wiki/Cash_sweep.

statement metrics of the target such as revenues, COGS, SGA, and other; and (iv) projected cash flows of the target such as capital expenditures, dividend distributions, and other;

- ▶ In investment financing transaction a separate blocker (limited partnership) entity is formed for the purpose of raising funds to invest in a specific project. The funds are typically raised from multiple sources including third-party debt, third-party investors, and the contribution from the tested borrowing entity. In most cases the borrower owns only a share of the project. The valuation model of the project is represented by a cash flow model, which estimates (i) borrowing and repayment of third-party debt; (ii) distributions to third-party investors; (iii) distributions to the tested borrowing entity.

2. Financing structure.

- ▶ In acquisition financing transaction, all existing third-party debt is typically repaid and the only debt at the borrower's level is represented by intercompany debt. Financing of the acquired target is often funded at the parent entity level (either through existing or new bank loans). The funds from the existing parent loans are allocated then to the borrower through intercompany loans and equity contributions. The third-party debt can't be used directly to estimate the credit rating of the borrower but is often used for reference to ensure that the financing costs of the parent entity do not exceed the financing costs of the borrowing entity.
- ▶ In investment financing transaction, the funds are often raised directly to the blocker entity through the issue of third-party debt. Therefore, the implied credit rating of the borrower can be assessed directly through the analysis of the interest rates charged in the third-party loans.

3. Credit rating analysis.

- ▶ In acquisition financing transaction, credit rating is typically estimated using sector-specific Moody's Rating Methodology (**MRM**) or other rating methodology, which is based on financial metrics of the borrowing entity. The estimated stand-alone rating of the borrower is adjusted then for implicit support from the parent group (halo effect adjustment). Since the target is typically incorporated as part of the group and shares the group brand and reputation, a positive halo effect typically exists. Therefore, the group credit rating has a material impact on the estimated creditworthiness of the borrowing entity.
- ▶ In investment financing transaction, credit rating is typically estimated based on both the MRM model and implied credit rating analysis. The interest rates on third-party bank loans provided to the blocker entities are used to infer the market valuation of the borrowing entity creditworthiness. No halo effect adjustment is typically performed as the blocker entity is viewed as a non-strategic entity according to the S&P Guidelines.⁷ In most cases the blocker is not functionally and operationally integrated with the parent group and does not share the same name or brand with the parent group. The equity in the investment project is likely to be sold if the acquired assets underperform relative to targets and expectations set by the parent group.

4. Interest benchmarking.

- ▶ In acquisition financing transaction, the intercompany debt is formally subordinated. However, in most cases there is no senior secured debt at the borrowing entity level. As a result, either no or minimum one-notch downward adjustment is performed to the intercompany loan transaction-specific credit rating (consistently with the S&P Criteria⁸);
- ▶ In investment financing transaction, the intercompany debt is often deeply subordinated to the senior secured debt provided by the bank. As a result, the intercompany loan can be characterized as a mezzanine debt. Applying mezzanine debt interest benchmarking approach

⁷ Standard & Poor's, *Group Rating Methodology*, November 2013, paragraphs 54-60.

⁸ reference

is not technically easy. The approach is discussed in detail in the accompanying Interest Benchmarking guide.⁹

DRAFT

⁹ Reference

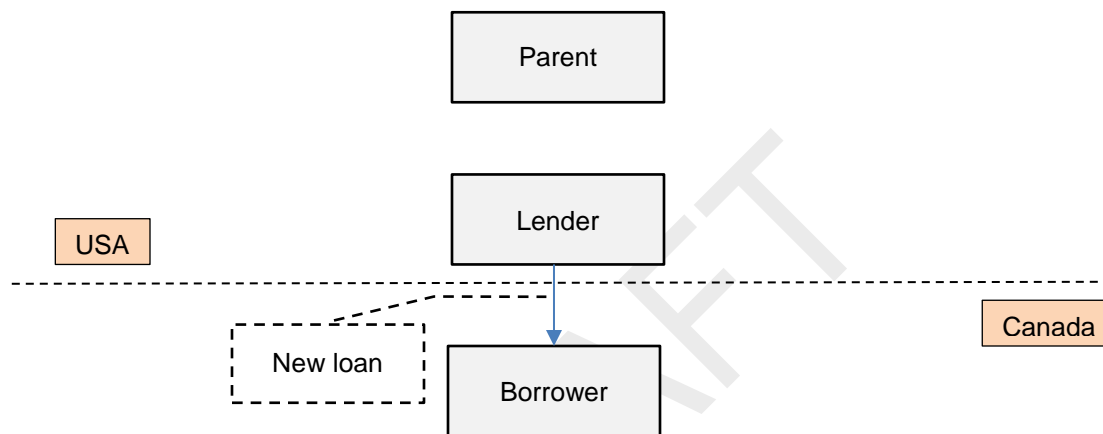
Section 4 Loan

In this section we consider a regular loan transaction that is issued for working capital or operational needs purpose. We describe different scenarios: (i) a new loan is issued; (ii) an existing loan is refinanced / amended; and (iii) an existing loan is transferred to a new lender.

4.1 Transaction structure

4.1.1 New loan

A typical structure of a new loan transaction is illustrated in the diagram below.



A

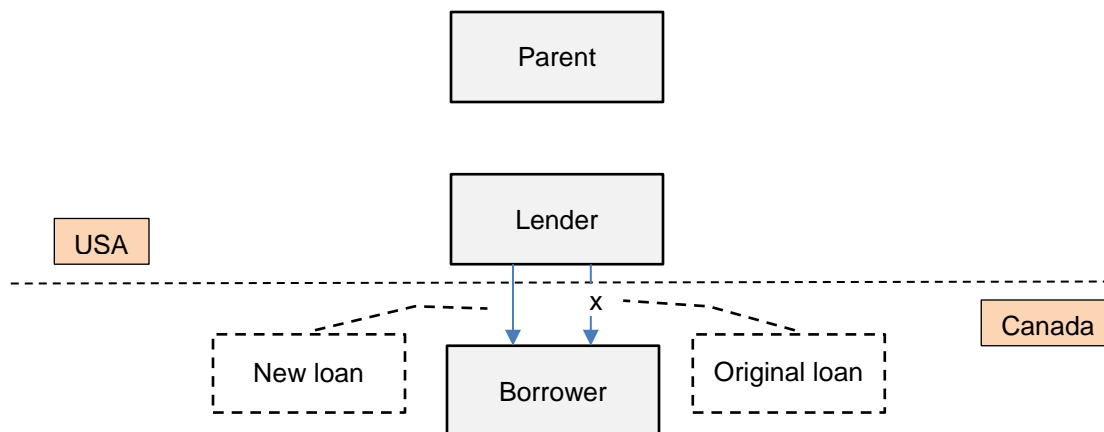
4.1.2 Loan refinancing / amendment

A loan refinancing / amendment structure is in my practice the second most typically observed type of transaction. Loan refinancing / amendment may be performed for different purposes:

- ▶ The loan is near its maturity term and the borrower needs to refinance it;
- ▶ The loan prepayment option is exercised to refinance the loan at a lower rate;
- ▶ The loan refinancing is part of a broader corporate restructuring transaction.

In most cases loan refinancing is implemented as part of a corporate restructuring.

A typical structure of a loan refinancing transaction is illustrated in the diagram below.



A basic loan refinancing / amendment diagram effectively shows an original loan cancelled and a new loan issued between the lending and the borrowing subsidiaries of the parent group. If loan refinancing is part of corporate restructuring, then additional elements can be added to the diagram to present a broader transaction structure. The transaction is typically summarized as follows.

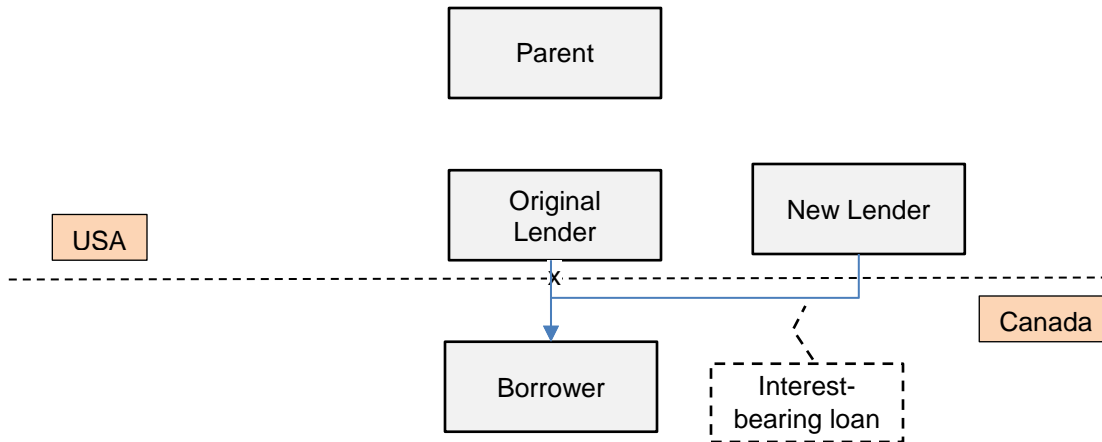
- ▶ Original loan was issued between the lender and the borrower on date XXX for the purpose of [describe the purpose of the original loan];
- ▶ On date XXX, loan was refinanced into a new loan with the following terms [describe the terms of the refinanced loan].

4.1.3 Loan transfer

A loan transfer transaction is similar to a loan refinancing / amendment transaction but has some important differences. In both cases the existing intercompany debt is being revaluated at a new loan refinancing / amendment date. However, in the case of the loan transfer is to estimate the value of the loan. The terms of the loan at the new valuation date are assumed to be the same as at the loan original issue date.

The interest benchmarking analysis in the loan transfer transaction is only the first step of the analysis. The estimated interest rate is applied to discount the cash flows of the transferred loan. The analysis is often referred to as discount benchmarking analysis (**DRB**) as opposed to the interest benchmarking analysis. At the second step, the estimated discounts are applied to estimate the net present value (**NPV**) of the transferred loan.

A typical structure of a loan transfer transaction is illustrated in the diagram below.



- ▶ Original Lender entered into the Loan agreement with the Borrower on XXX as part of the intercompany financing structure, which was put in place for the [describe the original business purpose of the Loan).
- ▶ On XXX, Original Lender assigned its lender rights under the loan agreements to New Lender for a total value of US\$XXX million. The performed economic analysis reflects the terms and conditions contained in the original loan agreements and the assignment and assumption agreement between the Original Lender and the New Lender dated on XXX.
- ▶ Contemporaneously, on XXX, the New Lender amended and restated the Loan agreement with the Borrower, without changing any material terms of the Loan.

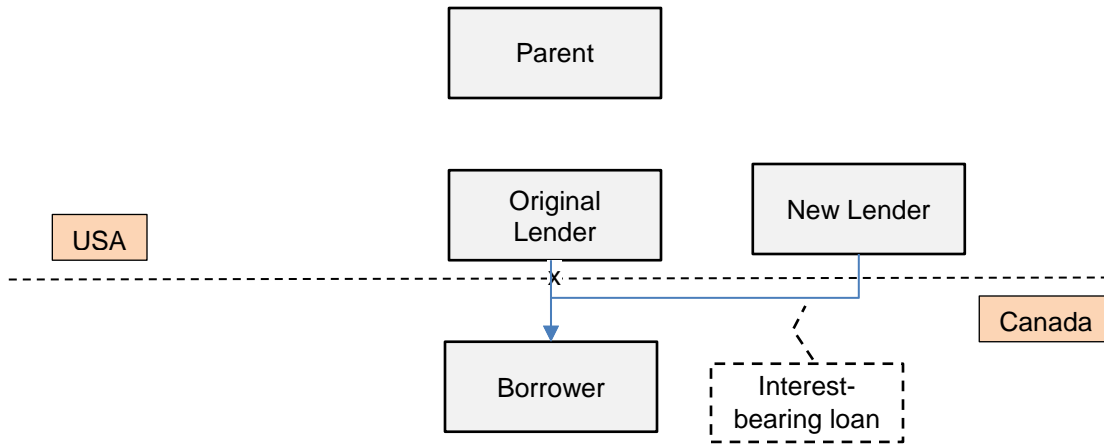
The Original Lender and the New Lender in the loan transfer transaction are also referred to as Assignor and Assignee; the loan transfer date is referred to as the Assignment Date; and the loan transfer value is referred to as the Assignment Value. The assignment value is often set at par (equal to outstanding principal and accrued interest value). The purpose of the loan FMV analysis is to demonstrate that the transfer of the Loan at par value is at arm's length.

4.1.4 Intercompany acquisition / restructuring

The intercompany acquisition / restructuring transaction has the following objectives:

1. Transfer operating subsidiaries from under one parent company under another parent company
2. Create leverage within the transferred group
3. Finance the transfer with a circular movement of funds (so that no actual funds are required for the transfer).

A typical structure of an intercompany acquisition / corporate restructuring transaction is illustrated in the diagram below.



The transaction steps are summarized as follows.

▶ .

DRAFT

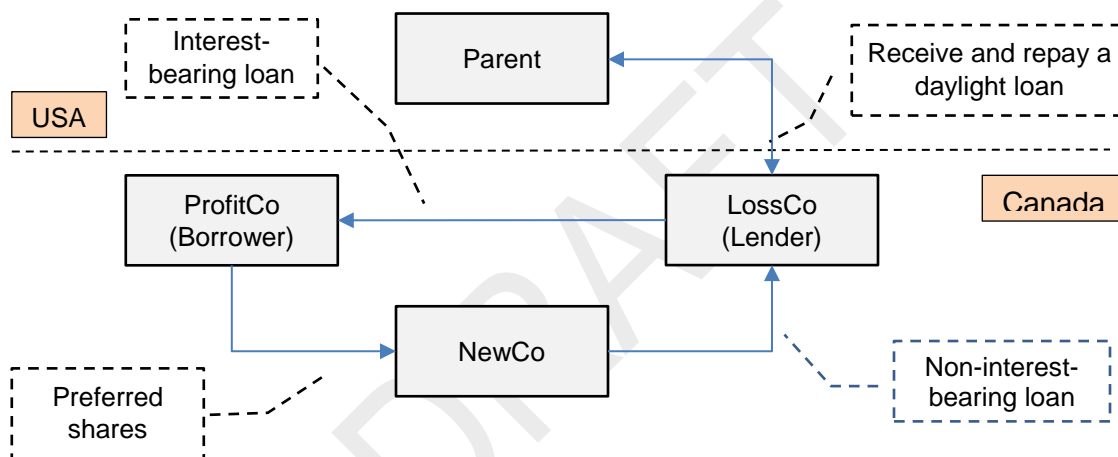
Section 5 Loss Utilization

Loss utilization structure is typically implemented within the same tax jurisdiction with the purpose to align the cost / revenue allocations across subsidiaries. The structure is implemented for tax purposes to distribute some of the profits to loss-making subsidiaries (and as a result to reduce the tax base).

Loss utilization structures are normally performed for Canadian entities (Canada-to-Canada transactions). Since loss utilization is not a cross-border transaction, the transaction documentation uses a different compliance language.

5.1 Transaction structure

A typical structure of a loss utilization transaction is illustrated in the diagram below.¹⁰



The loss utilization transaction steps are summarized as follows.

- ▶ LossCo obtains a daylight loan from the parent company;
- ▶ LossCo uses the funds from the daylight loan to make an interest-bearing loan to ProfitCo. The debt amount and applicable interest rate are determined based on the transfer pricing analysis;
- ▶ A new company NewCo is incorporated under the laws of Canada;
- ▶ ProfitCo used the funds from the loan to acquire preferred shares of NewCo.
- ▶ NewCo uses the received funds to make a non-interest-bearing loan to LossCo.
- ▶ LossCo uses the funds from the non-interest-bearing loan to repay the daylight loan.

The loss utilization transaction is characterized by a circular movement of funds, which are borrowed from and repaid to the parent during the same day (daylight loan). As a result of the funds circular movement, the offsetting debt / investment accounts are created in LossCo and ProfitCo. Since the loan to LossCo is non-interest bearing, no interest is paid to NewCo and respectively no dividends are paid to ProfitCo. The

¹⁰ The structure is referred to as a “three-way loss utilization” structure.

only tangible impact of the transaction is the interest paid from ProfitCo to LossCo to reduce the tax base of ProfitCo and respectively reduce the tax base of consolidated Canadian subsidiaries.

The purpose of the loss utilization transaction is purely tax optimization. However, it is recognized by Canadian tax authorities, since the tax base should be assessed on consolidated and not entity-specific level within each tax jurisdiction.

The indirect purpose of the loss consolidation transaction is to ensure that the allocations within the group are more consistent with the market terms. Consider for example a Canadian group of a REITs company, in which LossCo is an investment company, which invests in the Canadian properties and rents them to ProfitCo, which is an operating company of the Canadian group. Losses at the LossCo level imply that the terms between LossCo and ProfitCo may not be consistent with the market terms. To correct the allocation of profits / losses between LossCo and ProfitCo, some of the interest costs are pushed into the ProfitCo via the loss utilization transaction.

5.2 Project scope

As the diagram above demonstrates, a loss utilization transaction involves issuance of intercompany loans and intercompany preferred shares. The purpose of the transaction is to maximize tax savings through interest expense deductions by re-allocating profits within the group. Therefore, the objective in a loss utilization structure is to issue a maximum debt quantum.

Based on the above considerations, the following items should be discussed with a client and reviewed whether they are included in the scope of the loss utilization transaction analysis.

1. **Debt capacity** analysis to assess the maximum quantum of debt that can be issued by ProfitCo. In some cases, there can be multiple ProfitCo companies (ProfitCos). Additional analysis should be advised in this case to assess whether the ProfitCos should be assessed as borrowers on consolidated or individual basis to estimate which scenario produces a higher debt capacity;
2. **Loan IRB** analysis. This is a standard part which is always included in the scope.
3. **Preferred shares IRB** analysis. Since preferred shares are part of the structure, they should be priced consistently with the loans.

The interest rate on the preferred shares is typically set a few basis points above the interest rate on the loans.

The structure is implemented in such a way that there is an option to unwind the structure whenever necessary. The following features are typical for the structure:

1. The loans include a prepayment (call) option (to increase the rate) with no penalties or make-whole provisions;
2. The preferred shares include a pay-on-demand (put) option with no penalties.

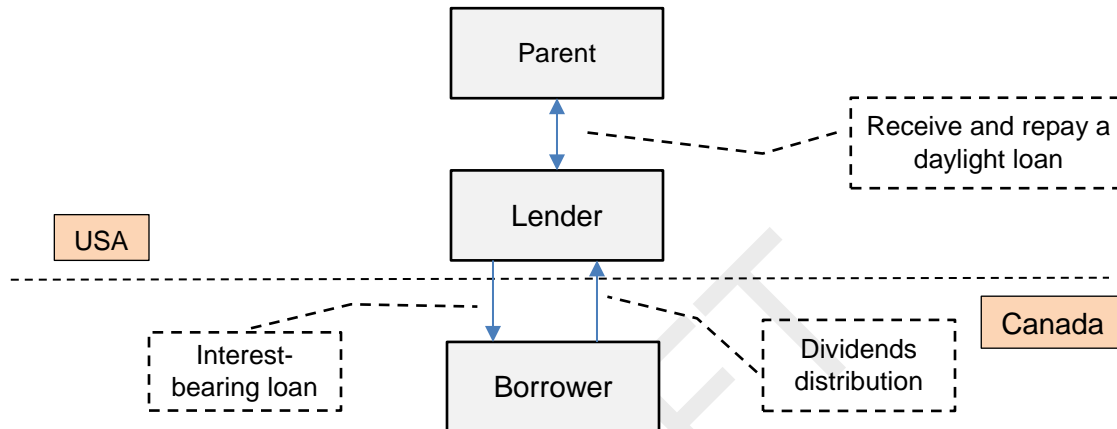
Note that preferred shares are typically rated below the loans (due to lower ranking and larger downward notching rating adjustment). Therefore, the interest rate on the preferred shares before the option adjustment is higher than the interest rate on the loans. However, the put option adjustment may be very material resulting in the interest rate on the preferred shares being lower than the interest rate on the loans. Additional review is required in this case to ensure that the ranges of loans and preferred shares interest rates overlap and consistent with each other.

Section 6 Leveraged Distribution

A leveraged distribution transaction is similar to the loss utilization transaction. The key difference is that in the leveraged distribution debt is not added but replaces the equity on the borrower's balance sheet.

6.1 Transaction structure

A typical structure of a loss utilization transaction is illustrated in the diagram below.



The leveraged distribution transaction steps are summarized as follows.

- ▶ Lender obtains a daylight loan from the parent company;
- ▶ Lender, who is also a parent company for the Borrower, uses the funds from the daylight loan to make an interest-bearing loan to the Borrower. The debt amount and applicable interest rate are determined based on the transfer pricing analysis;
- ▶ The Borrower makes a dividend distribution to the Lender in the amount matching the principal of the loan;
- ▶ The Lender uses the proceeds from the dividend distribution to repay the daylight loan.

Note that the difference between the leveraged distribution and loss utilization transaction is that in the first case the debt replaces the equity on the balance sheet of the borrower while in the second case there is a circular movement of funds which creates a debt and offsetting investment account on the Borrower balance sheet.

Appendix A Tax Structures

xx

A.1 Overview

Traditional tax optimization structures include the following hybrid financing transactions

1. Hybrid structures: (i) hybrid preferred shares (HPS) and (ii) reverse hybrid towers
2. Repo structures
3. Luxembourg MRPS
4. Luxembourg / Netherlands interest free loans

Hybrid entity is the entity which is treated differently for the US tax purposes from the treatment under the foreign law. A hybrid transaction is an instrument which payments are treated differently under the US and foreign laws.

A.2 Change in US regulations

In December 2017, US implemented a new tax reform by signing the Tax Cuts and Job Acts (**TCJA**). The act included the following sections.

- (i) IRC Section 267A (denial of deductions for certain hybrid payments). The section effectively eliminated all hybrid / repo debt structures.
- (ii) IRC Section 59A (base erosion and anti-abuse tax, **BEAT**). BEAT is the minimum tax imposed on a corporation (conditional on certain conditions being met).
- (iii) Section 163(j) – thin-cap rule to limit interest tax deductions to 30% of the adjusted taxable income.

As a result, of the new tax reform, hybrid debt structures became effectively disallowed under the US tax regulations and the structures were unwound and replaced with regular structures. An example of a hybrid debt structure is illustrated below. The impact of the tax regulations is summarized in the exhibit below.

Structure	Impact of Section 267A	Applicable tax years
Repo	Interest denied	After 31 Dec 2017
Hybrid Preferred Shares (HPS)	Interest denied	After 31 Dec 2017
Reverse Hybrid Towers	Interest denied	After 31 Dec 2018 (for structures put in place after 31 Dec 2018)
Luxembourg MRPS	Interest denied	After 31 Dec 2018
Luxembourg / Netherlands interest free loans	Possible denial of interest deductions	After 31 Dec 2018

A.3 Tax considerations

Canada – form driven, US – substance driven. New Repo structures.

Foreign affiliate rules (FAPI). Mandatory disclosure rules (MDR)

The following changes in the EU regulations have a potential impact on the tax structures.

1. Country-specific regulations which address concerns raised in Action 2 of the OECD's 2015 papers related to Base Erosion and Profit Shifting (**BEPS**).
2. Country-specific regulations which address concerns raised in the EU's Anti-Tax Avoidance Directives I and II (released in July 2016 and May 2017) including:
 - ▶ Double Deductions
 - ▶ Imported Mismatches
 - ▶ Deduction / No Inclusion structures
3. Introduction of country-specific legislation addressing reporting obligations under the Directive on Administrative Cooperation 6 (referred to as DAC 6 and the Mandatory Reporting Regime (**MDR**))

A.4 New US-Canada tax structures

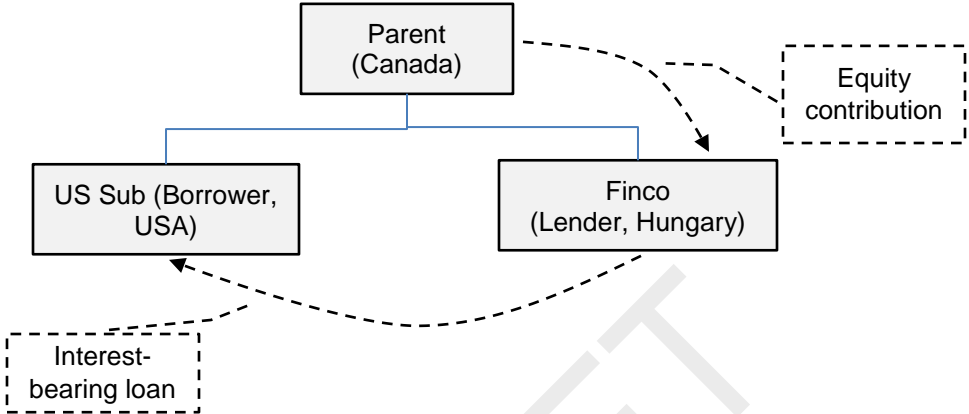
DRAFT

Appendix B Low Rate Finco Structure

The structure utilizes low-tax jurisdictions, which have treaties with US, which allow avoiding double taxation of the interest income related to withholding tax.

B.1 Transaction structure

A typical hybrid debt structure is illustrated in the diagram below.

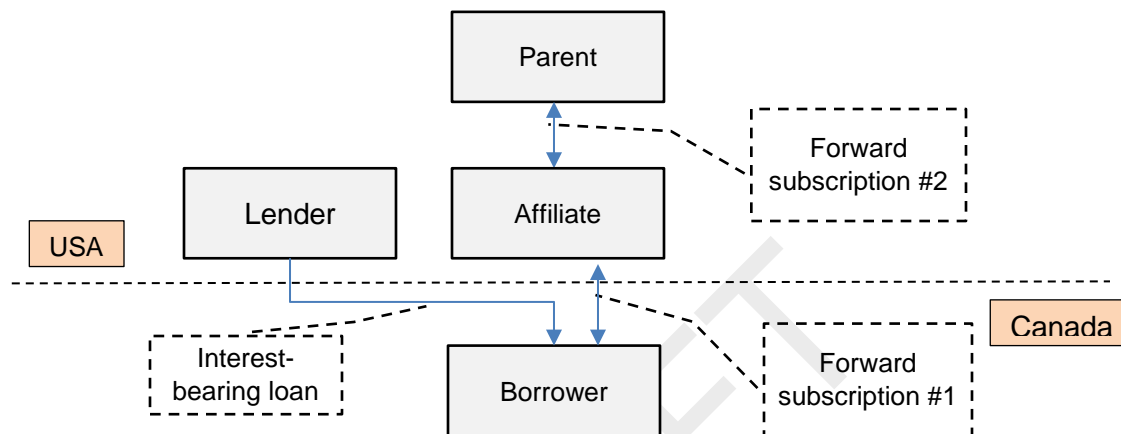


Appendix C Hybrid Debt Structure

Hybrid debt refers to a certain debt structure but not the debt business purpose. A hybrid debt structure has the characteristics of both debt and equity. Its purpose is to be treated from the tax perspective as debt in the borrower's tax jurisdiction and as equity in the lender's tax jurisdiction.

C.1 Transaction structure

A typical hybrid debt structure is illustrated in the diagram below.



The steps of a hybrid debt transaction are summarized as follows.

- ▶ The Borrower and the Lender enter into a loan agreement;
- ▶ Contemporaneously with the loan agreement, the Borrower and the Affiliate enter into a Forward Transfer Agreement (FTA) #1. Under the terms of the FTA #1, the Borrower can request that the Affiliate to make a subscription to the Borrower's common shares in the amount equal to the amount of the loan's interest and principal payment due on the loan maturity date;
- ▶ Contemporaneously with the loan agreement, the Affiliate and the Parent enter into a FTA #2. Under the terms of the FTA #2, the Affiliate can request that the Parent to make a subscription to the Affiliate's common shares in the amount equal to the amount of the loan's interest and principal payment due on the loan maturity date.

In some cases, the FTA #2 is replaced with a guarantee agreement between the Borrower and the Parent that the Affiliate will service its obligations under the FTA #1. A hybrid debt structure consists of three agreements issued contemporaneously: (i) a loan, (ii) an FTA, and (iii) a guarantee. All three agreements are typically included in the appendix of the report that documents the transaction.

The FTA #1 and #2 effectively give the Borrower an option to convert the loan into the equal equity amount issued to the Borrower. Because of the presence of the debt-to-equity conversion option, the structure is viewed as a hybrid debt structure.

Because of the hybrid structure of the debt transaction, the tax authority recognizes the loan as a debt transaction but may conclude that the risk of default on the debt is low due to the presence of the FTA agreement. As a result, the tax authority may conclude that the risk premium on the debt is low and may reassess the arm's length interest applicable to the loan based on these conclusions.

If the Parent is the Lender in the loan agreement, then the presence of the FTA agreement does not reduce but may actually increase the risk for the lender since the Parent is effectively guaranteeing its own loan. In general, the Parent effectively acts as a guarantor in the loan transaction.

In practice, the hybrid structure of the debt transaction is not taken into account in a transfer pricing analysis. The hybrid structure is implemented for tax purpose only. However formally the subordination ranking of a hybrid debt is effectively equivalent to subordination ranking of borrower's equity as the borrower has an option to convert debt into equity.

DRAFT

Appendix D Repo Debt Structure

In market repurchased debt (“repo debt”) transactions, party B acts as a lender of cash, whereas the seller A is acting as a borrower of cash, using the security as collateral. A repo is economically similar to a secured loan, with the buyer (effectively the lender or investor) receiving securities for collateral to protect himself against default by the seller. Although the transaction is similar to a loan, and its economic effect is similar to a loan, the terminology differs from that applying to loans: the seller legally repurchases the securities from the buyer at the end of the loan term. However, a key aspect of repos is that they are legally recognised as a single transaction (important in the event of counterparty insolvency) and not as a disposal and a repurchase for tax purposes.¹¹

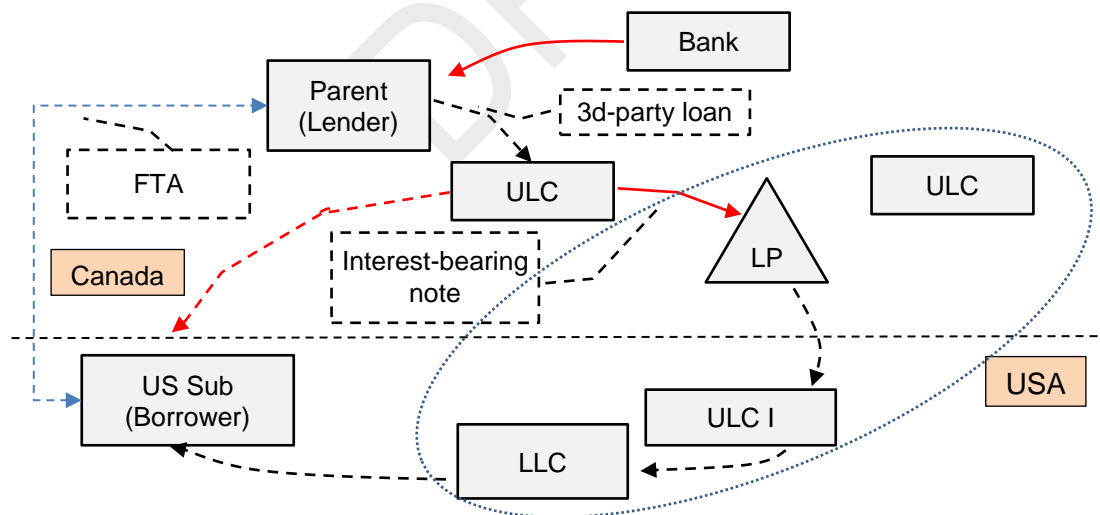
In intercompany financing transactions structures, a repo debt is a type of hybrid debt which is similar to a hybrid debt transaction structure described above. The difference from the hybrid debt structure is that a repo debt transaction issued between the lender and the borrower is represented by preferred shares which are treated as debt from the Borrower’s perspective.^{12,13}

D.1 Transaction structure

Two examples of Repo structures are presented below. A specific characteristic of the Repo transactions presented below, is that the intercompany debt is issued in the form of preferred shares, which is interpreted as preferred equity from the lender and as debt from the borrower perspective. The Repo structure includes the guarantee and FTA agreements, which are normally observed in hybrid debt transactions.

D.1.1 Example A (new ‘double dip’ Repo structure)

The ‘double-dip’ Repo structure, which does not violate the latest US regulations, is illustrated in the exhibit below.



¹¹ https://en.wikipedia.org/wiki/Repurchase_agreement

¹² The purpose of the FTA and the Support Agreement in the repo structure is to ensure that the preferred shares are treated as debt from the Borrower’s perspective.

¹³ The structure is called the “repo debt” structure because the lender receives the assets of the Target in consideration of the issued debt, which is transferred back to the Borrower on the maturity date.

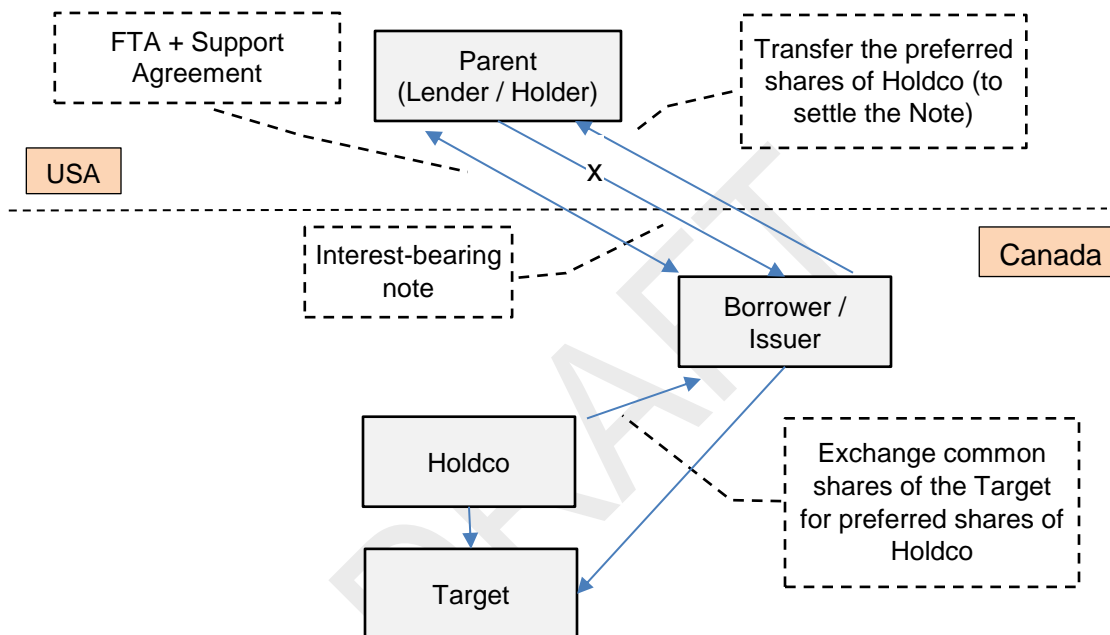
The structure is referred to as the 'double-dip' structure since it allows to have interest deductions in both US and Canada (in US interest on the intercompany note is deducted and in Canada interest on the 3d-party loan is deducted).

From the US perspective, the IB loan goes directly to the US Borrower (all entities in between are disregarded for tax purposes). The steps of a repo debt transaction are summarized as follows.



D.1.2 Example B

An example of a repo debt structure is illustrated in the diagram below.



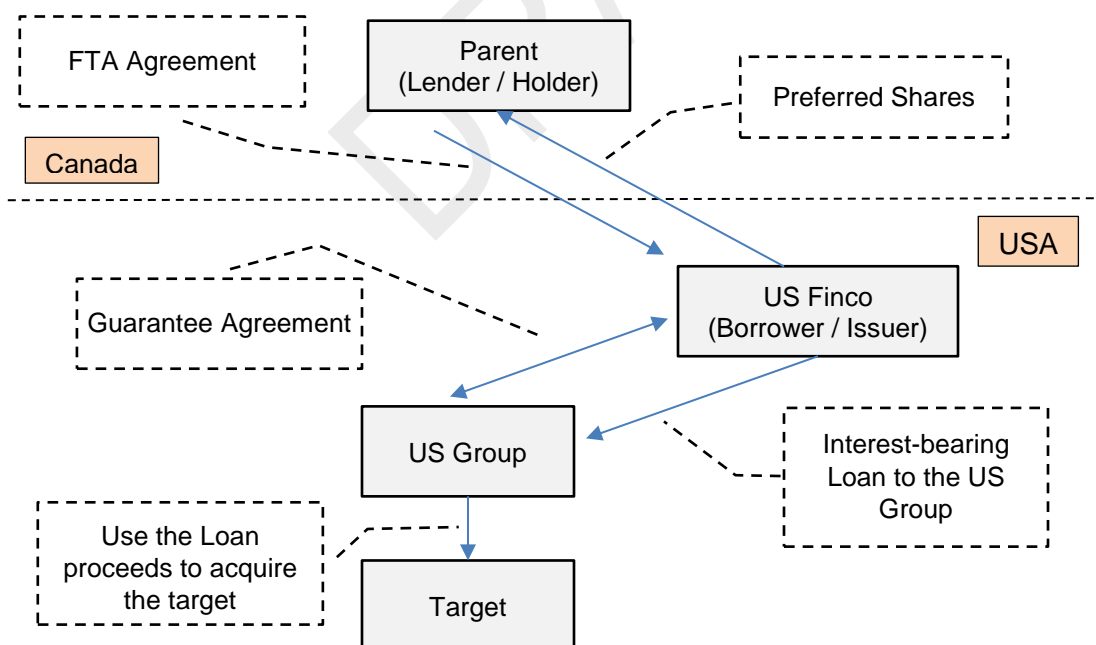
The steps of a repo debt transaction are summarized as follows.

- ▶ On date XXX, the Parent announced its plans to acquire the Target for an approximate purchase price of \$XXX million (Target Acquisition);
- ▶ As part of Target Acquisition, a new holding company (Holdco) was created;
- ▶ The Parent group entered into a Loan agreement with the Bank to raise the funds for acquiring the Target;
- ▶ The proceeds from the Loan were used to finance the acquisition of the Target through a combination of equity contribution and an intercompany promissory note (Note) from the Parent to the Borrower;
- ▶ The proceeds from the Note received by the Borrower were used to finance the Target acquisition;
- ▶ Entire membership interest of the Target was transferred by the Borrower to the Holdco. In exchange for the membership interest, Holdco issued \$XXX million worth of preferred shares ("Preferred Shares") and US\$XXX million worth of common shares to the Borrower. The Preferred Shares pay preferential cumulative dividends at an annual rate of x.x percent (matching the interest rate on the Note);

- ▶ The Borrower transferred the Preferred Shares of Holdco to the Parent in consideration for the full settlement of the Note.
- ▶ Contemporaneously with the transfer of the Preferred Shares, the Borrower and the Parent entered into a forward transfer agreement (“FTA”). Pursuant to the FTA, the Borrower agreed to purchase back the Preferred Shares from the Parent on the maturity date for a total value of \$XXX million (matching the principal amount of the Note).
- ▶ The Borrower and the Parent also entered into Support Agreement pursuant to which the Borrower agreed to guarantee the full and timely payment of the dividends on the Preferred Shares during the term of the FTA;
- ▶ The x.x percent fixed dividend rate and other terms of the Preferred Shares were set to match the x.x percent fixed interest and other terms of the Note. The Preferred Shares are treated as debt from the tax perspective, and the Borrower, as a guarantor under the Support Agreement, is treated as the effective borrower in the Preferred Shares transaction. Therefore, the settlement of the Note with the Preferred Shares is treated as a replacement of the original debt transaction with an equivalent debt transaction with matching terms and conditions;
- ▶ The transfer pricing analysis of the Covered Transaction was performed in this Report for the \$XXX million x.x percent fixed interest rate intercompany promissory note, but it also applies directly and interchangeably to the Preferred Shares transaction. Effectively, for the purposes of this analysis, the promissory note and the Preferred Shares are treated as a single debt transaction between the Borrower and the Parent.

D.1.3 Example C

An alternative example of a repo debt structure is illustrated in the diagram below.



The steps of a repo debt transaction are summarized as follows.

- ▶ On date XXX, the Parent announced its plans to acquire the US Target for an approximate purchase price of \$XXX million (Target Acquisition);

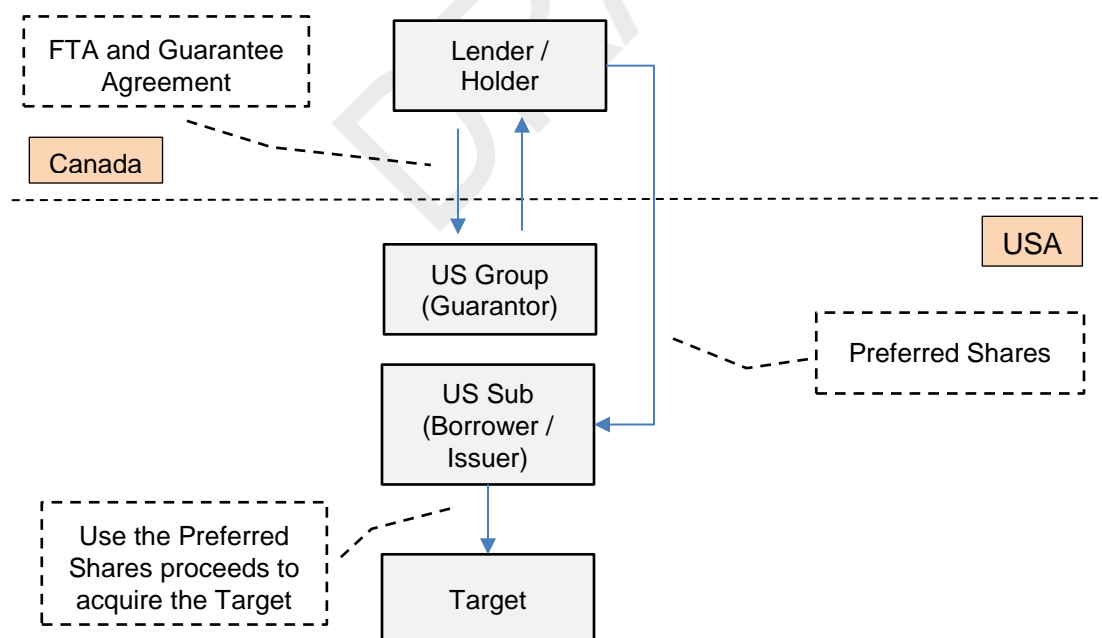
- ▶ The Parent group entered into a Loan agreement with the Bank to raise the funds for acquiring the Target;
- ▶ As part of acquisition, US Finco issued Preferred Shares to the Parent in the total amount of XXX.
- ▶ The proceeds from the Preferred Shares were used by Finco to finance the acquisition of the Target by providing intercompany Loan to the US Group, the direct US parent of the Target.
- ▶ Contemporaneously, US Finco and US Group enter into a Guarantee Agreement, pursuant to which US Group guarantees the payments under the Preferred Shares agreement.
- ▶ Contemporaneously, Finco and the Parent enter into a Forward Transfer Agreement pursuant to which US Finco agrees to purchase back the Preferred Shares from the Parent on the maturity date.

The transaction is interpreted as a repo debt, since the Parent holds the preferred shares of US Finco, which are guaranteed by the US Group. The preferred shares are transferred back to U Finco after the debt obligations are settled.

Under the financial structure the Preferred Shares are treated as equity from the Canadian side and as debt from the US side. The debt characterization of the Preferred Shares transaction is supported by the mandatory dividend payments on the Preferred Shares and mandatory repayment of the Preferred Shares principal balance on the maturity date (pursuant to the FTA Agreement).

Since the transaction is formally structured as preferred shares, a higher downward notching may be considered and it is recommended to include the comparable preferred shares in the search strategy.

An alternative structure of the repo transaction is presented below.



In the example, the preferred shares are issued directly by the company that makes Target acquisition and the guarantee and FTA agreements are issued between the borrower's group and the Lender / Holder.

Appendix E Luxembourg MRPS Structure

Xx

DRAFT

Appendix F Financial Models

Xx

F.1 Acquisition model

To assess the impact of the acquisition on the financial statements of the borrower, the following information is generally required (in addition to standard information request items for a loan analysis).

- ▶ A detailed information on the acquisition transaction (purchase price, revaluations of IP and fixed assets, estimated goodwill, acquisition costs, other metrics);
- ▶ Historical and projected financial statements of the Target. In the case of acquisition, certain projected metrics need to be revaluated consistently with the Target valuation analysis rather than assessed based on the historical information. Specifically, acquisition may have a material impact on the projections of the following accounts:
 - ▶ Capex;
 - ▶ Depreciation and amortization (due to revaluation of the intangibles and fixed assets);
- ▶ A summary of the terms and conditions and/or copies of legal agreements for any outstanding third-party debt held by the Target or any of their respective subsidiaries. If the Target has outstanding third-party debt, it should be confirmed whether the debt is planned to be repaid during the acquisition.

The acquisition information is typically provided in the form of the ‘Sources of funds’ and ‘Uses of funds’ tables as illustrated in the diagram below.

Sources of Funds	Notation	Uses of Funds	Notation
3d party debt	$DEBT^{Acq, 3d-party}$	Repayment of Target outstanding debt	$DEBT_0^{Tgt}$
i/c acquisition funds from Parent / financing affiliate	$X^{Tgt, i/c}$	Compensation to Target shareholders	$X^{Tgt, sh}$
<i>i/c debt from Parent / financing affiliate</i>	$DEBT^{CT}$	Transaction costs	$COST^{tr}$
<i>i/c equity from Parent / financing affiliate</i>	$EQTY_1^{Tgt}$	Acquisition price	$PRICE^{Tgt}$
Cash (Borrower)	$CASH_0^B, acq$		
Cash (Target)	$CASH_0^{Tgt, acq}$		
Acquisition price	$PRICE^{Tgt}$		

The impact of the Target acquisition on the borrower’s financial statements is presented on the diagram below.¹⁴

Metric	Borrower		Target		Consolidated
	prior to acquisition	post acquisition	prior to acquisition	post acquisition	post acquisition
Balance sheet					

¹⁴ Abbreviations B and Tgt. are used respectively for the Borrower and the Target. The subscripts 0 and 1 are used for the prior-to and post-acquisition financial metrics.

Metric	Borrower		Target		Consolidated
	prior to acquisition	post acquisition	prior to acquisition	post acquisition	post acquisition
Cash	$CASH_0^B$	$CASH_1^B = (CASH_0^B - CASH^{B,acq})$	$CASH_0^{Tgt}$	$CASH_1^{Tgt} = (CASH_0^{Tgt} - CASH^{Tgt,acq})$	$CASH_1 = CASH_1^B + CASH_1^{Tgt}$
Goodwill	G_0^B	$G_1^B = G_0^B$	G_0^{Tgt}	$G_1^{Tgt} = G_0^{Tgt} + (X^{Tgt,sh} - EQTY_0^{Tgt})$	$G_1 = G_1^B + G_1^{Tgt}$
Other assets	$OTHER_0^B$	$OTHER_1^B = OTHER_0^B + COST^{tr}$	$OTHER_0^{Tgt}$	$OTHER_1^{Tgt} = OTHER_0^{Tgt}$	$OTHER_1 = OTHER_1^B + OTHER_1^{Tgt}$
3d-party debt	$DEBT_0^{B,3d-party}$	$DEBT_1^B = DEBT_0^{B,3d-party} + DEBT^{Acq,3d-party}$	$DEBT_0^{Tgt}$	0	$DEBT_1^B,3d-party$
i/c debt	$DEBT_0^{B,i/c}$	$DEBT_1^{B,i/c} = DEBT_0^{B,i/c} + DEBT^{CT}$	0	0	$DEBT_1^{B,i/c}$
Equity	$EQTY_0^B$	$EQTY_1^B = EQTY_0^B + EQTY_1^{Tgt}$	$EQTY_0^{Tgt}$	0	$EQTY_1^B$
Income statement					
EBITDA	$EBITDA_0^B$	$EBITDA_1^B = EBITDA_0^B$	$EBITDA_0^{Tgt}$	$EBITDA_1^{Tgt} = EBITDA_0^{Tgt}$	$EBITDA_1 = EBITDA_1^B + EBITDA_1^{Tgt}$
EBIT	$EBIT_0^B$	$EBIT_1^B = EBIT_0^B$	$EBIT_0^{Tgt}$	$EBIT_1^{Tgt} = EBIT_0^{Tgt}$	$EBIT_1 = EBIT_1^B + EBIT_1^{Tgt}$
3d-party interest expense	$INTX_0^{B,3d-party}$	$INTX_1^{B,3d-party} = INTX_0^{B,3d-party} + INTX^{Acq,3d-party}$	$INTX_0^{Tgt,3d-party}$	0	$INTX_1^{B,3d-party}$
i/c interest expense	$INTX_0^{B,i/c}$	$INTX_1^{B,i/c} = INTX_0^{B,i/c} + INTX^{CT}$	0	0	$INTX_1^{B,i/c}$

Notes:

- ▶ Target balance sheet (prior to acquisition) is assumed to be re-evaluated at FMV;
- ▶ Target Goodwill is the plug variable which balances the post-acquisition consolidated balance sheet;
- ▶ Transaction costs are capitalized and amortized over the life of the acquired asset. Part of the cost may be deductible after the acquisition (and may reduce respectively the Borrower's equity);
- ▶ Sources of funds increase debt/equity and reduce cash and create an unbalance equal to $PRICE^{Tgt}$. The uses of funds reduce debt and equity and increase goodwill and other assets to restore the balance on consolidated basis;
- ▶ The $DEBT^{CT}$ and $EQTY_1^{Tgt}$ are estimated based on the results of debt capacity analysis;
- ▶ The Target first-year EBIT and EBITDA and the Covered Transaction first-year interest expense must be adjusted for the partial year.

F.2 Investment cash flow model

The analysis of an investment transaction is typically performed based on the cash flow model for the acquisition target provided by the model. The cash flow model usually includes the following metrics¹⁵:

1. Acquisition price of the target
2. EBITDA – this is a base for the acquired target valuation;
3. Third-party debt issuance and repayment schedule;
4. Interest expense on the third-party debt;
5. Depreciation and amortization (**D&A**) expense for the target;
6. Capital expenditure (**Capex**) expense for the target;
7. Free cash flow estimated for the target;
8. Dividend distribution from the target to the borrower.

The provided cash flow model must be consolidated with the financial metrics of the Borrower to produce consolidated financial metrics used in the credit rating analysis and debt capacity assessment. Conceptually the consolidation is performed as follows:

- ▶ EBITDA is pro-rated by the percentage share of the Borrower ownership in the target. The pro-rated EBITDA is adjusted then by the costs at the Borrower's level (which may include management and other fees);
- ▶ Third-party debt and interest expense are pro-rated by percentage share of the Borrower ownership in the target;
- ▶ Equity investment in the target equals pro-rated acquisition price minus pro-rated third-party debt issued for acquisition purposes¹⁶.
- ▶ At the Borrower's level the equity investment is divided into the shareholder loan and equity capital provided to the Borrower. The objective of the debt capacity assessment is to determine the quantum of the shareholder loan and equity, which is supported by the transfer pricing analysis;
- ▶ The intercompany interest expense is determined based on the quantum of the shareholder loan and the interest benchmarking (**IRB**) analysis.
- ▶ The common shares at the Borrower's level are equal to the difference between the Equity investment in the target and the quantum of the shareholder loan;
- ▶ The initial retained earnings as of the acquisition date are set to zero. The change in the retained earnings at the Borrower's level are estimated based on the net income at the target level and dividend distributions made by the Borrower. Note that in general the dividend distributions made by the Borrower may exceed the net income generated by the target. The cash flow for the dividend distributions may be generated for example by additional debt issuance by the target.¹⁷ In this case the total equity may decrease over time due to negative changes in the retained earnings.

¹⁵ The modelling steps below assume that the Borrower is a newly formed entity that was created for the purpose of target acquisition. If the Borrower is an existing holding company and the acquired target is added to the investment portfolio of the Borrower, then some of steps of the Borrower and the acquired target consolidation will be described differently.

¹⁶ Note that third-party debt is issued both for acquisition and operating purposes. Typically, term loans are issued for acquisition purposes and revolving facilities are issued for working capital and CapEx financing purposes.

¹⁷ In some cases, the target draws additional amounts from the third-party Revolving facility specifically for the purpose of dividend distributions. The dividend issue can be interpreted in the case as the leverage distribution made by the Borrower. In the leveraged distribution transaction, the equity investment in the target is replaced with the issuance of new debt.

The model for the Borrower's financial metrics is presented schematically on the diagram below.

6.1.1 Private equity

In some cases, the cash flow model is not provided by the client. In this case the cash flow model is derived from the provided financials of the acquired target. The financial statements of the target operating / holding companies must be provided. A typical structure of a cash flow model is illustrated below.

Metric	Target	Borrower
Funds from operations (FFO)		
EBITDA	EBITDA ^{Tgt}	
Interest expense	INTX ^{Tgt}	
Income tax	TAX ^{Tgt}	
Change in WC	Δ WC ???	
Financing cash flows (FCF)		
Debt Draws	+ Δ Debt ^{Tgt}	
Debt Repayments	- Δ Debt ^{Tgt}	
Investment cash flows (CFI)		
Capex + construction in progress (CIP)	CAPEX	
Investment income	FCF + CFF = EBITDA ^{Tgt} - INTX ^{Tgt} - TAX ^{Tgt} + Net Δ Debt ^{Tgt} - CAPEX - Δ WC	INV INCOME
Intercompany interest expense		INTX ^{i/c}
Income taxes		TAX
Distributions		DIV
Change in retained earnings		Δ RE

Note that EBITDA can be interpreted as a proxy for funds from operations (**FFO**); EBITDA - ΔWC can be interpreted as a proxy for the cash flows from operations (**CFO**); EBITDA – interest expense – ΔWC can be interpreted as the proxy for the free cash flows (**FCF**).

The following assumptions must be confirmed when estimating the cash flow model.

1. Debt draw / repayment schedule at the Target level;
2. Interest rates applicable to the Target;
3. Capex schedule for the Target operating companies;
4. The dividends paid by the Target based on the available cash flow;
5. Management and other fees paid by the Borrower;
6. Taxes paid by the Borrower;
7. Distributions made by the Borrower to the Fund.

6.1.2 Renewable energy

An illustrative example of a cash flow model used for CRA/DCA analysis of an investment in a renewable energy project is provided below. Similar to the acquisition transaction, analysis of an investment transaction starts with the review of the 'Sources of Funds' and 'Uses of Funds' tables.

Sources of Funds at Borrower level

Sources of Funds (Borrower)	Notation
i/c acquisition funds provided by parent / financing affiliate	$PRICE^{Proj,B}$
i/c debt from Parent / financing affiliate (shareholder loan)	$DEBT^{CT}$
i/c equity from Parent / financing affiliate	$EQTY_1^B$

Sources of Funds at Blocker level

Sources of Funds (Blocker)	Notation	Share
3d party debt	$DEBT^{Inv, 3d-party}$	$x\%^D$
Equity contribution from the Borrower	$EQTY^{Proj, B} = PRICE^{Proj,B}$	$x\%^B$
Equity from 3d-party investors	$EQTY^{3d-party}$	$x\%^{3d-party\ eqty}$
Tax equity from 3d-party investors	$EQTY^{tax}$	$x\%^{tax\ eqty}$
Acquisition price	$PRICE^{Proj}$	100%

The sources of funds are presented at the Borrower and at the Blocker levels. The Borrower receives the capital from the parent Fund and uses the capital to purchase an equity share in the Blocker. Blocker uses multiple sources of capital including borrowing from Bank, tax equity and non-tax equity from the Borrower and other investors.¹⁸

The funds are used for multiple purposes including development costs, transaction and financing costs, and other. The 'Uses of Funds' exhibit is typically not used directly in the analysis. The detailed uses of funds are provided as part of the investor cash flow model.

An illustrative example of a cash flow model of the Blocker, consolidated with the Borrower's financial metric, is provided below.

Metric	Project	Blocker	Borrower
EBITDA	$EBITDA^{Proj}$	$CFADS^{Block}$	$CFADS^B$
3d-party debt	$DEBT^{Proj}$	$DEBT^{Block} = DEBT^{Proj} + DEBT^{Inv,3d-party}$	$x\%^B * DEBT^{Block}$
i/c debt	0	0	$DEBT^{CT}$
3d-party interest expense	$INTX^{Proj}$	$INTX^{Block} = INTX^{Proj} + INTX^{Inv,3d-party}$	$x\%^B * INTX^{Block}$
i/c interest expense	0	0	$INTX^{CT}$

¹⁸ Tax equity investors receive non-cash return in the form of investment tax credit (ITC) or depreciation & amortization (D&A) credits, which are used by investors to reduce their taxable income. Non-tax equity investors obtain standard cash distributions in return for providing capital financing.

Metric	Project	Blocker	Borrower
Equity	N/A	$EQTY^{Block} = EQTY^{Proj, B} + EQTY^{3d-party} + EQTY^{tax}$	$EQTY_1^B$

6.1.3 REITs

F.3 Other models

F.3.1 Loss utilization

Schematically, the impact of the loss utilization transaction on the Borrower's balance sheet can be presented as follows. Loss utilization can be viewed as a combination of two transactions: (i) debt issuance by the borrower; and (ii) preferred shares acquisition by the borrower. The two transactions on the balance sheet are presented schematically as follows:

Financial metric	Debt issuance	Acquisition of preferred shares	Total
Cash	+100	-100	0
Investments		+100	+100
Debt	+100		+100

The direct impact of the financial structure on the borrower's financial statements is presented on the diagram below.

Change in borrower's financial statements			
Balance Sheet			
Assets			
.....			
Investments in related parties	+D	Acquisition of preferred shares	
Liabilities			
.....			
Debt to related parties	+D	New intercompany debt	
<hr/>			
Income Statement			
.....			
Intercompany interest expense	- i x D	Interest expense on new intercompany debt	



Note that change in the interest expense and dividends has an impact on projected cash and retained earnings.

F.3.2 Leveraged distribution

Schematically, the impact of the loss utilization transaction on the Borrower's balance sheet can be presented as follows. Loss utilization can be viewed as a combination of two transactions: (i) debt issuance by the borrower; and (ii) leveraged distribution made by the borrower. The two transactions on the balance sheet are presented schematically as follows:

Financial metric	Debt issuance	Leveraged distribution	Total
Cash	+100	-100	0
Debt	+100		+100
Equity		-100	-100

The direct impact of the financial structure on the borrower's financial statements is presented on the diagram below.