STANDARD & POOR'S

Sovereign Ratings

Business Development Bank of Canada

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CREDIT RATING

	AAA/Stable/A-1+

Outstanding Rating(s)

Counterparty Credit	AAA/Stable/A-1+

Credit Rating History

Mar. 11, 2003	AAA/A-1+

Sovereign Rating

Canada	AAA/Stable/A-1+

Related Entities

Canada

Counterparty Credit	AAA/Stable/A-1+
Senior unsecured	AAA

Bank of Canada

Counterparty Credit	AAA/Stable/A-1+

Canada Mortgage and Housing Corporation

Counterparty Credit *Local currency*	AAA/Stable/A-1+
Counterparty Credit *Foreign currency*	AAA/Stable

Canadian Wheat Board

Counterparty Credit	AAA/Negative

Export Development Canada

Farm Credit Canada

MILIT-AIR Inc.

Major Rating Factors

Strengths:

- Status as an agent Crown Corporation (an agent of Her Majesty in right of Canada)
- 100% government ownership
- The provision that its debt constitutes a direct obligation of the Government of Canada (AAA/Stable/A-1+) and is a charge on, and payable out of, the central government's Consolidated Revenue Fund
- Stable track record of financial self-sustainability on core lending business
- Good capitalization

Weaknesses:

- High-risk nature of mandate focus on small and medium-size enterprises (SMEs), including subordinate financing investments and venture capital equity investments

Rationale

The ratings on Business Development Bank of Canada (BDC) reflect:

- Its status as an agent Crown Corporation (an agent of Her Majesty in right of Canada);
- Its ownership by the Government of Canada (Canada; AAA/Stable/A-1+); and
- The provision that BDC's debt constitutes a direct obligation of the government and is a charge on and payable out of its Consolidated Revenue Fund (CRF).

Although debt is normally serviced from BDC's own resources, its obligations are full-faith and credit obligations of Canada, with timeliness of debt service assured by access to the CRF. Because of this, the ratings on BDC are equalized with those on its owner.

Outlook

The stable outlook on BDC mirrors that on Canada, and reflects the expectation of Standard & Poor's Ratings Services that BDC will continue to play an important role in Canadian public policy.

Profile

BDC is a Crown Corporation that was established by Canada in 1974 as the Federal Business Development Bank (FBDB). It is the successor to the Industrial Development Bank (IDB), which was created in 1944 as an arm of the Bank of Canada, with the Bank of Canada's governor as IDB's CEO. The IDB focused on the promotion of manufacturing enterprises. The IDB's mandate grew through the years, and the organization was already providing management consulting to small enterprises when it was succeeded by the stand-alone FBDB (independent of the Bank of Canada). The mandate expansion continued with the FBDB providing equity financing to small businesses in the 1980s. The FBDB became BDC in 1995 with a still broader mandate, including special attention to exporting and high technology businesses. Currently, BDC's core objective is "to promote and assist in the establishment and development of business enterprises in Canada, especially small and medium-size businesses, by providing a wide range of lending, investment, and consulting services complementary to those of commercial financial institutions."

BDC provides five key services to support Canadian entrepreneurship:

- Long-term loan financing
- Subordinate financing
- Venture capital
- Consulting
- Connex

The first category, traditional long-term loans to support business growth, start-ups, innovation, and equipment modernization, made up 79% (net of allowance for credit losses) of total assets in fiscal 2006 (ended March 31), and the vast majority of clients served.

The second category, subordinated (quasi-equity) loans (also known as “mezzanine financing” and offered to more mature businesses judged to have high growth potential), made up only 0.9% of total assets in fiscal 2006. All such financings are entered on a 50-50 basis with the Caisse de dépot et placement du Québec (AAA/Stable/A-1+), as a partnership managed by BDC.

The first and second categories together accounted for 90% of total revenue in fiscal 2006.

The third category, venture capital (equity) investments (VC investments), focuses on investing in early-stage and fast-growing companies in life sciences and information and communication technologies. Such investments made up 4% of total assets and accounted for 5% of total revenue in fiscal 2006. This segment has existed for more than 20 years, but began expanding in 1995 as part of a government policy directive. Despite the small size of BDC’s VC investments as a share of total assets, BDC is one of the largest investors in the Canadian VC market, with commitments to 193 clients at year-end fiscal 2006.

The fourth category includes a range of consulting services designed to support the innovation, productivity, and operational efficiency of Canadian SMEs. These services made up only 4% of revenue, and were used by less than 10% of BDC’s clients in fiscal 2006.

The fifth category represents BDC’s set of online services.

In fiscal 2006, BDC provided services to 26,000 Canadian entrepreneurs. There are more than 1 million SMEs with employees in Canada, of which more than 95% have fewer than 100 employees. These SMEs employ about 60% of the working population, and are responsible for almost half of Canada’s economic activity.

BDC’s service provision, although ultimately monitored by its headquarters, located in the City of Montreal (A+/Stable/—), is highly localized. BDC maintains more than 85 branches and offices across Canada’s large and diverse landscape, and has a presence in all 10 provinces and two of the three territories. More than 95% of loan credit decisions are made locally.

As a Crown Corporation, BDC also engages in other federal policy initiatives in addition to its core mandate. Examples include environmental risk assessments stemming from the Canadian Environmental Assessment Act, and the Circle of Entrepreneurial Success, a loan program targeting economic development in aboriginal communities.

Governance And Relationship With Supporting Government

The Business Development Bank of Canada Act provides for a 15-member board, appointed on the advice of Canada, to oversee BDC’s operations and formulate policy. All board members have at least some private-sector experience, and no member is either a current member of federal parliament or provincial legislative assembly, or a civil servant.

The corporation is accountable to Parliament through the Minister of Industry. BDC's annual financial statements are presented to Parliament, typically about three months after fiscal year-end. As with other agent Crown Corporations, BDC must submit both five-year corporate strategic and borrowing in public debt markets plans to the Minister of Finance for approval. BDC is not subject to regulation by the Office of the Superintendent of Financial Institutions.

Like other Crown Corporations, such as Export Development Canada (EDC), BDC is subject to regular annual audits by the Auditor General of Canada (AG), as well as a regular Special Examination, also by the AG, at least once every five years, to verify that BDC maintains financial and management control and information systems and management practices that provide reasonable assurance that its assets are safeguarded and controlled; its financial, human, and physical resources are managed economically and efficiently; and its operations are carried out effectively. BDC's next Special Examination will be in fiscal 2009. In addition, and unlike EDC, BDC is also audited each year, jointly with the AG, by private-sector auditors.

In September 2005, a KPMG study examining the costs and benefits of consolidating the borrowing of Canadian federal Crown Corporations, commissioned by the federal government, was made public. This potential policy change is still under consideration. Although centralized federal government borrowing, if it were to occur, would mean considerable change to the funding side of BDC's operations, it would not be expected to mean any change to the credit quality of BDC's borrowings outstanding at the time; as such, a change would not be expected to imply weakening in Canada's support for any of BDC's financial obligations outstanding. If any significant changes to BDC's funding framework were to be made, implementation would not be expected before fiscal 2008 at the earliest.

Asset Quality

Asset growth continued in fiscal 2006, led overwhelmingly by 9% growth in BDC's loan portfolio. Loans increased at the same rate in fiscal 2005, slightly slower than in the preceding three years, but well within the range of annual growth figures for the past 10 years. The credit quality of the loan portfolio improved slightly in fiscal 2006, with impaired loans at 3.5% of the total, slightly lower than the 3.9% experience of fiscal 2005. Loan quality, by this measure, has gradually but steadily improved since fiscal 1997. Reflecting this, both loan loss provisions (the flow) and loan loss reserves (the stock) were lower as a share of loans in both fiscals 2005 and 2006 than in the preceding five years. Loan loss reserves were 165% of impaired loans in fiscal 2006, their highest level since fiscal 1996.

BDC restores impaired loans to performing status once arrears have been cleared; it does not require that regular payments be established for an additional time period. Because of BDC's mandate to make large volumes of small loans to relatively high-risk SMEs (which are often enterprises lacking long track records or substantial tangible assets), BDC generally cannot benefit from ratings assessments by independent credit agencies. Specific provisions for impaired loans are based upon the default and recovery rates estimated by the corporation's historical loss experience and its assessment of the value of collateral. BDC generally tolerates a greater degree of risk than private-sector commercial lenders, and remains active during industry downturns.

BDC's loans were concentrated in manufacturing (36% of loans), wholesale and retail trade (23%), and tourism (12%) in fiscal 2006. Geographically, loans were outstanding in all 10 provinces, and also in the territories, although loans were highly concentrated in the Provinces of Quebec (A+/Stable/A-1+; 39%) and Ontario (AA/Stable/A-1+; 32%).

BDC's VC investments are concentrated in knowledge-based industries: communication and computer-related (38% of the directly invested VC portfolio), biotechnology/medical/health (33%), and electronics (21%). In fiscal 2006, BDC changed to "fair value" valuation from its practice of writing down carrying values. The change in the fair value of VC investments in fiscal 2006, a reduction of C$28 million, was smaller than any of the annual write-downs since 2003, though still higher than in any other year since fiscal 1996. The Canadian IPO market and takeover activity have both been limited for several years, affecting BDC's return on VC investments.

BDC also has exposure to certain variable interest entities (VIEs) within the overall VC investment envelope, although its maximum exposure to loss related to these was only 0.3% of total assets in fiscal 2006. Within the same envelope, BDC has invested in seed funds, although such investments amounted to only 0.1% of total assets in fiscal 2006.

Funding And Asset-Liability Management

Like EDC and other Crown Corporations, BDC does not accept deposits. Rather, external financing for its core operations is obtained entirely through capital market borrowing (although since 1996, Canada has contributed C$685 million in new capital injections, specifically earmarked for VC investments, of which C$250 million was added in fiscal 2005). The corporation's borrowings constitute direct obligations of Canada, and are charges on and payable out of the CRF—it is primarily for this reason that the ratings on BDC are equalized with those on Canada.

BDC's borrowings include both short-term and long-term notes, as well as structured notes for which interest and/or principal at maturity is linked to fluctuations in equity indices, currency rates, swap rates and other market references. Other notes could be called before maturity, or have their maturity extended, upon exercise of call or extension options by BDC or note holders.

BDC uses derivative instruments to manage its exposure to interest-rate, exchange-rate, and equity market risks. Derivatives hedging ensures that essentially all borrowings, post-hedge, represent Canadian dollar exposure at either fixed or floating rates. All of BDC's loans are denominated in Canadian dollars. For the past eight years, most of BDC's customers have chosen floating-rate loans, and BDC has consequently funded these assets with floating-rate exposure. In fiscal 2006, demand for BDC's fixed-rate loans began to rebound, resulting in an increase in BDC's fixed-rate funding.

BDC has a well-developed risk management system. Credit risk exposure to the counterparties in its derivatives transactions is managed via policies such as minimum counterparty credit rating requirements ('A-' or higher) and International Swaps and Derivatives Association Master Agreements including exposure netting provisions and Credit Support Annexes, which require collateral posting past certain exposure thresholds.

BDC's liquidity is bolstered by a well-established (and 'A-1+'-rated) CP program; holdings of cash and marketable securities (9% of total assets in fiscal 2006); an aggregate overdraft facility of C$75 million (0.7% of total assets, unused as of year-end 2006); and a line of credit of C$50 million (0.5% of total assets, unused in fiscal 2006). Development-related assets (in BDC's case loans, including subordinate financing investments, and VC investments) represented 84% of total assets in fiscal 2006, as in the previous year, with cash and marketable securities, along with derivative-related assets, making up most of the remainder.

Profitability

The net interest margin (on loans) was 4.4% of average assets in fiscal 2006, unchanged from the previous year. This margin has been slowly but steadily declining since fiscal 2002, although the cumulative decline is still only 0.4%. On the other hand, noninterest expense exceeded noninterest income by 1.8% of average assets in fiscal 2006, improved from a loss of 2.1% the previous year. This improvement was primarily thanks to VC investments. Although they still recorded a loss of C$13 million, that was substantially smaller than in any of the previous five years (the largest of which was C$59 million in fiscal 2003). Losses on consulting services remained in the C$3 million-C$4 million range in fiscal 2006. The cross-subsidy to the latter business line remains very minor, at less than 1% of total revenue. Losses on the nonloan business lines, as a share of average assets, have been gradually decreasing since 2002.

Putting this together, net operating income before loss provisions amounted to 2.6% of average assets in fiscal 2006, slightly higher than the 2.4% result in the preceding year but well within the bounds of recent experience. Overall, return on assets was 1.4% in fiscal 2006, slightly higher than the previous year's 1.2% and the strongest of the past five years. The same was true of return on average total equity, which rose to 8.5% in fiscal 2006.

Loss experience on VC investments has not altered the commitment of BDC, or that of Canada, to continuing to assist this sector. In fiscal 2005, Canada evinced its commitment by injecting an additional C$250 million of share capital into BDC, earmarked for direct VC investments and investments in specialized, third-party VC investment funds.

BDC's return goal is to "generate a return on common equity at least equal to the government's average long-term cost of funds and be able to withstand unfavorable economic circumstances without requiring government funding." With net income of C$138 million and common equity of C$836 million, this return measure amounted to 17% in fiscal 2006, well above long-term Canada bond yields, which averaged 4.3% in the same period. BDC's earnings are not subject to income tax.

Capital And Contingent Liabilities

BDC maintains defined benefit pension plans for eligible employees, including the main, registered pension plan (RPP), the supplemental plan, and other plans. Employer and employee contributions to the RPP were suspended from 1994 and 1997, respectively, until 2005 due to funding surpluses. During fiscal 2006, a decrease in the applicable discount rate led the RPP to an actuarial deficit, and the reintroduction of contributions. The aggregate funding deficiency for all three categories (RPP, supplemental, and other), which is both carried explicitly on BDC's balance sheet and detailed in the notes to its financial statements, amounts to a manageable 2%-11% of shareholder's equity, depending on the measure used.

Some BDC pensioners have launched a class-action recourse, for surplus amounts and reimbursement of certain expenses in the pension plans. BDC believes it has a strong defense against these claims, but it is too early to predict the outcome.

In the ordinary course of business, BDC enters many contracts containing indemnification provisions. Although in many cases there are no predetermined amounts or limits included in these provisions, and the occurrence of contingent events that would trigger payment under them is difficult to predict, BDC has not historically made any significant payments under these indemnities.

BDC is well capitalized. Total shareholder's equity amounted to C$1.7 billion in fiscal 2006, or 16% of total assets, slightly below 17% in fiscal 2005. This slight decline is due to growth in assets slightly outpacing growth in retained earnings.

BDC's debt and contingent liability is limited by legislation to 12x shareholders' equity. At fiscal year-end 2006, this ratio stood at 4.7x equity. Total equity amounted to 20% of net loans in fiscal 2006, and was 17% or higher in each of the past five years. Legislation also limits BDC's absolute level of equity. BDC's paid-in capital, contributed surplus, and proceeds that have been prescribed as equity must not at any time exceed C$1.5 billion. At fiscal year-end 2006, these amounts totaled C$1.1 billion.

BDC issues both preferred (22% of total shares) and common shares. Preferred shares have a fixed, preferential, and cumulative dividend, and are exchangeable for common shares. Dividend payouts on preferred shares vary by series. In fiscal 2006, BDC declared a C$8.7 million dividend on preferred shares and a C$7.8 million dividend on common shares. The total payout ratio was 12%, similar to the 11% payout ratio of the previous year, though substantially less than in fiscal 2003, when it reached 38%.

Business Development Bank of Canada—Financial Statistics

	Year ended March 31				
(Mil. C$)	*2006*	*2005*	*2004*	*2003*	*2002*
Assets	10,311.4	9,445.2	8,809.2	7,791.4	6,897.2
% change	9.2	7.2	13.1	13.0	10.8
Loans (net)	8,273.8	7,582.8	6,977.5	6,288.6	5,669.5
% change	9.1	8.7	11.0	10.9	12.2
Total equity	1,691.3	1,569.6	1,218.5	1,170.0	960.3
% change	7.8	28.8	4.1	21.8	4.0
Revenues	523.7	464.1	448.3	389.3	367.5
% change	12.8	3.5	15.1	5.9	(9.1)
Non-interest expense	270.2	249.0	234.4	209.4	199.8
% change	8.5	6.2	11.9	4.8	1.7
Net operating income before loss provisions*	253.5	215.1	213.9	179.9	167.7
% change	17.8	0.6	18.9	7.3	(19.2)
Loss provisions (LP)	115.3	101.6	154.8	148.0	113.9
% change	13.5	(34.3)	4.5	29.9	(4.5)
Net income	138.2	113.5	59.1	31.9	53.7
% change	21.8	92.0	85.4	(40.7)	(39.2)
Profitability (%)					
Revenues/average assets	5.3	5.1	5.4	5.3	5.6
Net interest income/average assets	4.4	4.4	4.6	4.6	4.8
Noninterest income/average assets	0.9	0.7	0.8	0.7	0.8
Noninterest expense/average assets	2.7	2.7	2.8	2.9	3.0
Net operating income before LP/average assets	2.6	2.4	2.6	2.4	2.6

Business Development Bank of Canada—Financial Statistics (cont.'d)

	Year ended March 31				
(Mil. C$)	***2006***	***2005***	***2004***	***2003***	***2002***
LP/average assets	1.2	1.1	1.9	2.0	1.7
Net income/average assets (ROA)	1.4	1.2	0.7	0.4	0.8
Net interest income/revenues	82.7	86.7	84.4	86.9	85.0
Noninterest income/revenues	17.3	13.3	15.6	13.1	15.0
Noninterest expense/revenues	51.6	53.7	52.3	53.8	54.4
Net operating income before LP/revenues	48.4	46.3	47.7	46.2	45.6
LP/revenues	22.0	21.9	34.5	38.0	31.0
Net income/revenues	26.4	24.5	13.2	8.2	14.6
Net income/average total equity (ROE)	8.5	8.1	5.0	3.0	5.7
Liquidity (%)					
Loans (net)/assets	80.2	80.3	79.2	80.7	82.2
Capital (%)					
Total equity/assets	16.4	16.6	13.8	15.0	13.9
Total equity/loans (net)	20.4	20.7	17.5	18.6	16.9
Dividend payout ratio¶	11.9	10.9	18.1	38.2	31.1
Asset quality (%)					
Loan loss provisions/average loan portfolio (gross)	1.0	0.7	1.7	1.5	1.7
Loan loss reserves/loan portfolio (gross)	5.7	6.0	6.5	6.4	6.6
Impaired loan portfolio/loan portfolio (gross)	3.5	3.9	4.3	4.2	4.4
Loan loss reserves/impaired loan portfolio	165.0	154.0	152.5	154.4	149.7

*Loss provisions include both loan loss provisions and change in unrealized depreciation of venture capital investments. ¶Aggregate dividend paid on preferred and common shares together.