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APPLICATION OF
THE MARKET APPROACH
IN VALUING A CANADIAN BUSINESS

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by

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TABLE OF CONTENTS

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1.   INTRODUCTION

My presentation has been prepared to assist my American *confrères* and *consœurs* in using the Market Approach to value a Canadian business. I should note at the outset that the Market Approach is adopted far less frequently in Canada than in the U.S., basically because (a) there are far fewer transactions in Canada — and even when there may appear to be a transaction that would help the valuator, much of the relevant data may not be available — and (b) Canada has substantially fewer listed companies than the U.S.: 1,297 (Toronto Stock Exchange) vs. 7,144 (NYSE, NASDAQ and AMEX combined).

Therefore, both as to the number of transactions and the number of companies whose shares are listed on the stock exchange, Canadian data pale compared with those of the U.S.

Nonetheless, there is a substantial amount of information that can be gleaned from Canadian sources to help in applying the Guideline Public Company Method, the Merger and Acquisition Method (or, alternatively, a method under the Income Approach). This paper proposes to provide the American business appraiser with various reference sources to assist him or her in performing the appraisal. Needless to say, the data that would be gathered from these sources cannot be a substitute for conducting appropriate interviews with knowledgeable persons and applying other procedures and due diligence that should in any event be applied.

2. GUIDELINE PUBLIC COMPANY METHOD

The market capitalization of a public company comprises (a) the market value of its common stock and (b) the market value of the company's interest-bearing debt, capital leases and preferred stock, net of cash or cash equivalents.

The business valuator therefore attempts to develop equity-based multiples as adjusted for valuation purposes. Alternatively, the valuator might apply a multiple developed from guideline companies on a debt-free basis (using the guideline company's Total Enterprise Value), the denominator being earnings before interest, taxes, depreciation and amortization ("EBITDA"), earnings before interest and taxes ("EBIT"), or revenue. These multiples or valuation ratios must be appropriately adjusted for valuation purposes before being applied to the subject's adjusted (normalized) EBITDA, EBIT and/or revenue for purposes of arriving at an indication of the Total Enterprise Value of the subject.

The invested-capital multiples are more often used in valuing controlling interests, whereas the common equity[1] multiples are more often used in valuing minority shareholdings. This is because the controlling shareholder can, of course, alter the capital structure of the company in a manner that can increase the value of the equity; the minority shareholder lacks such ability.

The valuator who is valuing a Canadian business enterprise using the Market Approach will search for Canadian guideline company data to help develop a valuation ratio to apply to the subject. The process typically involves first attempting to identify publicly-traded Canadian companies that can serve as guideline companies for use in valuing the subject.

Hopefully, there will be a sufficient population of Canadian publicly-traded guideline-company candidates to choose from; however, it may be necessary nonetheless to search for companies in the United States. A valuator would have to tread very carefully in the search for (and selection of) U.S. guideline companies, considering difference in markets, size, taxation laws, regulatory

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(1)   Computed on a totally diluted basis.

authorities (if appropriate), accounting conventions[2], management compensation/options issues, etc. It would generally be the exception to the rule that the U.S. guideline-company candidates will have similar enough investment characteristics to those of the Canadian subject to be meaningful for use in developing valuation ratios.

3.   MERGER AND ACQUISITION METHOD

As with the Guideline Public Company Method, the M&A Method involves a search for companies that would provide a reasonable basis for comparison to the investment characteristics of the subject. The M&A Method uses data from transactions involving the sale, merger or acquisition of entire businesses or significant interests therein. Here too, valuation ratios (multiples) are developed by the valuator based on transactional data that are meaningful. Guideline-company empirical data can also be found in transactions involving significant minority interests in publicly-traded or closely-held companies as well.

In applying the M&A Method, the business valuator will review mergers and acquisitions:

(a)   between public companies;

(b)   between a publicly-traded company and a closely-held corporation; and

(c)   if there are data available (which is not often the case), between closely-held companies.

As with the Guideline Public Company Method, the valuator will obtain and analyze relevant financial and operating data of the guideline companies, as available. In some cases, the valuator may have been involved professionally in a market transaction, or may have been given access to

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(2)   For example, last-in first-out inventory costing is generally not used in Canada.

the parties to the transaction or other knowledgeable persons. Canadian disclosure rules with respect to acquisitions rarely provide details with respect to the closely-held company that was taken over by the publicly-traded company. This is in contrast to the rule in the U.S.[3]

4.   DIRECT MARKET DATA METHOD

Unlike the traditional Guideline Public Company Method, which uses a small number of guideline companies, the Direct Market Data Method groups many transactions involving businesses of the same general type as the subject business. With a sufficient number of transactions in the group, the Direct Market Data Method defines the range of Price/Earnings and/or Price/Revenue ratios for all closely-held businesses of that type.

The transactions must relate to the same or similar industry as the subject and should be of sufficient quantity to provide a reasonably accurate representation of the market for "surrogate" companies similar to the subject.[4] In applying the Direct Market Data Method, the valuator must perform a search for transactions in significant interests in surrogate companies. This will include the criteria for screening and selecting such companies. Generally, the market data will be found in transactions of controlling interests in closely-held companies.

Under this method, price information regarding transactions involving surrogate companies is related to the appropriate underlying financial data of each surrogate company so as to compute the applicable valuation ratios. These ratios, which are derived from the market of surrogate companies and the comparison of appropriate valuation ratios to be applied to the subject company are used together in determining indications of value. When applying valuation ratios

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(3)   In the U.S., the SEC requires disclosure for all "material" transactions undertaken by publicly-traded companies on Form 8K. Quarterly Form 10Q and Annual Form 10K often disclose transactional data that can be of assistance in developing valuation pricing multiples.

(4)   Companies that provide a reasonable basis for comparison based on limited investment characteristics, such as price/gross sales and price/discretionary earnings, to the subject company being valued.

derived from the market of surrogate companies to the subject company, the valuator will consider whether the subject company is above or below average performance, and by approximately how much.

Several valuation ratios may be selected for application to the subject company, and several indications of value may result. The valuator considers the relative significance accorded to each of the indications of value used in arriving at his or her valuation opinion. In some cases, adjustments are necessary for dissimilarities with respect to minority, control, marketability or other factors that have not been dealt with earlier.

Because the business valuator will likely have not been involved in these open-market transactions, there will often not be sufficient data to develop a meaningful multiple.

5.   SOURCES OF INFORMATION

As in the U.S., numerous relevant data sources are offered through the Internet, as can be seen from the following partial list. However, data on closely-held companies are still most difficult, if at all possible, to obtain (unless the valuator or his or her firm was directly involved in the transaction). Hence, to the extent that meaningful valuation ratios can be developed from data gleaned from the public marketplace, guideline public company analysis can sometimes prove useful. Absent such data, it may simply be that the Market Approach would be applied using U.S. data (subject to a number of considerations to take into account the various differences between them) in particular:

- Size of the business (U.S. companies are generally much larger than Canadian companies);

- Markets;

- Geographic dispersion;

- Accounting policies;

- Nature of competition;

- Income tax considerations;

- Alternative rates of return (e.g., the 10-year government benchmark bond is 4.77% in Canada and 4.17% in the U.S.; the prime rate in Canada is currently 4.50% and 4.00% in the U.S.; the equity-risk premium is 3.17% in Canada and 5.28% in the U.S.);

- Cyclical and seasonal aspects (including, for example, weather);

- For labour-intensive industries, wage and union considerations.

The following sources of information are readily available to a valuator using the Market Approach (or the Income Approach, as applicable) to value a Canadian business:

- **Industry Information/Trends**

  - *Report on Business,* The Globe and Mail (monthly)

  - *Canadian Business*, Rogers Publishing (bi-weekly)

- **Public Company Information**

  - **News Services**

    - Canadian Newswire (www.newswire.ca)

    - Canadian Corporate News (www.cdn-news.com)

- ◆ **Directories**

  - ➢ Scott's Industrial Series (www.scotsinfo.com)

  - ➢ Dun & Bradstreet (www.dnb.ca)

    - ⌘ National Directory of Canadian Service

    - ⌘ Companies, Canadian Key Business Directory

- ◆ **Annual Reports**

  - ➢ Sedar-Electronic filings of Canadian public companies[5] (www.sedar.com)

  - ➢ Corporate Web sites

  - ➢ Micromedia Limited (commercial service www.mmltd.com)

- ◆ **Historical Stock Quotes**

  - ➢ BigCharts (www.canada.bigcharts.com)

- ◆ **Stock Prices**

  - ➢ www.yahoo.ca

- ◆ **Basic Stock Research**

  - ➢ Globeinvestor.com (www.globeinvestor.com)[6]

  - ➢ MSN Money (money.msn.ca) — *similar to moneycentral.msn.com*

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(5)   System for Electronic Document Analysis and Retrieval. Provides documents issued by publicly-traded companies for investors and regulators, which are available for download. These include prospectuses, annual reports, press releases and early-warning reports and press releases.

(6)   Globeinvestor.com provides quotations, press releases, financial data, financial ratios, charts as well as investing news.

- **Financial Press**

  - *Financial Post* (section of *National Post*, daily)

  - *Report on Business* (section of *The Globe and Mail*, daily)

- **Transactional Data**

  - Sedar Electronic filings of Canadian public companies (www.sedar.com) — *see above*

  - *Mergers & Acquisitions in Canada*[7] — Provides an overview of Canadian M&A activity as well as in-depth data for specific analysis. It includes, on a monthly basis, industry and transactional analysis, M&A trends and statistics as well as a detailed listing of the month's transactions. Information is available on the Internet: tdias@crosbieco.com or (416) 362-0020.

  - Dominion Bond Rating Service (www.dbrs.com)

  - Canadian Bond Rating Service (www.cbrs.com)

  - Strategis (www.strategis.ic.gc.ca)

- **Other**

  - Financial Post Investment Reports (www.fpmarkets.com)

  - Carlson (www.fin-info.com)

  - Quicken (www.quicken.ca)

  - *Stock Guide*, Stock Guide Publications, Toronto (monthly) —Provides data and ratios from companies listed on the Toronto Stock Exchange.

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(7)   Published by Crosbie & Company Inc., Toronto (monthly).

- **<u>Closely-Held Company Data</u>**

  - ◆ **Business Brokers Associations in Canada**

    - ➢ Ontario Business Brokers Association

    - ➢ Western Canada Business Brokers Association

    - ➢ Certified business Brokers, Royal LePage (Atlantic Canada) http://canadian.businessesforsale.com/canadian/professionalsDirectory/2281/brokerPage.aspx

- **<u>Canadian Valuation Information</u>**

  - ◆ The Canadian Institute of Chartered Business Valuators — (416) 204-3396 (www.businessvaluators.com)

    - ➢ *The Journal of Business Valuation* (biennial conference proceedings)

    - ➢ *Business Valuation Digest*

    - ➢ *Regional Conference Reports*

    - ➢ *Valuation Law Review*

- **<u>Articles, Periodicals and Books</u>**

  - ◆ Various web sites, including:

    - ➢ Wise, Blackman (www.wiseblackman.com)

  - ◆ S.P. Pratt, J.E. Fishman, R.M. Wise, *Guide to Canadian Business Valuations*, Carswell (Toronto: loose-leaf service)

- A.H.R. Davis and G.E. Pinches, *Canadian Financial Management,* fourth edition, Addison Wesley Longman (Toronto: 2002)

- *Recommended Accounting Practices for Real Estate Investment and Development Companies*, Canadian Institute of Public Real Estate Companies

- M.J. Robinson and D.F. Smith, *Canadian Capital Markets*, Toronto Stock Exchange and Western Business School, University of Western Ontario (London, Ont: 1993)

- *TSE Review*, Toronto Stock Exchange (monthly)

- *Bank of Canada Review*, Bank of Canada, Ottawa (monthly and annually), www.bankofcanada.ca

- *Canadian Corporate Financial Performance Survey*, Canadian Institute of Chartered Accountants (1994-1997)

- *Canadian Small Business Financial Performance Survey*, Canadian Institute of Chartered Accountants (1994-1997)

- *Canada Valuation Service*, Carswell (Toronto: loose-leaf service)

- *Canadian Small Business Performance: A Financial Survey*, CCH Canadian

- *Financial Survey of Canadian Business Performance*, CCH Canadian

- *Globe and Mail Report on Business/Canadian Company Handbook*, Globe and Mail Publications (1989 to 1997)

- *The Canadian Business Financing Handbook* (updated periodically; also in loose-leaf format in three binders) — This provides practical information, including sources of secondary market information, financial and economic charts, standard industrial classification, etc.

◆   Federated Press, publishers of business and legal information, Toronto, issues *Financial Intelligence,* which includes a newsletter entitled, *Financial Strategist*, which contains a broad array of current articles on financing, investment, mergers and acquisitions, corporate reorganizations, valuation issues, raising capital, risk assessments, securities laws, cross-border transactions, etc.

5.1   Financial Post DataGroup (www.financialpost.com)

The *FP Survey — Industrials,* published by Financial Post (www.financialpost.com), is a guide to all industrial companies publicly-traded in Canada. Its listing covers companies involved in manufacturing, real estate development, forestry, investment holding and financial management, as well as communications, transportation, banking, retailing and other service industries. It provides investment information on more than 3,000 manufacturing and service companies in Canada. Also listed are those companies that provide services to these areas as well as some prominent natural resource companies having industrial operations.

FP Survey — Industrials also includes a section containing a tabular summary of redemption announcements, rights offerings as well as purchase offers and exchanges. To assist with comparative analysis, in and between industries there is included a "Top Ten by Industry" section containing key financial ratios for the top companies in each of twenty-three Industry Groups under the Global Industry Classification Standard (GICS).[8] The GICS was developed by Standard & Poors and MSCI as the basis for reconfiguration of the TSE 300 to the S&P/TSX Composite Index. In addition, the DataGroup replaced the previous TSE 300 sub-indices with the new sub-indexes created by Standard & Poors and the TSX.

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(8)   Corporate surveys information is also available electronically through the online retrieval systems of Star Data Systems Inc.; ILX Systems; LEXIS-NEXIS; Bridge Information Systems and Infomart Limited.

Corporate Surveys information is also available electronically through the on-line retrieval systems of:

- Star Data Systems Inc.;

- ILX Systems;

- LEXIS-NEXIS;

- Bridge Information Systems; and

- Infomart Limited.

The listings in the *FP Survey – Industrials* contain, among other things:

- company profile;

- list of directors and officers;

- authorized and issued share capital

- majority shareholder (of more than 10% of voting stock);

- stock price range, along with volume, high, low and close for four calendar years (prices are blended prices from all Canadian exchanges on which the stock is listed);

- summary of capital stock changes;

- dividends paid on each security for the previous two calendar years;

- details of long-term debt;

- list of controlled subsidiaries;

- financial statistics, etc.

The financial data presented in the financial statistics tables are based upon use of specific criteria, thereby making the data consistent and comparable for all companies being covered. Items such as net income, current assets and total assets are self-explanatory. Other items are given specific definitions.

Financial Post DataGroup also offers its Investor Suite of Web-based financial products designed to meet both personal and corporate information needs. These are cross-referenced and updated on a daily basis:

- *FP New Issues —* A comprehensive, up-to-date overview of Canadian IPOs and New Issues;

- *FP Corporate Profiler* — News and in-depth research on all Canadian publicly-traded companies. It includes up to date corporate profiles on over 4,500 public companies, the latest news and analysis on corporations, industries and trends, three-year charts of stocks performance and access to in-depth research.

- *FP Corporate Analyzer* — Fundamental data items on over 1,400 Canadian companies, ready for immediate retrieval, screening and analysis.

- *FP Corporate Reports* — Historical, Investor and Industry Reports on Canada's top 900 publicly-traded companies with interactive charting capabilities.

- *FP Dividends* — Distributions of all Canadian and foreign inter-listed companies, trusts and mutual funds.

- *FP Corporate Connection* —allows quick access on CD-ROM to financial, operational and up to date contact information on over 4,000 companies. The data may be filtered by geographic area, industry type, assets, revenues, number of employees, etc.

5.2   Government Sources

5.2.1   *Industry Canada ("Performance Plus") (www.strategis.gc.ca)*

"Performance Plus" is an online performance benchmarking tool. It provides detailed financial and employment data on more than 600 business sectors across Canada, including more than 30 performance benchmarks to help small businesses determine how they measure up against their competitors. These "Small Business Profiles" are created from a sample of tax returns filed with the Canada Customs and Revenue Agency (CCRA) for both incorporated and unincorporated businesses operating in Canada. In summary, it assists valuators in determining where the subject stands as compared to the relevant industry average. The data are taken from incorporated businesses and provide an income statement, a balance sheet and supporting CCRA schedules. Unincorporated businesses, including professional practices, provide an income statement and other supporting documents. Each Profile provides statistics indicating the general performance and financial structure of all businesses within a given industry grouping and within a province. Each Small Business Profile is representative of all businesses operating within the specified industry within a province and earning between $30,000 and $5,000,000 in gross revenues for the reference year. Because businesses at the lower end of this revenue scale can exhibit very different financial characteristics from businesses at the higher end, each Profile contains financial data for the entire revenue range as well as various groupings within that range.

Details of Industry Canada's Small Business Profiles are given at www.strategis.gc.ca under "Performance Plus".

5.2.2 *Statistics Canada (www.statcan.ca)*

Financial Performance Indicators for Canadian Business — Volume 1 provides ratios[9] for medium- and large-sized firms (firms with revenues of $5,000,000 and over) and Volumes 2 and 3[10] provide financial ratios for small- and medium-sized firms (having revenues under $25,000,000).

There are fifteen ratios given. These measure profitability, solvency and operating efficiency for numerous industries (144 in the case of medium and large firms and 800 in the case of small and medium firms) in the incorporated business sector of the Canadian economy:

- Net profit margin;

- Pre-tax profit margin;

- Operating profit margin;

- Goss profit margin;

- Operating revenue/net operating assets;

- Return on net operating assets;

- Pre-tax profit/assets;

- Return on capital employed;

- Return on equity;

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(9)   Catalogue No. 61F0058XCB. Each industry is further broken down for annual revenue between $5,000,000 and $75,000,000 and for annual operating revenue over $75,000,000. The data are available for the national level only; there are no individual company data in the report.

(10)   Catalogue No. 61F0059XCB. Each industry is further broken down for annual revenue from $50,000 to $499,000, $500,000 to $4,900,000 and $5,000,000 to $25,000,000. The data are at the national level only; there are no individual company data in the report.

- Receivables turnover;

- Inventory turnover;

- Working capital;

- Debt/equity;

- Liabilities/assets; and

- Interest coverage.

The percentage distribution of firms, by profits, is shown for each industry. In addition, a "common-sized" balance sheet is provided for each industry, showing the distribution of assets, liabilities and shareholders equity as percentage of total assets. The distributions are based on the combined balance sheets of all firms in each industry and revenue size group. This allows the reader to compare the subject with the average for the industry. The industrial groups are based on the North American Industry Classification System Canada 1997.[11] The data are presented for the three most recent years.

For each financial ratio, the firms in the group are ranked from highest to lowest, or from best to worst. The typical or average firm is the median. The quartile data display the median ratio (50% position in the ranking) and the ratio for two other positions: (1) the ratio for the firm situated at the 25th percentile and (2) the ratio for the firm situated at the 75th percentile in the ranking of firms. Quartile data are available when the number of firms in the group has reached a sufficient amount. Otherwise, only median values are shown. The quartile presentation gives the user not only the average firm, but also the distribution of the firms within the group.

There are numerous surveys, reports, statistical, economic and industry data and useful indices available online at *www.statcan.ca* under the caption "Internet Publications".

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(11)   NAICS, Catalogue No. 12-501-XPE.

5.2.3 Source Data — Provincial Governments

In addition to the substantial data available from federal government sources, such as Industry Canada and Statistics Canada, the Canadian provinces provide useful statistical data. Some examples of the types of information available from Canadian provincial government sources are summarized below.

The Province of British Columbia publishes *A Guide to the BC Economy and Labour Market,* available at www.guidetobceconomy@workinfonet.bc.ca. The Province of British Columbia also publishes "BC Stats – Business and Economic Statistics", which includes "Small Business Profiles", which provides performance benchmarks for the financial planning of start-up and established small- and medium-sized businesses.[12] B.C.'s Profile of Small Business available at www.cse.gov.bc.ca/publicinfo/publications provides much data on small businesses and answers a number of questions about their role in British Columbia.

The Province of British Columbia, through B.C. Stats (the central statistical agency of B.C.), provides statistical products, services and expertise (www.bcstats.gov.bc.ca). This includes business and economic statistics, a small business profile, selected economic statistics, etc.

The Province of Ontario, through the Ministry of Finance, provides a host of economic and industry data (www.gov.on.ca). The Ministry of Enterprise, Opportunity and Innovation publish the *Ontario Business Report*, which among other things deals with issues affecting Ontario's business climate. It is published ten times a year and can be viewed on the Ministry's Web site at www.ontariocanada.com or can be subscribed to on a no-charge basis at www.ontariobusiness. program@eoi.gov.on.ca**.**

The Province of Alberta publishes *Economic Outlook*, which provides among things data from Alberta Finance as well as Statistics Canada. Economic trends are available at

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(12)   Small Business Profiles are available for Canada and all the provinces and territories at Industry Canada's Strategis site.

www.finance.gov.ab.ca. The Office of Budget & Management of Alberta Finance publishes *Economic Spotlight*.

The Province of Nova Scotia, Department of Finance — Statistics Agency, publishes data relating among other things to the retail and wholesale sectors, construction, imports and exports, information technology and so forth. Data are available at www.gov.ns.ca/finance/statistics/ agency.

6. THE NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM

Canada uses the North American Industry Classification System (NAICS), which replaces the Standard Industrial Classification (SIC) system. It was developed jointly by Canada, the U.S. and Mexico in order to provide a common statistical framework for economic analysis among the three countries.

The SIC was originally developed in the 1930s to classify establishments by the type of activity in which they are primarily engaged and to promote the comparability of establishment data describing various facets of the U.S. economy.

The SIC covers the entire field of economic activities by defining industries in accordance with the composition and structure of the economy. Over the years, it was revised periodically to reflect the economy's changing industry composition and organization. The Office of Management and Budget (OMB) last updated the SIC in 1987.

A March 31, 1993, Federal Register notice (pp. 16990-17004) announced OMB's intention to revise the SIC for 1997, the establishment of the Economic Classification Policy Committee (ECPC), and the process for revising the SIC.

The ECPC and Statistics Canada reviewed the existing structure of detailed "4-digit" industries in the 1987 U.S. SIC and the 1980 Canadian SIC for conformance to economic concepts.

Beginning in 1997, the SIC was replaced by the NAICS. The six-digit code is a made revision that not only provides for newer industries, but also reorganizes the cateogories on a production/process-oriented basis. SIC uses a mixture of production-based and market-based categories. The new NAICS system was developed jointly by the U.S. Census Bureau in co-operation with the U.S. Economic Classification Policy Committee, Statistics Canada and Mexico's Instituto nacional de estadística, geografía e informátics. This new, uniform, industry-wide classification system has been designed as the index for statistical reporting of all economic activities of the U.S., Canada and Mexico.

The longer code accommodates the larger number of sectors and allows more flexibility in designating sub-sectors. It also provides for additional detail not necessarily appropriate for all three NAICS countries. The international NAICS agreement fixes only the first five digits of the code. The sixth digit, where used, identifies subdivisions of NAICS industries that accommodate user needs in individual countries. Thus, 6-digit U.S. codes may differ from counterparts in Canada or Mexico, but at the 5-digit level they are standardized.

NAICS categories are constructed on a production/process-oriented basis. Like SIC, NAICS is a hierarchical system, but whereas SIC has only four digits, NAICS is a six-digit classification. The levels of detail are as follows:

XX	Industry Sector
XXX	Industry Sub-sector
XXXX	Industry Group
XXXXX	Industry
XXXXXX	Country-specific industry detail

In summary, the NAICS provides:

- a common code among the U.S., Canada and Mexico;

- compatibility with two-digit level of ISIC of the United Nations;

- more industries and distinctions;

- emerging high-tech industries and service industries included;

- new information industry; and

- new six-digit codes instead of four-digit as in SIC.

7. CONCLUSION

The foregoing information sources and related comments are provided to assist non-Canadian business valuators in valuing a Canadian business. Coupled with the data gleaned from these sources, the valuator may well have to conduct interviews, as appropriate, with industry experts, legal and accounting professionals, business brokers, business valuators, government officials, market participants and others who can provide relevant and objective information. Careful analysis, due diligence and judgment will be the final determinants of the quality of the valuator's opinion.