THE CANADIAN INSTITUTE

WINNING & FINANCING PRIVATE EQUITY TRANSACTIONS

THE SUTTON PLACE HOTEL, TORONTO, ONTARIO

MAY 8-9, 2008

PRICING AND VALUATION OF TARGET'S EQUITY

by

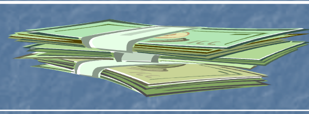
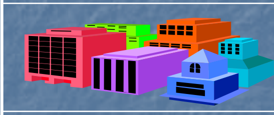
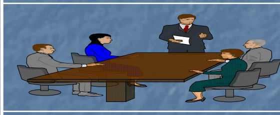
Richard M. Wise, FCA, FCBV, FASA, MCBA

Chartered Business Valuator

Wise, Blackman LLP

Business Valuation Advisors

COMPOSITION OF A BUSINESS ENTERPRISE

	Working Capital
	Other Tangible Assets
	Intangible Assets
	Intellectual Property

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THE BUSINESS ENTERPRISE EQUATION

VALUE OF BUSINESS ENTERPRISE

=

VALUE OF NET MONETARY ASSETS
+
VALUE OF TANGIBLE ASSETS
+
VALUE OF INTANGIBLE ASSETS

=

VALUE OF EQUITY
+
VALUE OF LONG-TERM DEBT

Value of Underlying Assets

Value of Invested Capital

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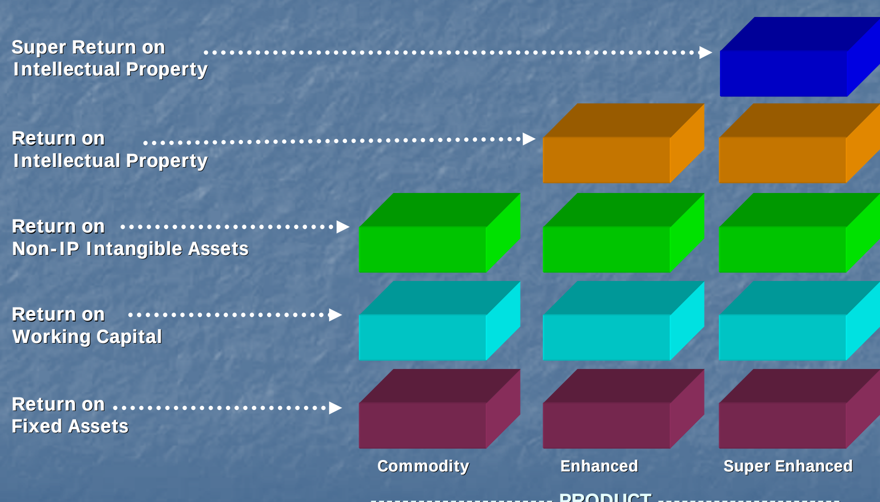
GENERAL ALLOCATION FORMULA

Monetary & Current Assets + Fixed Assets + Intellectual Property + Other Identifiable Intangible Assets + Goodwill	=	Short-Term Liabilities + Long-Term Debt + Shareholders' Equity

EXCESS RETURNS FROM INTELLECTUAL PROPERTY



THREE POSSIBLE COMPONENTS OF A TRANSACTION

1. Intrinsic Value ("Stand-Alone" Value) of Acquiree
2. Net Economic Value Created by Acquisition
3. Value of "Redundant" Assets

VALUATION ISSUES

At Entity Level:

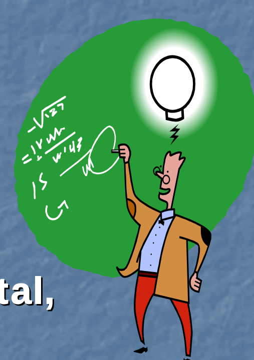
- Valuation approach
- Valuation methodology and techniques applied
- Adjustments to "normalize" reported results
- Capitalization rate (price/earnings multiple) to apply to maintainable earnings (net cash flow) of the business (i.e., cost of capital)

VALUATION ISSUES

- If “Discounted Cash Flow Method” used, reasonableness of:
  - a. projections and underlying assumptions <u>as well as</u>
  - b. <u>discount rate applied</u>
- If “Guideline Company Method” used, appropriateness and similarity of market comparables relied on
- Identification (and valuation) of “redundant” assets
- Effect of any cyclicality and/or seasonality on earnings and cash flows

VALUATION/PRICING CONSIDERATIONS

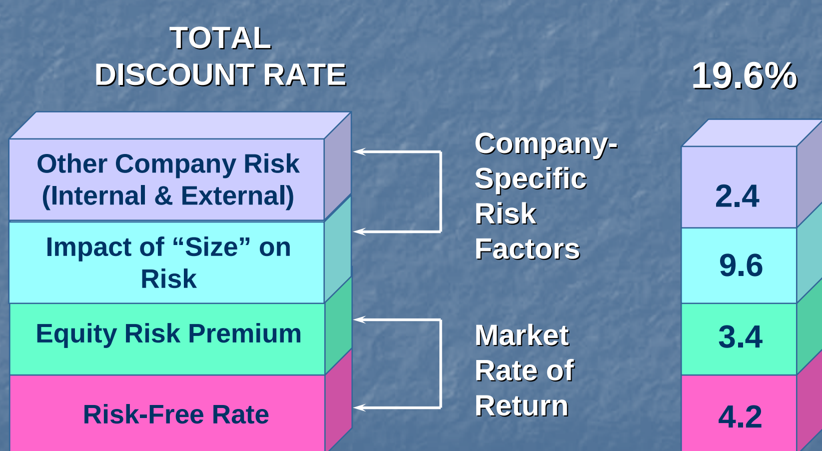
- Valuation formula components
  - Numerator (cash flow)
  - Denominator (cap rate, discount rate, cost of capital, i.e., rate of return)



RATE OF RETURN —
WEIGHTED AVERAGE COST OF CAPITAL

- Capital Structure
  - Comparable companies
- Cost-of-Equity Component
  - Build-Up Approach, or
  - Capital Asset Pricing Model
- Cost-of-Debt Component

DEVELOPMENT OF DISCOUNT RATE OR CAPIALIZATION RATE (RATE OF RETURN)
BUILD-UP METHOD



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VALUATION ISSUES

- Valuation of off-balance sheet items (e.g., valuable intangibles, including IP)
- Dependency on key person(s)

SYNERGY

"The increase in performance of the combined firm over what the two businesses are already expected or required to accomplish as independent, stand-alone businesses."

SPECIAL PURCHASER / STRATEGIC BUYER SYNERGIES

- Economies of scale
- Reduction / elimination of competition
- Assured source of supply
- Product identification
- Market share / tie-up
- Maximizing target's production capacity

POST-ACQUISITION SYNERGIES

Increase value of the combined business beyond the sum of its components, resulting from:

- increasing quantum of aggregate prospective discretionary cash flows
- reducing risk of either buyer, seller, or both
- creating growth opportunities and strategic advantage not otherwise available to either the buyer or seller.

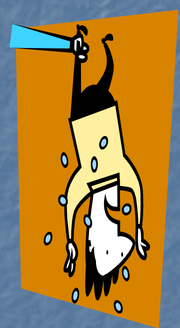
SPECIAL-PURCHASER/STRATEGIC BUYER SYNERGIES ("1 + 1= 3")

- **FINANCIAL**
  - Size and related lower financing costs
  - Leverage ability
  - Improved capital structure
- **OPERATING — TANGIBLE**
  - Economies of scale
  - Product diversification
  - Utilization of excess capacity
- **OPERATING — INTANGIBLE**
  - Assured source of supply
  - Gain in technology
  - Growth opportunities

ASSESSMENT OF SYNERGIES

- **QUANTUM OF SYNERGISTIC BENEFITS**
  - Forecast and analysis of increased cash flows, net of working capital and fixed-asset investments and related financing
  - Likelihood of achievement
  - Use best-case, most-likely-case and worse-case scenarios, including sensitivity analysis
- **TIMING OF SYNERGISTIC BENEFITS**
  - As forecasts go further into the future, there is more risk in meeting target; synergies in shorter term can be forecasted more reliably.

OVERPAYING FOR THE TARGET



- Paying total consideration that:
  - exceeds target's Fair Market Value
  - exceeds special-purchaser/strategic-buyer value of target
  - results in internal rate of return ("IRR") being less than purchaser's return on investment ("ROI")

PRICING THE TARGET

- Consequences of overpaying for target:
  - Dilution of purchaser's interest in a merger transaction
  - Impairment in value of purchaser's equity
  - Increase in purchaser's cost of capital
  - Reduction of purchaser's liquid and credit resources available for alternative investments (or reduction of debt)

PRICING THE TARGET
(CONT'D)

- Consequences of overpaying for target:
  - Impairment of purchaser's key financial ratios that may be subject to scrutiny by third parties
  - Possible decrease of credit availability
  - Possible shareholder litigation, e.g., oppression remedy or dissent remedy

AOL TIME WARNER INC.
YEAR ENDED DECEMBER 31, 2002
(Source: Audited financial statements)

Reduction in Carrying Value of	Billions (U.S.)
Goodwill (AOL)	$33.5
Cable segment	10.6
Music segment	0.6
Brands and trademarks at Music segment	0.9
Impairment charge (against operating income)	$45.5

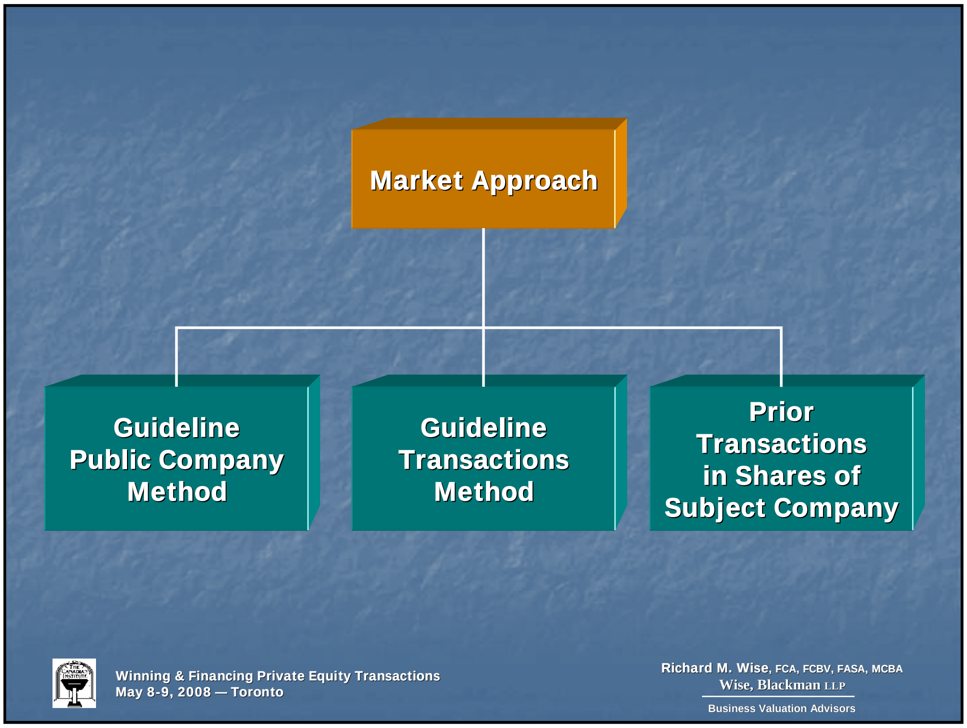
AOL MANAGEMENT'S EXPLANATION OF WRITE-DOWNS

The $33.489 billion charge at the AOL segment reflects AOL segment's lower than expected performance, including continued decline in online advertising market. The $10.550 billion charge at Cable segment reflects current market conditions in cable television industry, as evidenced by decline in stock prices of comparable cable television companies. The $1.499 billion charge at Music segment reflects declining valuations in music industry, primarily due to negative effects of piracy.

The impairment charges are non-cash in nature and do not affect the company's liquidity … .

HOW TO AVOID OVERPAYING FOR TARGET

1. Apply alternative valuation approaches, methods and techniques
2. Corroborate earnings or cash flow based valuation with dual capitalization methodology, where reasonableness of implied intangible value can be tested
3. Determine stand-alone Fair Market Value of target (absent special purchaser / strategic buyer considerations) to check reasonableness of implied transaction premium


Market Approach
Guideline
Public Company
Method
Guideline
Transactions
Method
Prior
Transactions
in Shares of
Subject Company
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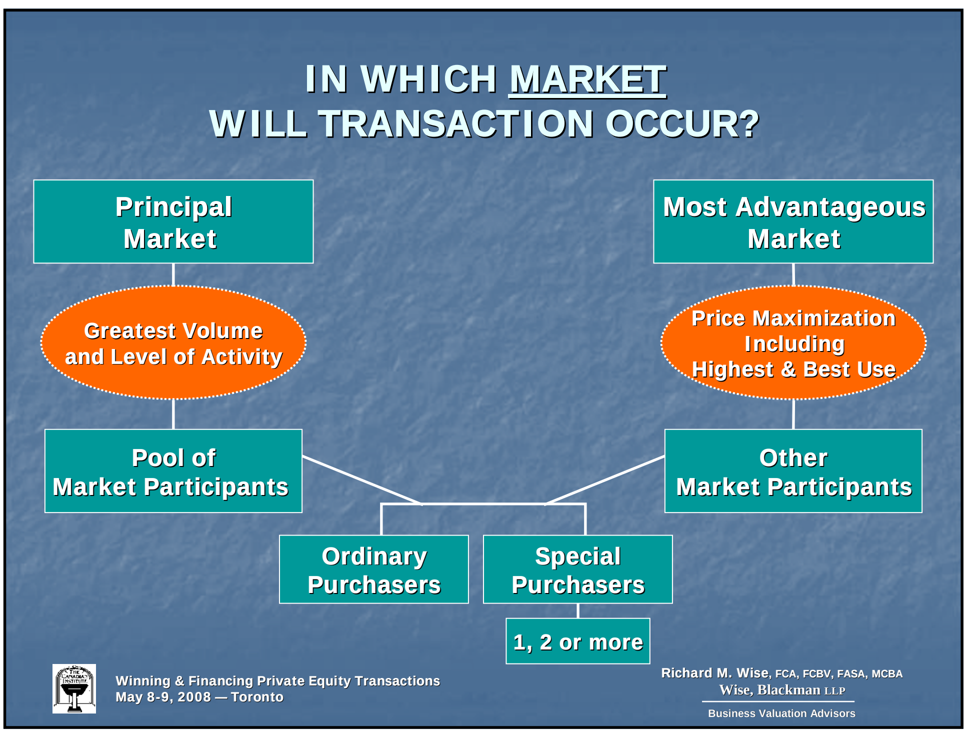
IN WHICH MARKET
WILL TRANSACTION OCCUR?
Principal
Market
Most Advantageous
Market
Greatest Volume
and Level of Activity
Price Maximization
Including
Highest & Best Use
Pool of
Market Participants
Other
Market Participants
Ordinary
Purchasers
Special
Purchasers
1, 2 or more
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EXAMPLES OF MARKETS

- ***Example 1*:**

  Parking lot operation on ABC land

  vs

  Apartment building / condo development on ABC land

- ***Example 2:***

  Summer camp on XYZ land

  vs

  Condos or resort hotel on XYZ land

NOTE: See, for example, FAS 157 ("principal" vs "most advantageous" market).

EXAMPLES OF MARKETS
(CONT'D)

THE MARKET FOR

Control of publicly-traded companies
and
Control of closely-held companies

vs

THE MARKET FOR

Minority interests in publicly-traded companies
and
Minority interests in closely-held companies

MARKET, PRICES AND INFORMATION AVAILABLE

Public Companies	Private Companies
Organized market	Not organized
Regulated market	Not regulated*
Liquid market	Illiquid*
Trading prices/ patterns (active vs thin)	No frequent share transactions

* May be affected by Shareholders' Agreements.

MARKET, PRICES AND INFORMATION AVAILABLE
(CONT'D)

Public Companies	Private Companies
Takeover bids influenced by stock market price	No reference price
Company's own stock price may influence offer/bid	No quoted market/liquid price
Required information disclosure, 10-Qs, etc.	Limited information disclosure

MARKET, PRICES AND INFORMATION AVAILABLE
(CONT'D)

Public Companies

- Disclosure of information on takeover
- Investment analysts' reports
- Competing bids may surface due to publicity

Private Companies

- Takeover information not publicly available
- No published reports No competing bids
- Shareholders generally active; have much information regarding plans and policy

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MARKET, PRICES AND INFORMATION AVAILABLE
(CONT'D)

Public Companies

- Shareholders not active; have little information re business plans, strategy, etc.
- Stock market investors do not formulate policy
- In takeover bid, purchaser relies on filings, analyses, etc. (after, will do pre-closing due-diligence)

Private Companies

- Shareholders generally active; have much information regarding plans and policy
- Investors consider potential strategic benefits
- In takeover, purchaser has lots of information regarding target

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IF RELYING ON OTHER ("GUIDELINE") MARKET TRANSACTIONAL DATA, YOU MUST KNOW ABOUT

- Seller's motives
- Buyer's motives
- Special/strategic buyers vs financial/ordinary buyers
- Redundant assets, if any, included in price
- Tax structuring
- Other "consideration" included in/excluded from transaction "price":
  - Consulting agreement with seller
  - Non-compete covenant with vendor
  - Earn-out provision

NON-COMPETE AGREEMENT

- Project earnings of subject business under each of two scenarios:
  1. Without competition
  2. With competition
- Establish financial projection period
- Project lost sales revenues absent non-competition covenant

NON-COMPETE AGREEMENT
(CONT'D)

- Project sales with a non-competition covenant in place
- Project costs of implementing appropriate counter-measures (such as increased advertising, price reductions, etc.) absent covenant
- Determine capitalization multiples to apply to earnings of business under each scenario, considering respective risk profiles

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NON-COMPETE AGREEMENT
(CONT'D)

- Seller's (i.e., covenanter's) business expertise to compete
- Seller's intent to compete
- Seller's economic resources
- Potential damage to buyer posed by seller's competition
- Seller's contacts and relationships with customers, suppliers and others in the business

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SELLER’S PROJECTIONS

- Assumptions go to heart of projections
- Often optimistic; can be unrealistic
- Assumptions must be scrutinized and challenged
- Perform sensitivity analyses

SELLER’S PROJECTIONS
(CONT’D)

Are assumptions realistic and consistent with:

- General economic environment and entity’s economic circumstances?
- Existing market information?
- Entity’s plans, including management’s expectations of outcome of specific objectives and strategies?

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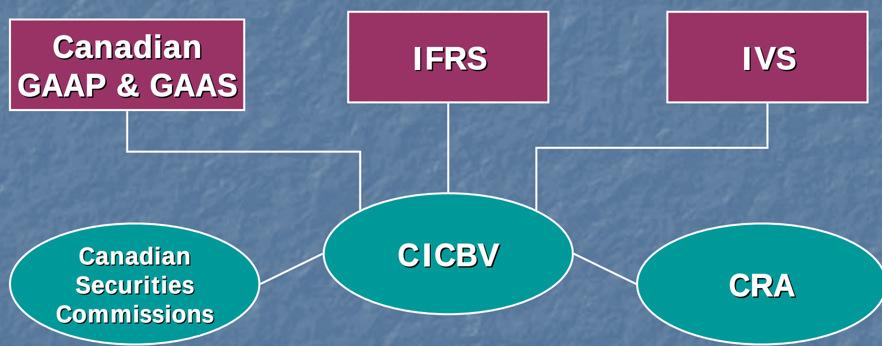
STANDARDS AFFECTING BUSINESS VALUATION



INTERNATIONAL VALUATION STANDARDS COMMITTEE (IVSC)

Objectives of IVSC:

- To formulate and publish, in public interest, valuation Standards for property valuation and to promote their worldwide acceptance; and
- To harmonize Standards among world's States and identify and disclose differences in statements and/or applications of Standards as they occur.

FINANCIAL REPORTING

- Canadian Accounting Standards Board adopt International Financial Reporting Standards ("IFRS") by 2011
- No longer harmonizing Canadian GAAP with U.S. GAAP

INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS")

OBJECTIVES FOR "FAIR VALUE"

a. Establish simple source of guidance for all Fair Value measurements required by IFRS
b. Clarify definition of Fair Value and relevant guidance
c. Enhance disclosures regarding Fair Value

"FAIR VALUE" MEASUREMENT CRITERIA

CICA and FASB set hierarchy for Fair Value Measurement:

1. Quoted market prices in an active market
2. Recent transactions for similar assets
3. Other valuation techniques

(CICA *Handbook* 1581 and SFAS 157.)

IFRS

- Conceptual framework substantially same as for Canadian standards (GAAP)
- Cover many of same topics
- Reach same conclusions on many issues
- Structured same way as CICA *Handbook* (Accounting)
- GAAP principles highlighted in similar language
- Of similar style, length and detail as CICA *Handbook*

"FAIR VALUE" MEASUREMENT AND DISCLOSURE UNDER GAAP

	CANADA	U.S.A.
Fair Value Measurements under GAAP	Awaiting IFRS	SFAS 157
Allocation of Purchase Price in Business Combinations	CICA 1581	SFAS 141
Annual Impairment Test — goodwill and other intangibles	CICA 3062	SFAS 142
Reorganizations under bankruptcy laws: "fresh start" accounting	CICA 1625	SOP 90-7

"FAIR VALUE" MEASUREMENT AND DISCLOSURE UNDER GAAP (CONT'D)

	CANADA	U.S.A.
Impairment or disposal of long-lived assets; Using Cash Flow Information and Present Value in Accounting Measurements	CICA 3063	SFAS 144, CON 7
Auditing Fair Value Measurements	CICA 5306	SAS 101, AU 328
Using Work of a Specialist	CICA 5049	SAS 73, AU 336
Performance in Assurance Engagements	CICA 5025	