THE CANADIAN INSTITUTE

4TH ANNUAL NATIONAL SUMMIT ON PRIVATE EQUITY

FOUR SEASONS HOTEL, TORONTO, ONTARIO

THURSDAY, MAY 17, 2007

PRICING AND VALUATION CONSIDERATIONS

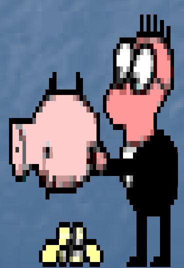
by

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

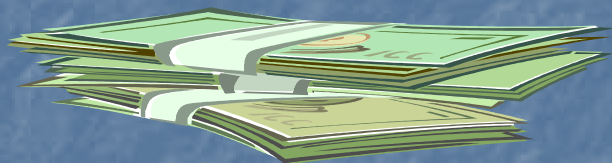
Chartered Business Valuator

Wise, Blackman LLP

Business Valuation • Transfer Pricing



COMPOSITION OF A BUSINESS ENTERPRISE



Working Capital

Other Tangible Assets

Intangible Assets

Intellectual Property

THE BUSINESS ENTERPRISE EQUATION

VALUE OF BUSINESS ENTERPRISE

=

VALUE OF NET MONETARY ASSETS

+

VALUE OF TANGIBLE ASSETS

+

VALUE OF INTANGIBLE ASSETS

Value of Underlying Assets

=

VALUE OF EQUITY

+

VALUE OF LONG-TERM DEBT

Value of Invested Capital

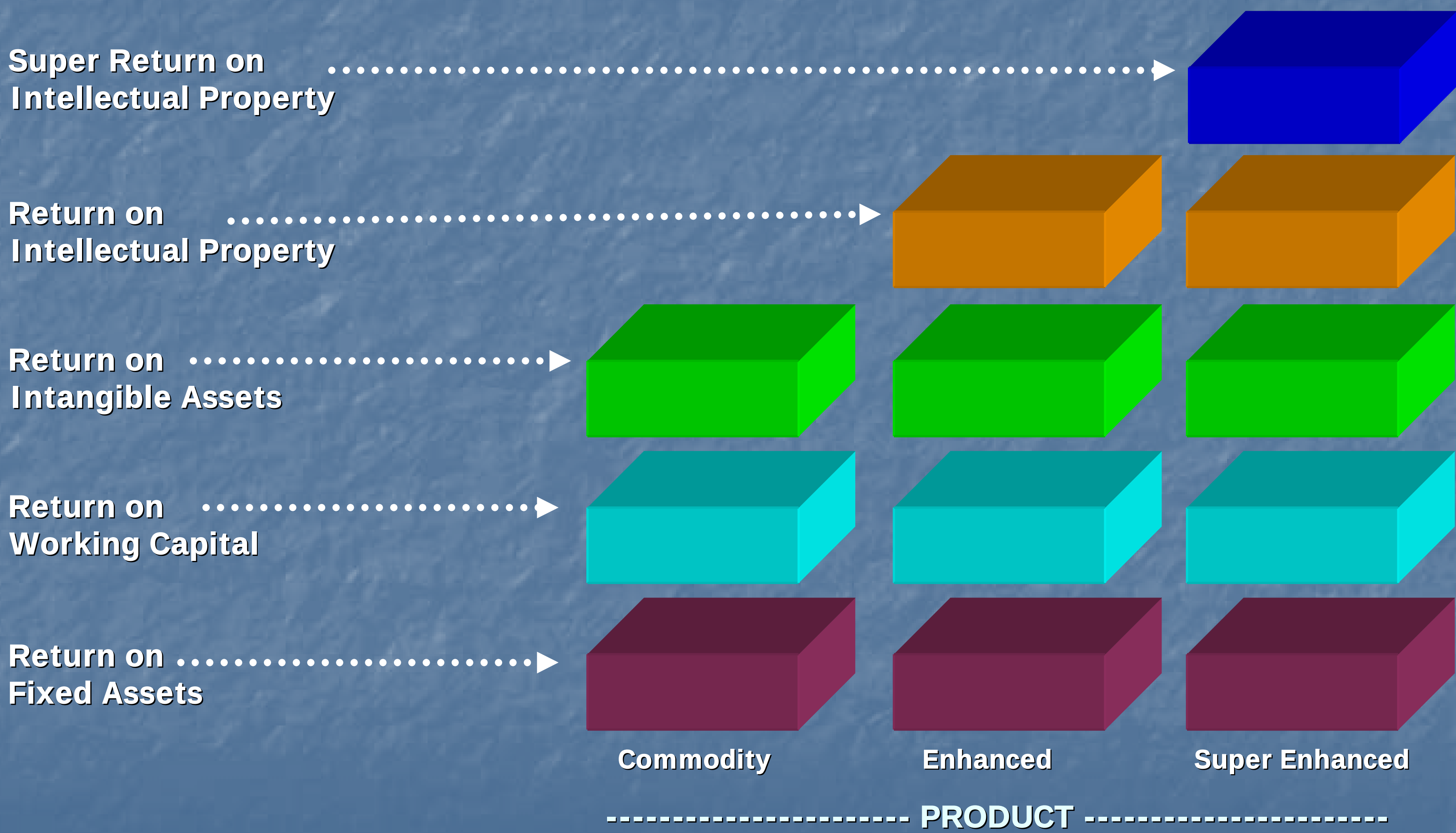
Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

GENERAL ALLOCATION FORMULA

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

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

EXCESS RETURNS FROM INTELLECTUAL PROPERTY



Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

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

<u>At Entity Level</u>:

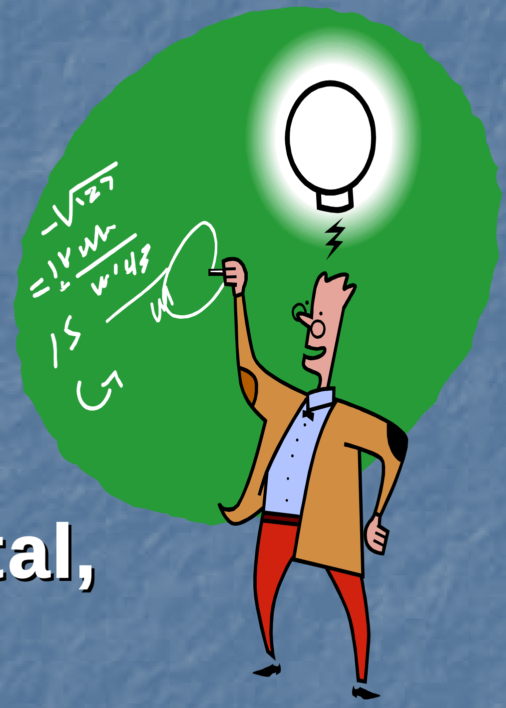
- Valuation approach
- Valuation methodology and techniques applied
- Adjustments to "normalize" reported results
- Capitalization rate (price/earnings multiple) to apply to maintainable earnings (net cash flow) of the business

VALUATION ISSUES

- If "Discounted Cash Flow Method" used, reasonableness of projections and underlying assumptions <u>as well as discount rate applied</u>
- Where "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 maintainable earnings

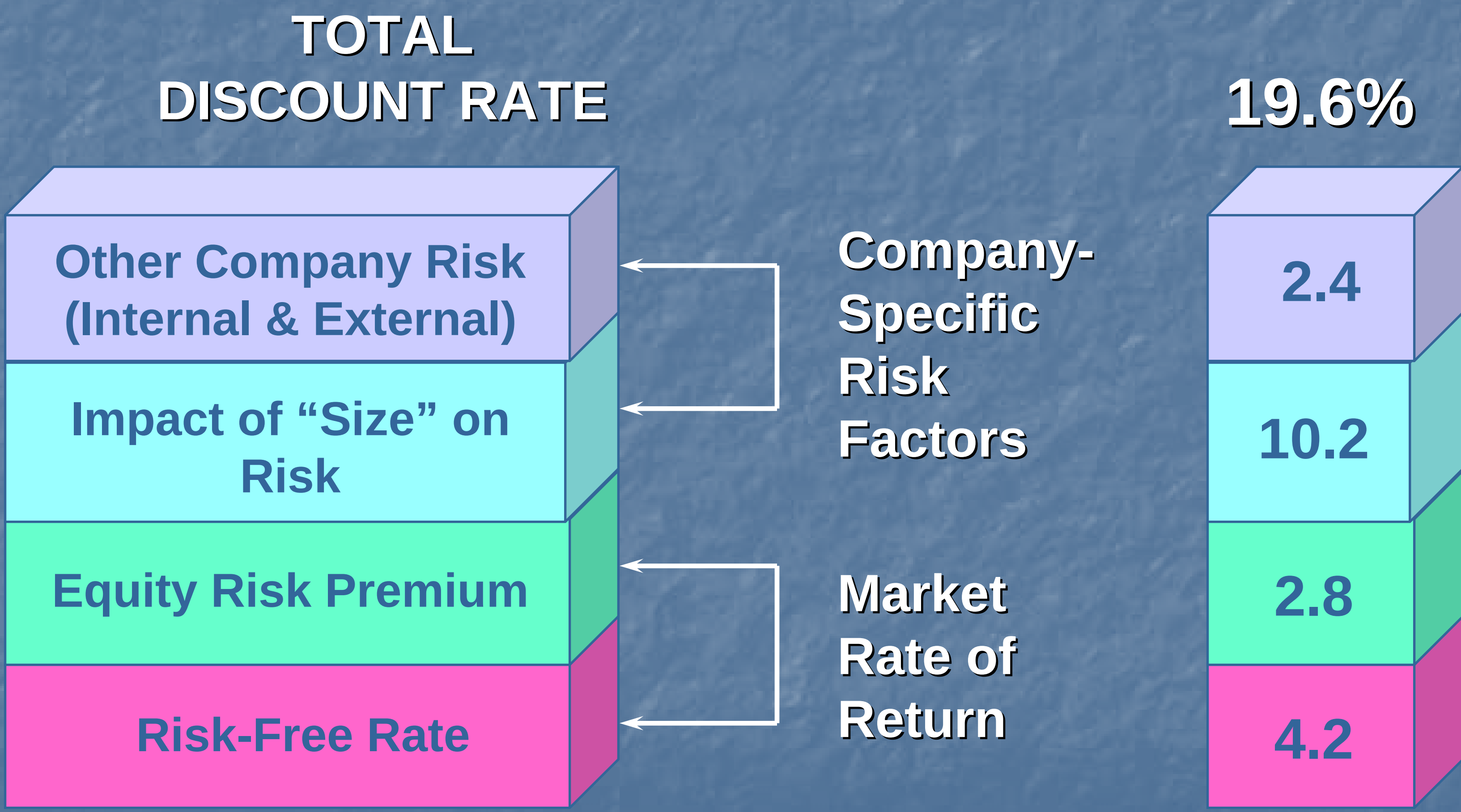
VALUATION/PRICING CONSIDERATIONS

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



Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

DEVELOPMENT OF DISCOUNT RATE
BUILD-UP METHOD



Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

DISCOUNT RATE —
WEIGHTED AVERAGE COST OF CAPITAL

- Capital Structure
  - Comparable companies
- Cost-of-Equity Component
  - Build-Up Approach
  - Capital Asset Pricing Model
- Cost-of-Debt Component
- Tax Rate
- Risk Adjustment

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

VALUATION ISSUES

- Valuation of off-balance sheet items
- Dependency on a key person

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

SELLER'S PROJECTIONS

- Often optimistic and can be unrealistic
- Assumptions must be scrutinized and challenged

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

MANAGEMENT'S SIGNIFICANT ASSUMPTIONS

- Assumptions go to heart of projections.
- Do "significant assumptions" used by management to estimate fair value, provide reasonable basis for inclusion of values in entity's financial statements?
- Are assumptions made by management reasonable and reflect market information used by market participants?

MANAGEMENT'S SIGNIFICANT ASSUMPTIONS
(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?

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

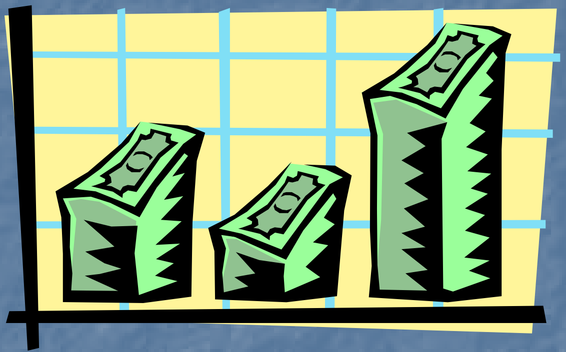
MANAGEMENT'S SIGNIFICANT ASSUMPTIONS
(CONT'D)

- Assumptions made in prior periods.
- Past experience of, or previous conditions experienced by, entity.
- Assumptions used by management in accounting estimates for financial statement accounts.

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

SWOT ANALYSIS

- Strengths
- Weaknesses
- Opportunities
- Threats



Should be assessed using industry benchmarks.

SYNERGY

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

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

SPECIAL-PURCHASER SYNERGIES ("1 + 1= 3")

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

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

POST-ACQUISITION SYNERGIES

Increase value of the combined business beyond the sum of its components by:

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

SPECIAL PURCHASER SYNERGIES

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

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

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
  - Probability of achievement
  - Best-case, most-likely-case and worse-case scenarios should be used, 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.

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

CONSIDERATIONS IN ASSESSING REASONABLENESS OF EMPLOYEE/SHAREHOLDER COMPENSATION

1. Employee's qualifications
2. Nature, extent and scope of employee's work
3. Size and complexity of business
4. Comparison of salaries paid to gross income and net income
5. Prevailing general economic conditions

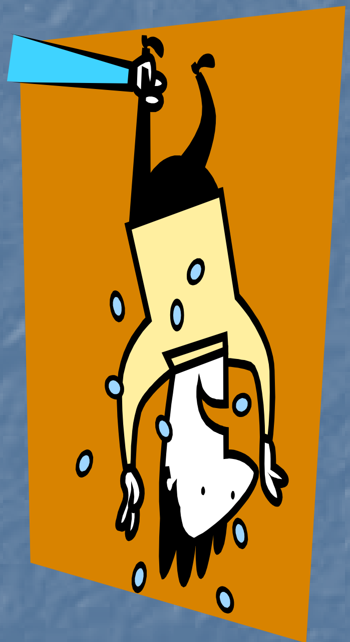
CONSIDERATIONS IN ASSESSING REASONABLENESS OF EMPLOYEE/SHAREHOLDER COMPENSATION
(CONT'D)

6. Comparison of salaries to distributions to shareholders.
7. Prevailing compensation for comparable positions in comparable companies.
8. Salary policy of company *vis-à-vis* all employees.
9. Compensation paid in prior years.

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

OVERPAYING FOR THE TARGET

- Paying total consideration that:



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

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

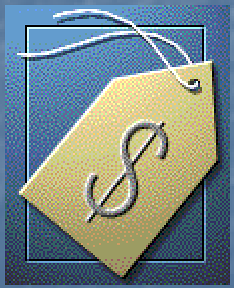
PRICING THE TARGET

- **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**

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

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

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 (to operating income)	$45.5

AOL MANAGEMENT EXPLANATION OF WRITE-DOWNS

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

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

POSSIBLE UNRECORDED LIABILITIES

- Leases with non-arm's length parties
- Repayment obligations for government grants, loans subventions
- Advertising commitments
- Customs and import duties on foreign purchases

TAX RATE ANALYSIS

- Taxes are an economic issue and may be relevant to subject valuation.
- At a minimum, taxes impact discount rate through recognition of tax savings on cost of debt firm includes in its cost of capital calculation for specific investment.
- Taxes impact cash flows that are present-valued in valuation formula.
- Differences in taxes are incorporated into both political risk and interest-rate differential methods.

COUNTRY-SPECIFIC TAX ISSUES

1. **Special regional taxes and surcharges**
2. **Foreign tax credits**
3. **Tax holidays**
4. **Specific deductibility of expenses**
5. **Reciprocal tax treaties**

HOW TO AVOID OVERPAYING FOR CROSS-BORDER 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, intrinsic Fair Market Value of target (absent special purchaser/ strategic buyer considerations) to assess reasonableness of implied transaction premium.

HOW TO AVOID OVERPAYING FOR CROSS-BORDER TARGET

4. **Quantify perceived post-acquisition economies of scale, reduced competition, entry into new markets, etc.**
5. **Assess potential effect on value of cyclicality and seasonality on target's business.**
6. **Structure deal so that vendor and its key management have incentive for deal to succeed (e.g., stock options, performance bonuses, etc.).**
7. **Prepare sensitivity analyses of key variables for target on stand-alone basis and perceived post-acquisition basis.**

COVENANT NOT TO COMPETE

- Assumptions underlying projected earnings of subject business under each of two scenarios:
    1. Without competition
    2. With competition
- Financial projection period used
- Quality of projections
- Estimate of lost sales absent non-competition covenant

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

COVENANT NOT TO COMPETE
(CONT'D)

- Projected sales with a non-competition covenant in place
- Costs of implementing appropriate counter-measures (such as increased advertising, price reductions, etc.) absent covenant
- Capitalization multiples to apply to earnings of business under each scenario, considering different risk profiles that would prevail

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

COVENANT NOT TO COMPETE
U.S. "ECONOMIC REALITY TEST"

- Seller's (i.e., covenanter's) having 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

COVENANT NOT TO COMPETE
U.S. "ECONOMIC REALITY TEST" (CONT'D)

- Seller's intention to remain in same geographic area
- Buyer's interest in eliminating competition
- Duration and geographic scope of covenant
- Enforceability of covenant not to compete under state law
- Age and health of seller

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing

COVENANT NOT TO COMPETE
U.S. "ECONOMIC REALITY TEST"
(CONT'D)

- Whether payments for non-compete covenant are pro-rata to seller's share ownership in company being sold
- Whether such payments cease upon breach of covenant or upon death of seller
- Existence of active negotiation over terms and value of covenant

Richard M. Wise, FCA, FCBV, FASA, MCBA
Wise, Blackman LLP
Business Valuation • Transfer Pricing