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CROSS BORDER DEALS COURSE

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DUE DILIGENCE
IN THE CONTEXT OF A MULTI-JURISDICTIONAL OR CROSS-BORDER M&A TRANSACTION

by

Richard M. Wise, FCA, CA•IFA, FCBV, FASA

WISE, BLACKMAN LLP
Business Valuators • M&A Advisors
Montreal, Canada

SELECTED STATUTES TO BE AWARE OF IN PRICING A CANADIAN BUSINESS

- *Investment Canada Act*
- *Income Tax Act*
- *Canada-U.S. Reciprocal Tax Convention*
- *Canada Business Corporations Act* (or relevant provincial counterparts)
- *North American Free Trade Agreement*
- *Canada-U.S. Free Trade Agreement*

SELECTED STATUTES TO BE AWARE OF IN PRICING A CANADIAN BUSINESS (CONT'D)

- **Public Companies:**
  - Provincial securities acts and regulations
  - Ontario Securities Commission Rule 61-501 and Companion Policy 61-501CP

ADVERSE TAX CONSQUENCES WHEN PRIVATE CANADIAN COMPANY IS ACQUIRED BY FOREIGN PURCHASER

- Loss of "Small Business Deduction" (CCPC)
- Withholding taxes on dividends, interest, etc.
- Loss of Refundable dividend tax on hand (RDTOH)
- Capital dividends taxable
- Loss of investment tax credits

STEPS IN THE M&A PROCESS

Asymmetrical information between seller and investor

↓

Due Diligence

↓

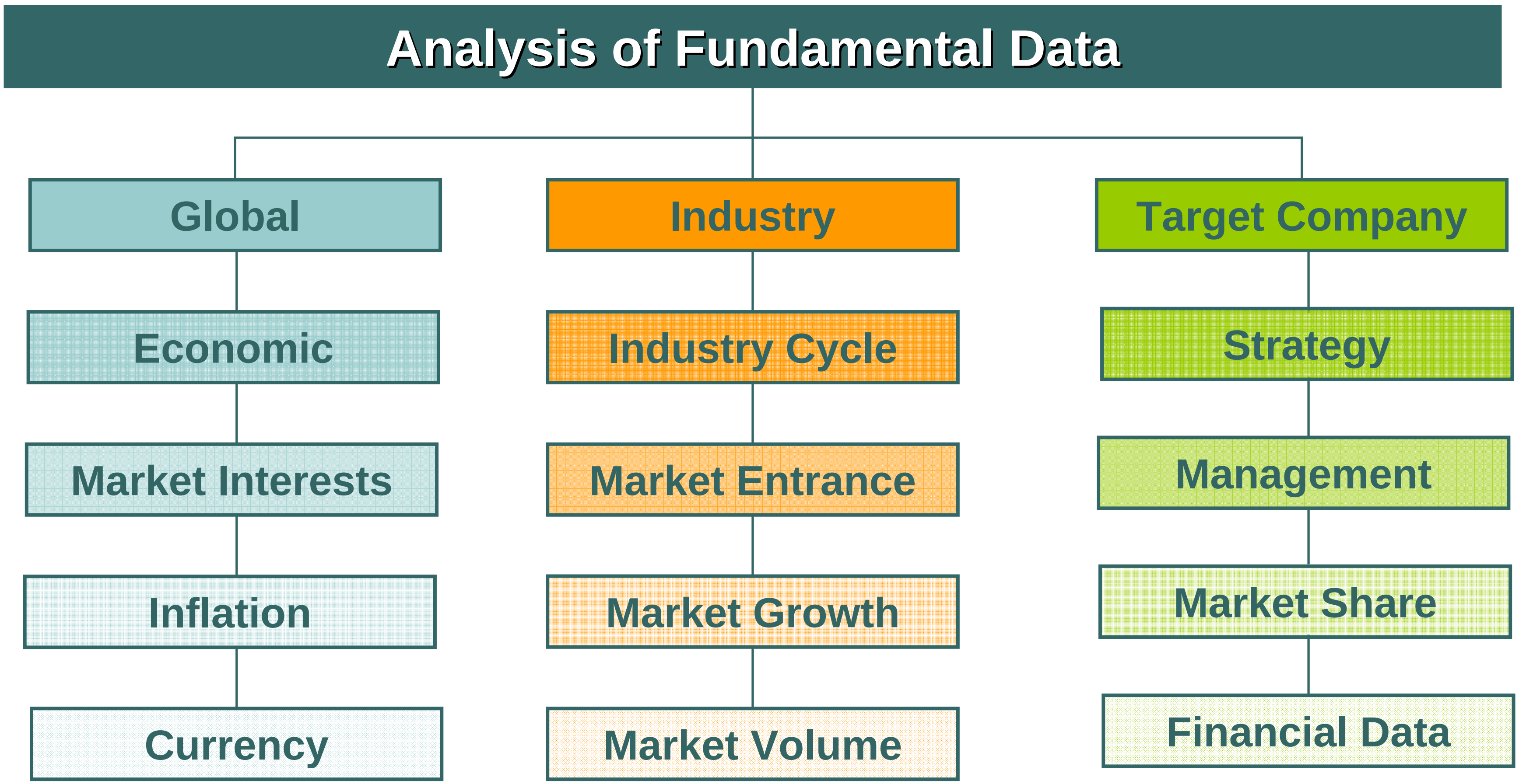
Identification & Analysis of Risks	Analysis of Financial Information	Identification of Deal Breaks

Business Valuation

Structuring of Transaction/Transaction Pricing

SOURCE: H. Erchinger and T. Rowles, "M&A Transactions",
Valuation Strategies, September/October 2004.

ANALYSIS OF DATA IN THE M&A PROCESS



SOURCE: H. Erchinger and T. Rowles, "M&A Transactions", *Valuation Strategies*, September/October 2004.

DUE DILIGENCE

- Investigation
- Verification

INVESTIGATION

- Gathering information
- Understanding acquiree's business operations
- Assessing risks
- Pricing considerations

VERIFICATION

- **Are all assets bargained for included?**
  - **Quantity**
  - **Quality**
- **Are there liabilities *not* bargained for?**

GLOBAL VALUATION / PRICING CONSIDERATIONS

- Role of Business Valuator
  - Financial reporting
  - Tax planning and compliance
  - Mergers, acquisitions and divestitures
  - Financing

BACKGROUND

- Valuation/pricing considers:
  - Standard valuation theory
    - Cost, Income or Market
  - Value definitions (Standards of Value)
  - Perspectives of possible buyers/sellers
  - Attributes of property being appraised
  - Political and economic environment

POLITICAL ENVIRONMENT

- Can impact valuation approach
  - Degree of free-market enterprises
  - Availability of arm's-length transactions for study
  - Need to study transactions across country borders and make appropriate adjustments
  - Preference as to Income and Market Approaches
  - Possible reliance on Cost Approach where no meaningful transactional data exist

COUNTRY ECONOMIC DEVELOPMENT

- A country's economic development is dynamic rather than static
- Developed countries should be distinguished from developing/ emerging market countries
- Country analysis is essential regardless of business, property or type of legal entity

COUNTRY ANALYSIS

- Study of:
  - Interest rates
  - Costs of funds
  - Political climate
  - Tax rates
  - Currency issues

ECONOMIC CONSIDERATIONS

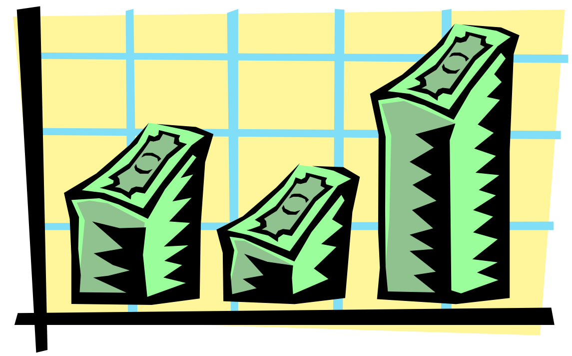
- Consider country, regional and global issues to assess risk issues and potential economic returns
- Assess existing or proposed trade affiliations (e.g., NAFTA and EU) and their impact on country and regional economics, interest rates and internal risks

TRADITIONAL DUE DILIGENCE

- Perform country analysis for due diligence review
  - Historical and forecast analysis
  - Competitive factors
  - Barriers to entry
  - Contributory tangible vs. intangible assets
  - “SWOT” factors

SWOT ANALYSIS

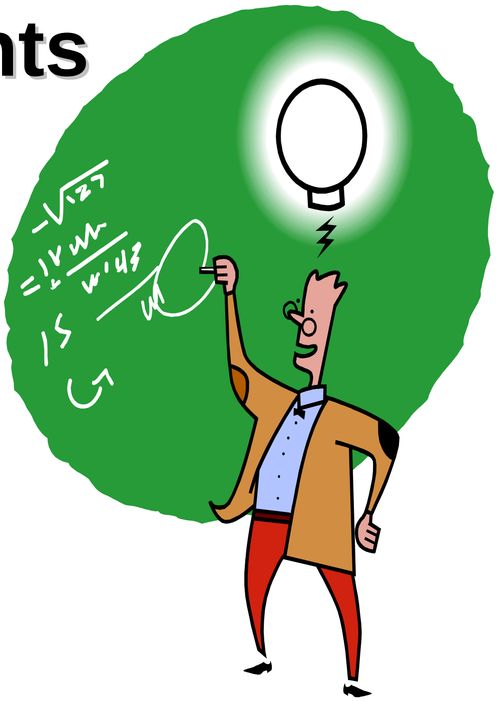
- Strengths
- Weaknesses
- Opportunities
- Threats



Should include using industry benchmarks in analysis.

VALUATION/PRICING CONSIDERATIONS

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



APPLICABLE METHODS

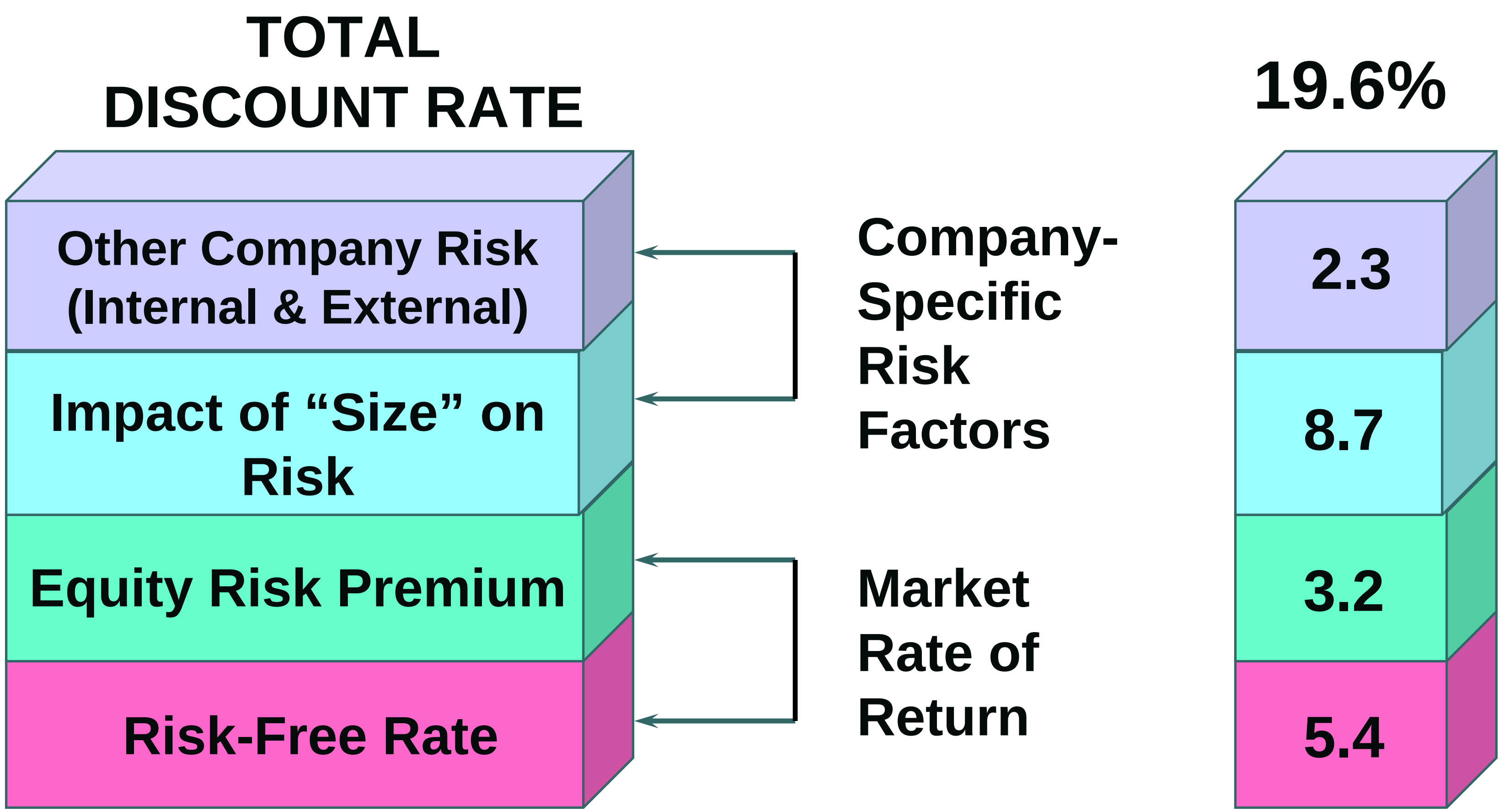
- Country analysis/due diligence and related valuation methods applicable to:
  - The business enterprise
  - Its common and preferred shares
  - Its tangible and intangible assets

COUNTRY RISK ANALYSIS

- Consideration of:
  - Political ratings and yield spread methods
  - Possible currency risk adjustment
  - Risk adjustment for both cost of equity and cost of debt in Weighted Average Cost of Capital (WACC) calculation

SEE: James T. Budyak, "Developing Discount Rates in a Global Environment", *Valuation Strategies,* Vol. 4., No. 1, May/June 2001

DEVELOPMENT OF DISCOUNT RATE
Build-Up Method



RECOGNIZE DYNAMIC MARKETS

- Emerging markets often highly volatile
- Same principles of time horizon apply to emerging markets as do domestic valuations in developing risk-related components of discount rate

COUNTRY RISK

Michael Milken, Wall Street "Junk Bond" King of the 1980s:

> **"You can seize MCI for failure to pay interest but you can't seize Brazil, or Russia, or Southeast Asia, or the rest of Latin America!!"**

DEVELOPED vs DEVELOPING

Developing countries possess more risk elements, such as defaulting on debt or “constructively defaulting” by running high rates of inflation

COUNTRY RISK

1. **Country risk can be significant. Distinguish *developed* from *developing* countries.**
2. **Country risk is incremental — especially to a developed country's discount rate; calculate a base rate using developed country's industry data; U.S. lots of industry data for development of base rate.**
3. **Concept of country risk supported by academia and marketplace.**

COUNTRY RISK
(CONT'D)

4. Quantifying country risk is subjective with inherent lack of perfect data; monitor evolution in finance and cost of capital development.
5. Glean data from marketplace—observe existing relationships of risk/return from arm's length investor transactions.
6. Use normalization of risk/return estimates used to adjust WACC for country risk.

COUNTRY RISK
(CONT'D)

7. Consider that valuation formula's numerator and denominator permit adjustment for such country risk issues and project specific issues in either numerator (cash flow/earnings) or denominator (rate of return).
8. Consider currency risk as potential added risk depending on source data used for yield-spread analysis.
9. Country risk can become exchange rate risk.

DISCOUNT RATE —
WEIGHTED AVERAGE COST OF CAPITAL

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

RISK DIVERSIFICATION

- **Developed, or “Integrated”, countries follow overall market, whereas *developing* countries do not always follow overall market**

RISK MANAGEMENT

- Risk management can vary from currency risk hedges to political risk insurance

- Political risk insurance market can provide protection coverage for such risks as expropriation and inconvertibility
- Political risk insurance is most often used in projects in emerging countries

POLITICAL RISK ANALYSIS

"Political Risk measures may include frequency of changes of government, level of violence in country, number of armed insurrections, conflicts with other states, and so on. Other popular indicators of political risk include various economic factors such as inflation, balance of payments deficits or surpluses, and level and growth rate of per capital GNP."*

Political risk not only includes violence and expropriation, but also currency devaluation and inflation.

***   International Corporate Finance.**

POLITICAL RISK

1. Turmoil,
2. Financial transfer,
3. Direct investment, and
4. Export market.

POLITICAL RISK
(CONT'D)

1. Turmoil—large-scale protests, general strikes, demonstrations, riots, terrorism, guerrilla warfare, civil war and cross-border war. Also includes turmoil caused by a government's reaction to unrest and economic turmoil.
2. Financial transfer—risk from non-convertibility from local currency to desired foreign currency and transfer of foreign currency out of country. Transfer could be for payment of exports, repatriation of profits or capital or any other business purpose.

POLITICAL RISK
(CONT'D)

3. Direct investment—risks to foreign investment in wholly-owned subsidiaries, joint ventures and other forms of direct ownership of assets in foreign country.

4. Export market—risks faced by exporters to the country: e.g., risks related to market conditions, barriers to imports, delays or difficulties in receiving payment for goods.

COUNTRY/POLITICAL RISK ANALYSIS

Turmoil could diminish value of investment or returns that it could produce to foreign investor

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

ECONOMIC DEPENDENCIES

- Developing countries or economies may be more prone to volatility because of their reliance on commodities (such as oil, aluminium or forest products), for significant portion of their GDP
- Developing economies face effects of lower market prices from their exports and flight away from their currency as investors shun emerging markets

ECONOMIC FACTORS

- Inflation
- Debt service as a percentage of exports of goods and services
- International liquidity ratios
- Foreign trade collection experience
- Current account balance as percentage of goods and services
- Parallel foreign exchange rate market indicators

Financial Analysts Journal, November/December 1996.

FINANCIAL FACTORS

- Loan default or unfavourable loan restructuring
- Delayed payment of suppliers' credits
- Repudiation of contracts by governments
- Losses from exchange controls
- Expropriation of private investments

Financial Analysts Journal, November/December 1996.

FOREIGN EXCHANGE RISK

- Interest rates in marketplace are Prospective and include expectation of inflation related to currency in which security denominated
- *Ceteris paribus*, inflation causes currency to depreciation on exchange market

POLITICAL FACTORS

- Economic planning failures
- Political leadership
- External conflict
- Government corruption
- Military involvement in politics
- Organized religion in politics
- Law-and-order tradition
- Racial and national tensions
- Political terrorism
- Civil war
- Political party development
- Quality of bureaucracy

Financial Analysts Journal, November/December 1996.

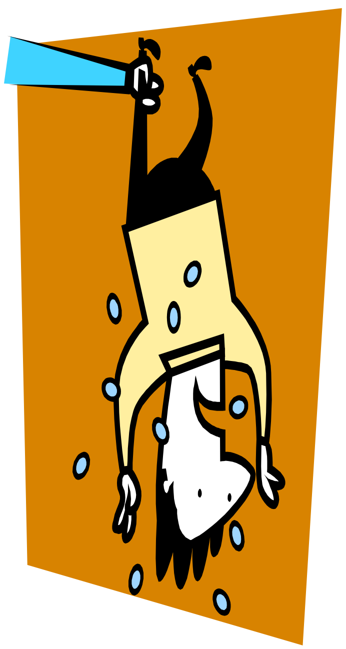
RELATIONSHIP OF PARTIES TRANSFER PRICING

Transfer pricing rules recognize three relationships:

1. **Both parties to transaction are controlled, e.g., sale between a Canadian sub and a foreign sub of parent company**
2. **One party to transaction is controlled, other party is uncontrolled, e.g., sale between a Canadian sub and an unaffiliated company**
3. **Neither party is controlled, e.g., when transaction is wholly independent from taxpayer's activities**

OVERPAYING FOR THE TARGET

- Paying a 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")

PRICING THE CROSS-BORDER TARGET

- **Consequences of overpaying for target can include:**
  - **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**
  - **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**

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.

SELLER'S PROJECTIONS

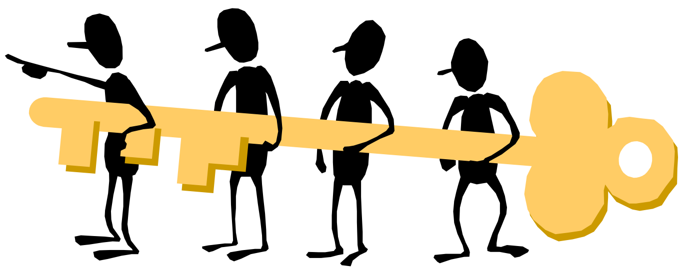
- Often optimistic; can be unrealistic
- Assumptions must be scrutinized and challenged

AUDITING MANAGEMENT'S SIGNIFICANT ASSUMPTIONS

- 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
- Assumptions made in prior periods, if appropriate
- Past experience of, or previous conditions experienced by, entity to extent currently applicable
- Assumptions used by management in accounting estimates for financial statement accounts other than those relating to FVM&D
- Any risk associated with cash flows, including potential variability thereof and related effect on discount rate

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."



QUESTIONS?

Please feel free to contact me:

Richard M. Wise's e-mail — rmwise@wiseblackman.com

Wise, Blackman LLP
Royal Bank of Canada Building
1 Place Ville Marie
Suite 3430
Montreal, Quebec
Phone: (514) 875-8100 or (866) 998-8100
Fax: (514) 875-9109
www.wiseblackman.com