

# FEDERATED PRESS

*M&A SKILLS — DEAL-MAKER SUMMIT*

SEPTEMBER 11 AND 12, 2006 — TORONTO

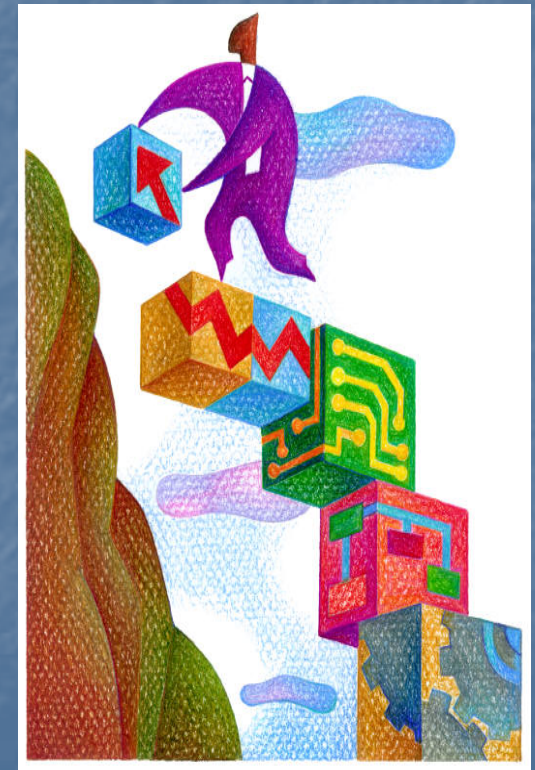


## VALUATION AND DEAL STRUCTURES Panel Discussion

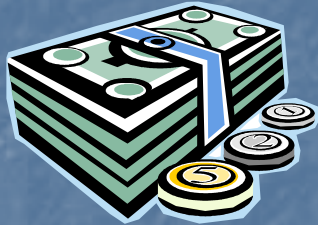
by

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

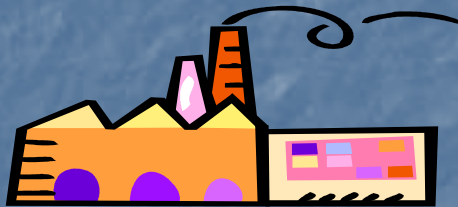
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Montreal, Quebec



# COMPOSITION OF A BUSINESS ENTERPRISE



Working Capital



Other Tangible Assets



Intangible Assets



Intellectual Property

# BACKGROUND

## Valuation/pricing will consider:

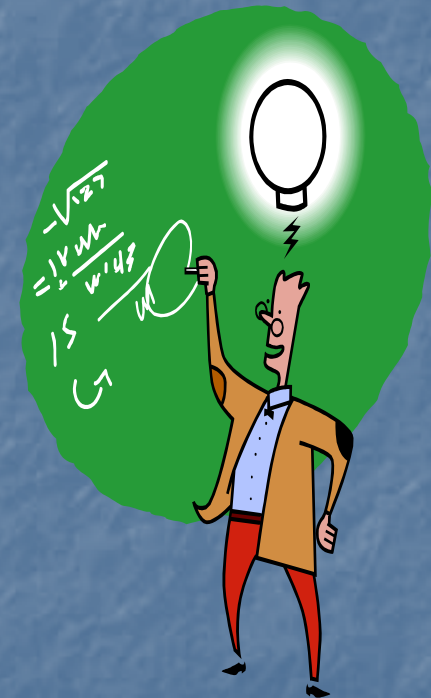
- Standard valuation theory
  - Cost, Income or Market
- Value definitions (Standards of Value)
- Perspectives of possible buyers/sellers
- Attributes of property being appraised
- Political and economic environment



# VALUATION/PRICING CONSIDERATIONS

## ■ Valuation formula components

- Numerator (cash flow)
- Denominator (cap rate, i.e., rate of return)



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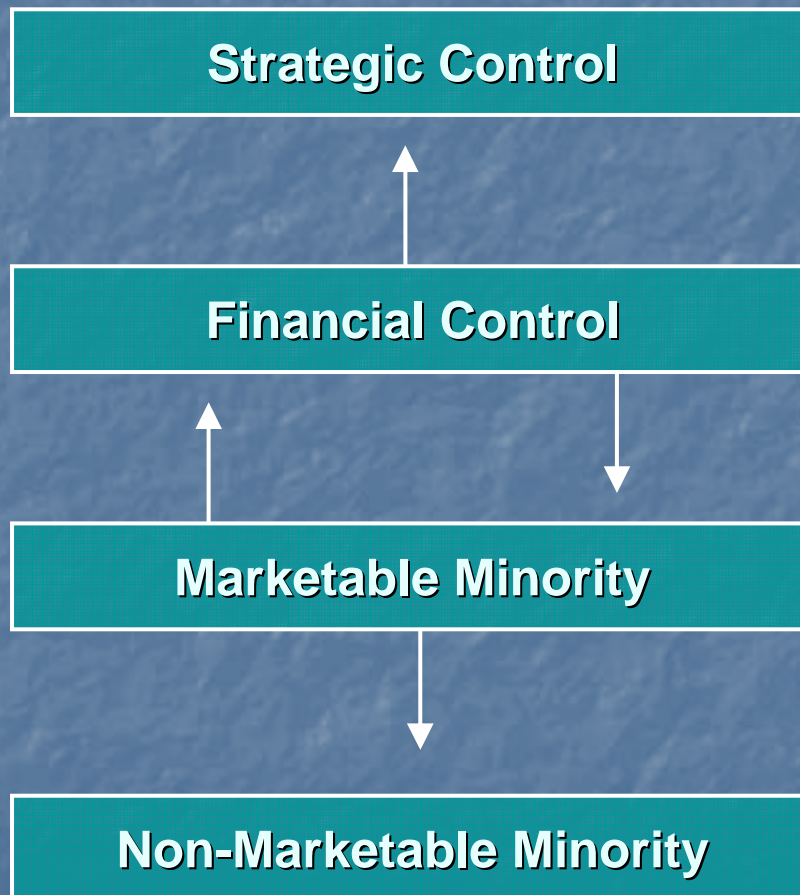
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# THREE POSSIBLE COMPONENTS OF A TRANSACTION

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



# ENTERPRISE vs. SHAREHOLDER LEVEL



## Enterprise Level

Value a function of Expected Cash Flows of Enterprise (as capitalized by public markets or controlling buyers)

## Shareholder Level

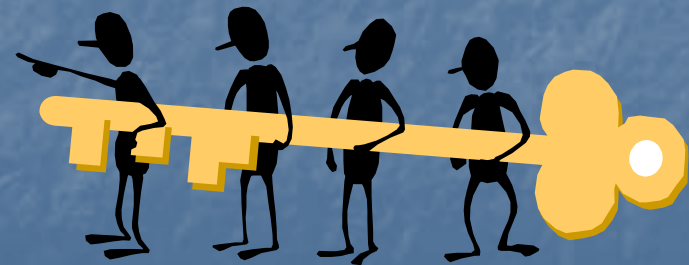
Value a function of Cash Flows anticipated by Shareholders (derived from cash flows of Enterprise, but not necessarily equal)

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# 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.”**



# 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



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# SPECIAL-PURCHASER SYNERGIES

## ■ FINANCIAL

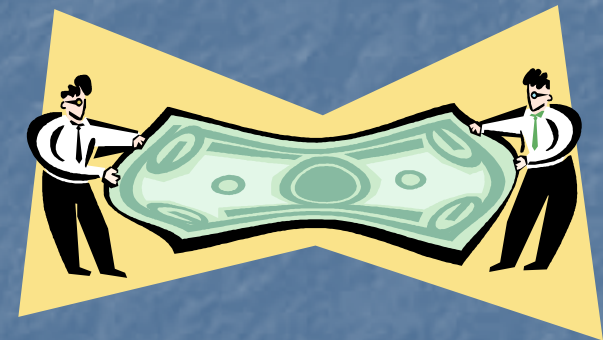
- Size and related lower financing costs
- Leverage
- Capital structure

## ■ OPERATING — INTANGIBLE

- Annual source of supply
- Technology
- Growth opportunities

## ■ OPERATING — TANGIBLE

- Economies of scale
- Diversification of products
- Utilization of excess capacity



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# 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.



# 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 prepared, using sensitivity analysis



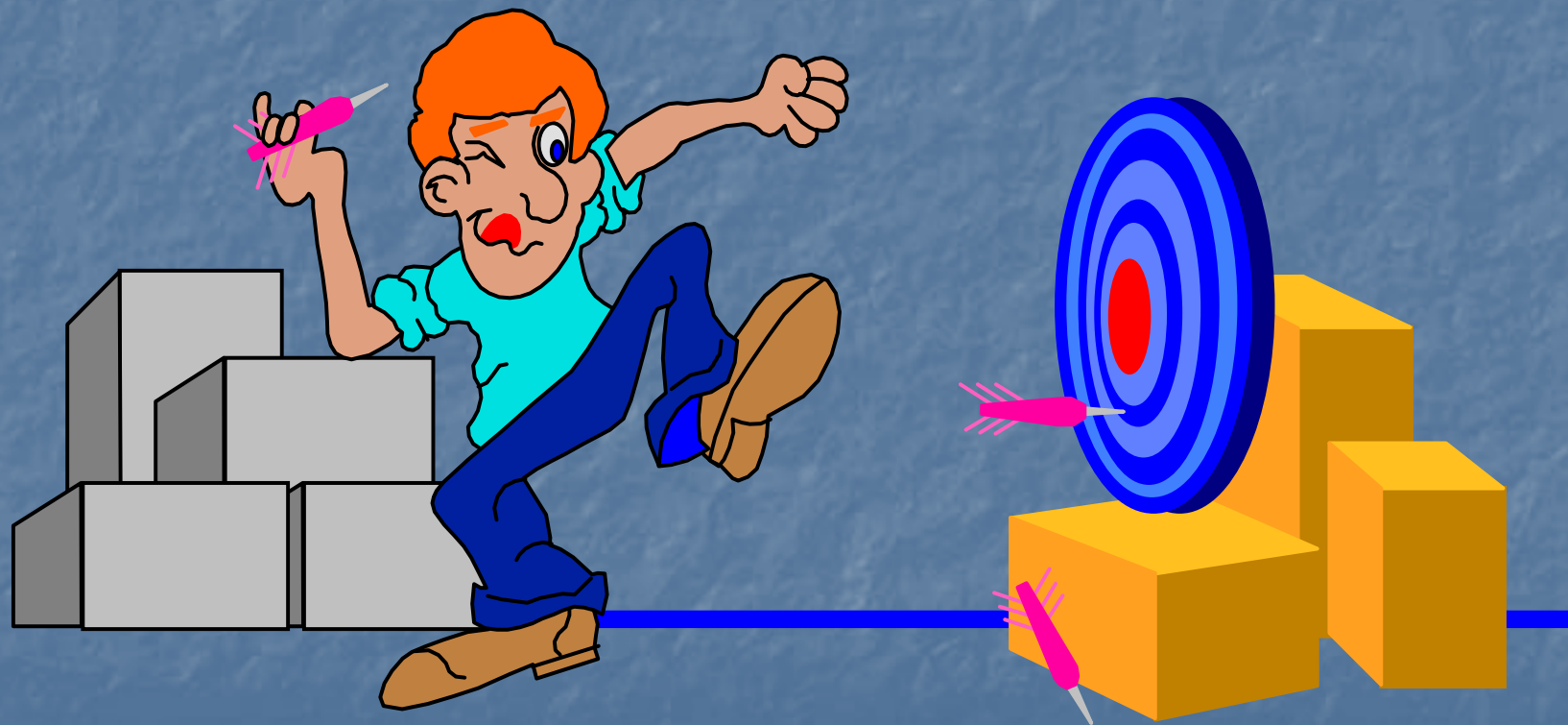
## ■ TIMING OF SYNERGISTIC BENEFITS

- As forecasts are made further into the future, there is more risk in being on target; synergies in shorter term can be forecasted more reliably.

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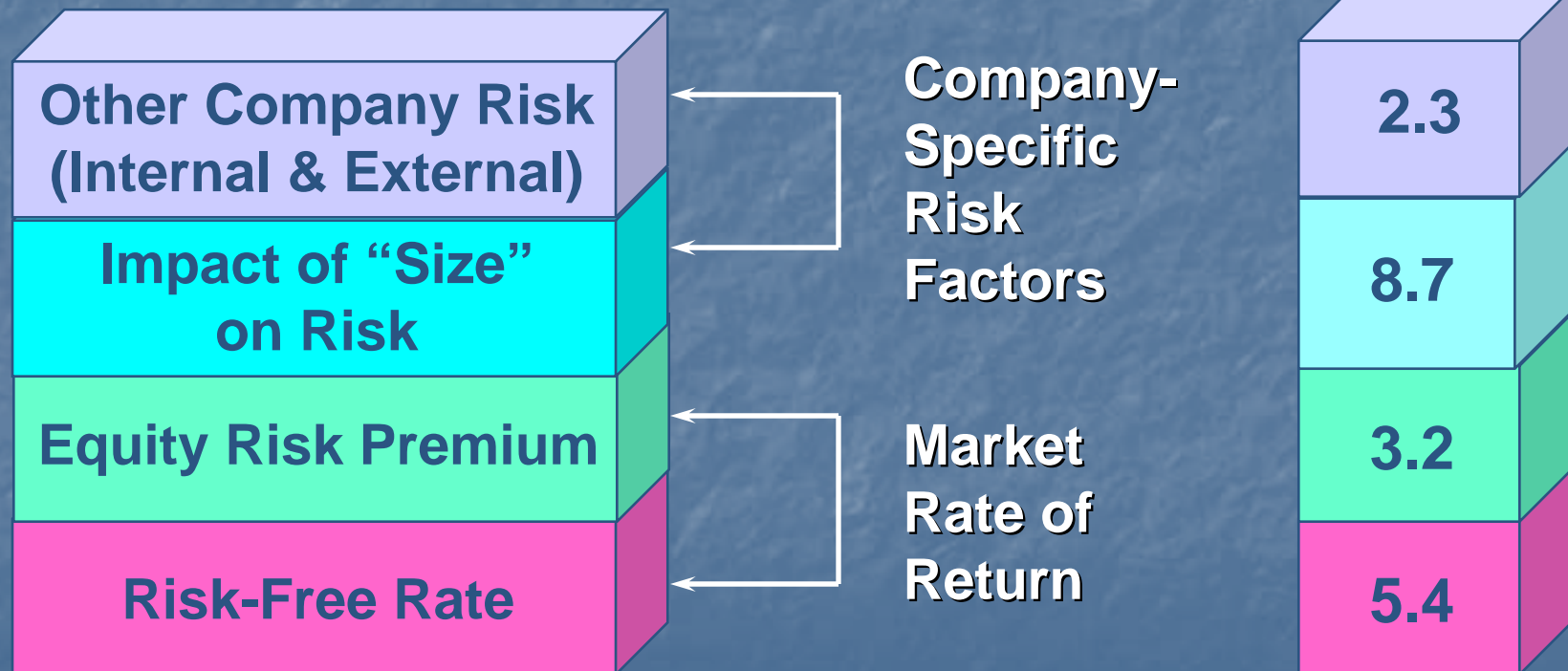
# DEVELOPMENT OF CAPITALIZATION RATE



# DEVELOPMENT OF CAPITALIZATION RATE

## BUILD-UP METHOD

### TOTAL CAPITALIZATION RATE



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# INTERNAL FACTORS TO CONSIDER IN DEVELOPING CAPITALIZATION RATE

- Financial condition of business
- Tangible asset backing
- Management depth and continuity
- Products and services offered
- Research and development
- Plant facilities
- Marketing ability



# INTERNAL FACTORS TO CONSIDER IN DEVELOPING CAPITALIZATION RATE (CONT'D)

- Labour force
- Contracts, leases, etc.
- Customer dependence
- Supplier dependence
- Ability to cope with, and react to, change
- Patent, copyright, etc. protection



# EXTERNAL FACTORS TO CONSIDER IN DEVELOPING CAPITALIZATION RATE

- Industry conditions
- Economic conditions, including cyclicalities
- Money and stock market conditions
- Foreign exchange rate fluctuations
- Political environment
- Social environment





# EXTERNAL FACTORS TO CONSIDER IN DEVELOPING CAPITALIZATION RATE

(CONT'D)

- Competition
- Ease of entry by others
- Presence of identifiable prospective purchasers and their strategic objectives at given point in time
- Sources of raw material supply
- Market psychology



# INTANGIBLES SEPARATE AND DISTINCT FROM GOODWILL

- Trademark and trade names
- Newspaper mastheads
- Customer lists
- Customer contracts and relationships
- Advertising contracts
- Lease agreements
- Employment contracts
- Patented technology
- Franchise agreements
- Broadcasting rights
- Literary and musical works
- Non-competition agreements

# INTANGIBLE ASSET CATEGORIES APART FROM GOODWILL

## 1. *Marketing-related, including:*

- Trademarks, trade names, brands, logos
- Foreign trademark rights
- Service marks, collective marks, certification marks
- Product distribution channels
- Delivery systems
- Internet domain names
- Trade dress (unique colour, shape or package design)
- Non-competition agreements



## 2. *Customer-related — customer structure of the business, including:*

- Customer lists
- Order backlog
- Customer contracts and the related customer relationships
- Non-contractual customer relationships
- Retail shelf space

## 3. *Artistic-related — artistic works (to which the business has title), including:*

- Books, magazines
- Musical works, including advertising jingles
- Literary
- Video and audiovisual material, motion pictures, music videos
- Pictures, photographs

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# INTANGIBLE ASSET CATEGORIES APART FROM GOODWILL

## 4. *Contract-based — where there is a fixed or definite term, including:*

- Licenses, including operating licenses and operating rights
- Leases, including terminal facility leases
- Franchise agreements
- Rights, including route authorities
- Permits
- Royalties
- Advertising, construction, management and service or supply contracts
- Employment contracts/collective agreements
- Airport gates and slots
- Financing agreements
- Insurance contracts

## 5. *Technology based — relate to innovations or technological advances within the business, including:*

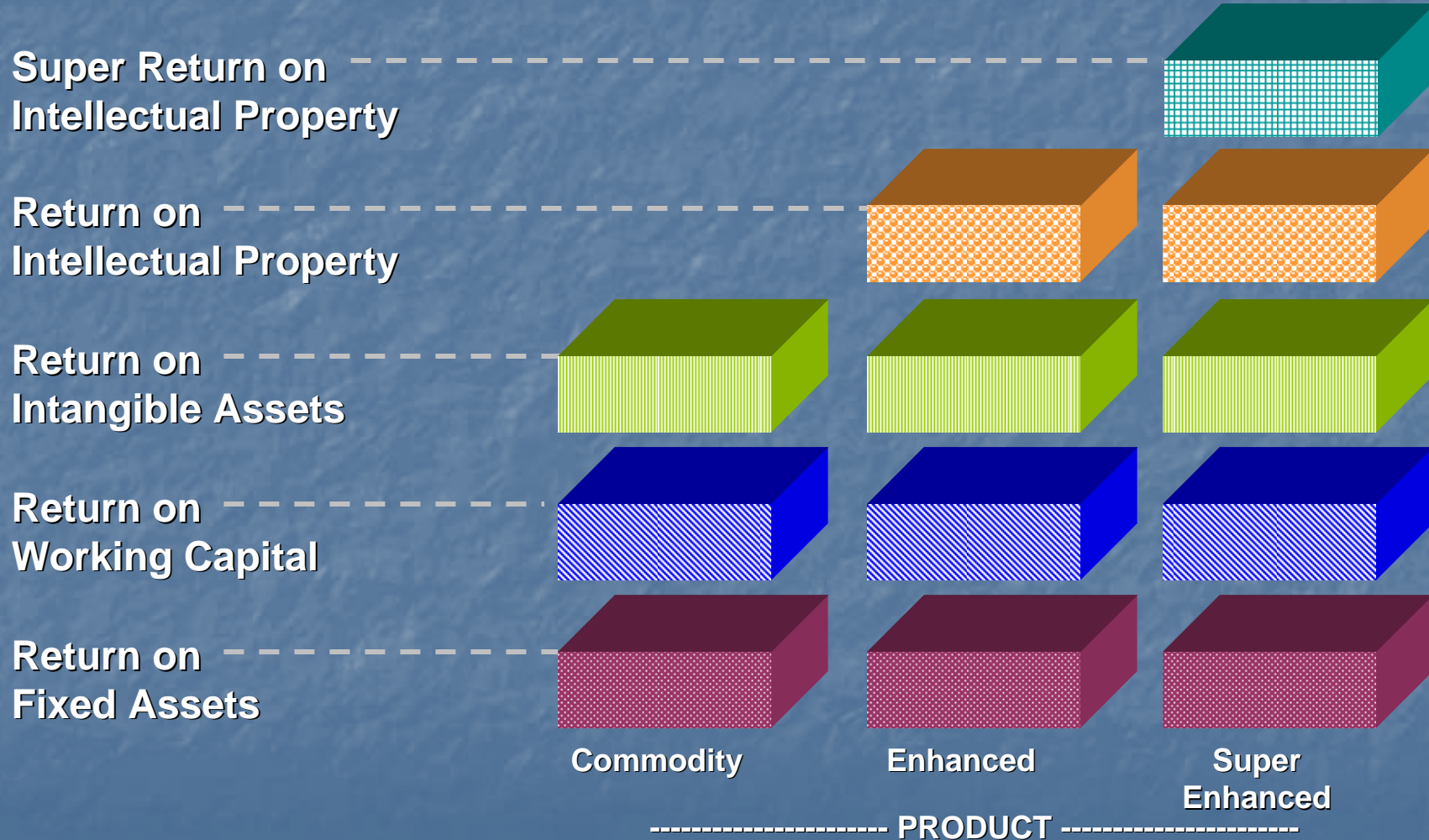
- Patents
- Non-patented technology
- Computer software (operational software) and licenses
- Databases
- Technical drawings
- Research and development
- Trade secrets
- Know-how



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# EXCESS RETURNS FROM INTELLECTUAL PROPERTY



# BASIS OF INTELLECTUAL PROPERTY'S VALUE

- The present value of future benefits/  
income approach
- The market approach
- The avoided cost approach



# VALUATION CONSIDERATIONS FOR IP

- Historical track record.
- Scientifically proven?
- Commercial viability proven?
- Speculation vs. worth?
- Growth potential.
- Risk of failure.
- Product-life cycle.
- Structure of deal.
- Financing requirements.

# VALUATION OF INTELLECTUAL PROPERTY

## SELECTED U.S. BRANDS – IN BILLIONS

<u>Brand Name</u>	<u>Estimated Brand Value</u>	<u>Book Value of "Other Assets"</u>
Coca Cola	\$52.8	\$1.7
Marlboro	52.2	1.8
IBM	23.1	5.3
Microsoft	15.8	2.2
Kodak	15.7	0.9
Budweiser	15.4	1.3
Kellogg's	14.9	0.3
Gillette	13.1	0.5
Nike	7.4	0.1

SOURCE: *Financial World* (New York: 1995). Amounts converted to Canadian dollars at 1.35.



# FACTORS IN DETERMINING VALUE OF IP

- Degree of patent or trademark protection.
- Exclusive vs. non-exclusive rights and development.
- Strategic attraction to notional purchaser.
- Ability to increase royalty rates.
- Market strength (patent or trademark).
- Industry and competition.
- Perspective re value-to-owner or user.
- Special purchaser considerations (value to competitor).



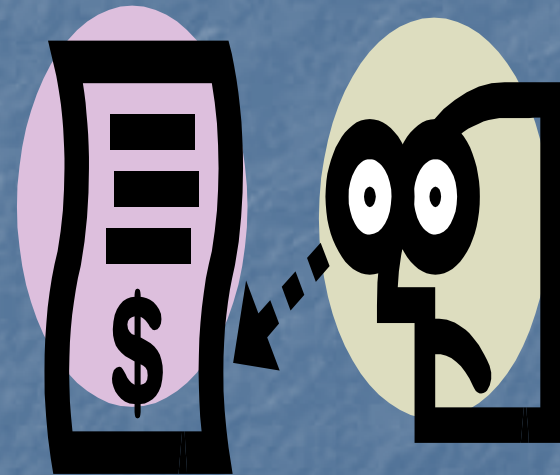
# HIDDEN LIABILITIES

"To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit."

*Huddleson v. Herman & MacLean,*  
650 F.2d 815 (U.S. 5th Cir. 1981)

# ACCRUED LIABILITIES

- Vacation pay
- Management remuneration
- Employee bonuses
- Customer rebates
- Insurance
- Taxes
- Professional fees



# POSSIBLE UNRECORDED LIABILITIES

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

# INFORMATION REQUIRED FOR VALUING BUILT-IN TAX LIABILITIES

## ■ DEPRECIABLE CAPITAL PROPERTIES

- Fair market values
- Original capital costs
- Undepreciated capital cost (of pool)

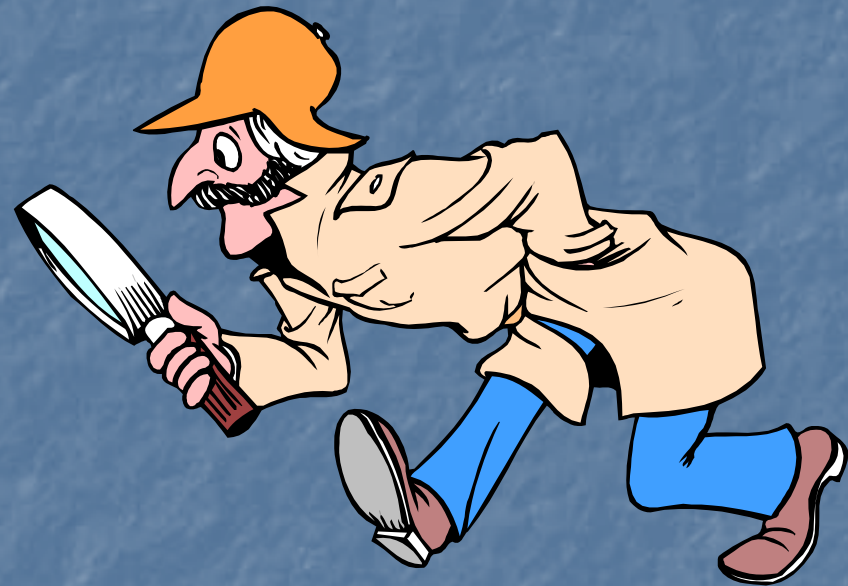
## ■ NON-DEPRECIABLE CAPITAL PROPERTIES

- Fair market values
- Adjusted cost bases
  - V-Day value for pre-1972 properly held continuously

# DUE DILIGENCE

Investigation

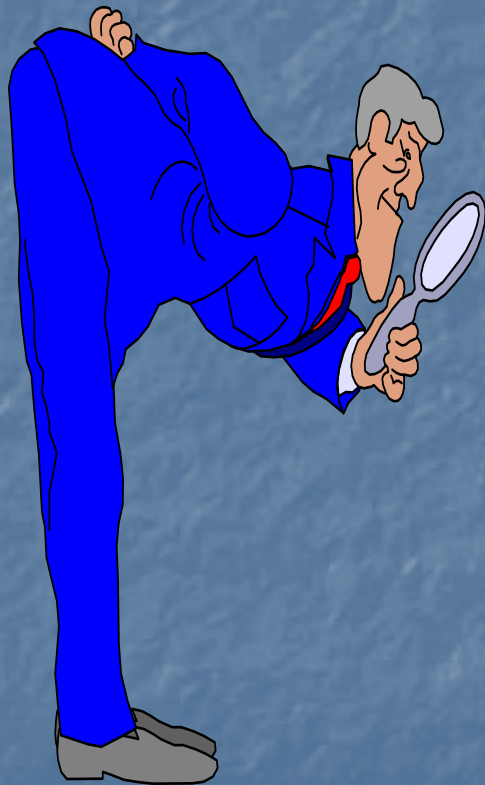
Verification



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# INVESTIGATION



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

# VERIFICATION

■ Are all assets bargained for included?

- Quantity

- Quality

■ Are there liabilities *not* bargained for?





# OVERPAYING FOR THE TARGET

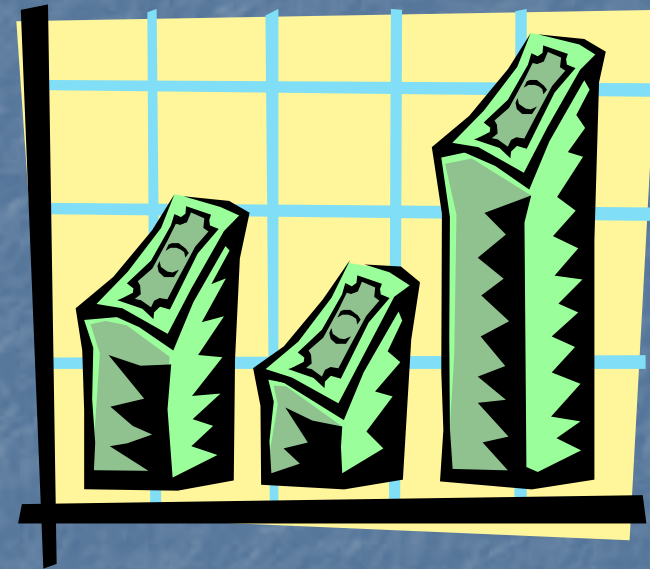
## ■ Paying a total consideration:



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

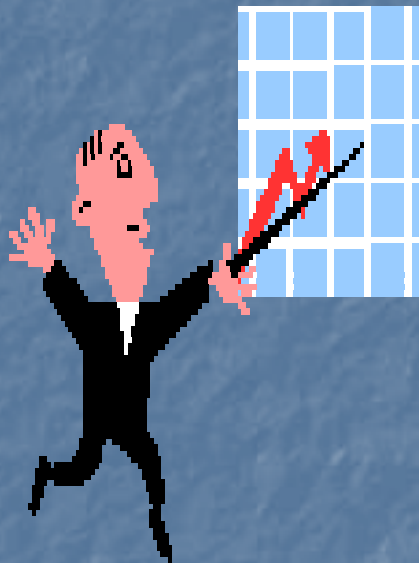
# SWOT ANALYSIS

- Strengths
- Weaknesses
- Opportunities
- Threats



These should also be assessed using industry benchmarks.

# SELLER'S PROJECTIONS



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

