VALUATIONS IN THE CURRENT RECESSION

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Some sixty years after "The Great Depression", Ontario is going through "A Little Depression", which seems to hang on tenaciously and refuses to fade away. In Toronto, which used to be referred to as Canada's locomotive, over the last four years, reported unemployment increased from around 4% to over 10%. Including the discouraged job seekers, I believe the real rate is closer to 15%, and many of the unemployed are victims of the third Industrial Revolution.

The first one originated in England during the last quarter of the eighteenth century, when steam replaced animal power; this enhanced the scope of skilled craftsmen and created opportunities for mass production.

The second Industrial Revolution started a hundred years later. Its prime movers and shakers hailed from this side of the Atlantic, such as Edison and his electric power, Alexander Graham Bell's telephone, and far reaching applications for the internal combustion engine. All those developments as well as some others, freed society from geographical confines and, among numerous benefits, also brought us the one-and-a-half-hour one-way commute....

In the third industrial revolution, specialised knowledge has joined labour, capital and resources as a key component of production. On the other hand, the jobs of many skilled tradesmen can now be handled more accurately, and certainly more cheaply, by robots. I am told that in Japan, there is even a robot factory creating more robots; I have it on reliable authority that this particular activity takes place with the lights turned off, but I wouldn't touch that with a ten foot pole ....

In this new economy, the role of the valuator has changed drastically. While in the past, many assumptions could be based on a company's history, today, present and future values are more important; we must therefore look beyond any past earnings record and consider many other factors to come up with the truth; but, to quote from The Importance of Being Earnest, "truth is never pure, and rarely simple". It takes years of experience to read between the lines, and to look not only for a buried skeleton, but for every individual buried bone.

"Nothing can have value without being an object of utility. If it be useless, the labour contained in it is useless, cannot be reckoned as labour, and cannot therefore create value". That was not written by some smart young know-it-all Harvard MBA, but over a hundred years ago, towards the end of the first industrial revolution; the author was Karl Marx. With a thoroughly bourgeois background, he certainly knew value, and could even be considered a leading participant in the knowledge industry.

As you can see, I believe that you can learn something from almost anyone, but even with over thirty years' experience as a valuator, I am not sure how I would value the enterprises resulting from the single-minded application of Marx's ideology; however, his motivation was not to please valuators, but to retain control.

This brings me to one fact your clients must understand: when you engage a valuator, don't hold back. Give him all the documents he wants, including Financial Statements, Projections, Business Plans etc., and give them to him when he wants them; this is not relinquishing control or letting out secrets, it simply saves frustration, delays and fees.

But back to the matter at hand. I have broken my comments on "Valuation in the Current Recession" into four segments: Tax; Reverse Take-overs, Matrimonial, and Real Estate. In the first three, I am using material drawn from actual valuations.

Now to Taxes

We all know they've been around for a long, long time, causing various degrees of pain, but there is always a new way of looking at that particular curse.

For instance, one of the most famous tax cases was the 1773 Boston Tea Party. We have all seen paintings and drawings and read eyewitness reports about those 342 chests of tea being thrown into the raging sea by a bunch of workers disguised as Indians. However, according to recent studies, there was a low tide on that occasion, and the packages were simply dropped into the mud. To a certain extent, practicality may have outweighed patriotism ....

Normally, even at that time, by global agreement, one plus one equalled two, and two plus two equalled four; however, a recent job here in Southern Ontario reinforced my notion that for nearly every purpose, perception is reality, but that reality has very little connection with Revenue Canada.

In this valuation, we were able to convince - or at least I believe we were able to convince Revenue Canada, as the matter has not been reassessed for over two years - that for taxation purposes, a 25% economic interest was worth less than 15% of the total value.

The background is not complicated: two unrelated men established a successful manufacturing company, exporting about 90% of its production to the United States and to Europe. Each partner owned one share; one partner had two sons, the other none. When the son-less partner came to retire, he sold his single share jointly to the two brothers, his partner's offspring. No stock split took place, and therefore, each brother had an undivided 50% interest in the single share. A short time later, one of the sons was killed in an accident.

It would be an elementary reaction to immediately assume that his heirs owned a 25% economic interest, which had the same proportion of the value of the company.

Not so. In family owned companies, Revenue Canada normally takes the position that no minority discount can be claimed, as there is always a relative who would willingly purchase the deceased member's position. This is fine if there are a number of shares, and enough cash to make such a purchase. Today, profits in most cases are limited, and as a result, cash can usually only be obtained by borrowing.

Due to the recession, profits of our manufacturing company were down quite sharply in 1990, though expected to improve during 1991, the year in question. An outside buyer would not find the situation attractive; other than dividends, he could not obtain any benefits from the purchase of a half interest in a single share, which did not control the company.

Under these circumstances, Corporate Valuation Services was retained to prepare the Valuation Report necessary to establish to Fair Market Value for the Capital Gains Tax due on death. In our Valuation Report, we not only reflected the impact of the recession on the earnings and liquidity of the company, but also claimed a 43% discount for the lack of marketability of the participation in the share.

This rather odd discount is based on the discounts that have been demonstrated in the United States between sales of shares of companies when they were private, and the issue price of their subsequent initial Public Offering.

What was required was a little imagination combined with what you learned in school. As I said, this was over two years ago, there was no inquisition from Ottawa, and we are all breathing a little easier with each passing day.

Later, the shares of the little manufacturing company were split 1,000 for 1, and the heirs of the deceased brother now directly own their rightful 25%.

This December, the sugarplums in tax shelters seem to be software; in one case, a 100% write-off in 1993 is being offered to investors who purchase the units at a December 30 closing. Most of these transactions appear to assume highly inflated values; one of them uses a value of over $30 million for a 50% interest in a piece of Systems Software.

This value was obtained by making all sorts of rather unrealistic assumptions, for instance that the software will be useful for the next ten years, that interest rates will remain at the same low percentages for the whole period, and that there is little risk.

Life isn't like that. In the present climate of rapid change, and with innumerable garden shed inventors certain they are on the way to emulate well-known computer success stories, a major revision of the principal software packages comes out about every two years, and the old versions just fade away.

Can you remember what brand of Word Processing equipment you were using ten years ago? Or perhaps I should ask which one your secretaries were using, because then, typing wasn't considered a fit activity for a professional, while today "keyboarding" most certainly is... I know that at that time, I bought a Wang, which was totally incompatible with our first PC purchased the following year. Wang's US parent slid into Chapter 11 quite some time ago.

In many of these software valuations, there are likely to be reassessments by Revenue Canada, who will not easily accept the inflated figures; there will be additional taxes and fees payable by the clients, and losses and messes all around. So, unless your client needs an enormous tax write-off, which in today's economy is not as common as it used to be, except perhaps among Minden Gross clients, get somebody to come up with a realistic value, someone who may possibly appear a touch obstreperous at first glance, but who has eaten enough of today's sugarplums not to get carried away.

As I said before, if you are imaginative, there are opportunities for presenting the facts in a light that gives the best position to your clients.

Second Topic, Reverse Takeovers:

An old adage from a much earlier recession was "Go public rather than go broke"; today, in the hyperactive new-issue markets, this once again seems to be true. Almost anything or anyone can go public; one Ottawa high-tech company, with sales of about $16 million and a loss of $900,000 in the last twelve months, was able to go public on NASDAQ at a price that represented 5.5 times revenue.

If a US investment banker is prepared to underwrite such a Canadian IPO on this basis, management would be foolish to reject it. All I can say is "nice work if you can get it", even though this offering price is far above any value determined by normal investment criteria. By the way, we did not value that particular company; we valued one of its competitors, for whom we envisage a fair break for the investor, and no risk of any bubble collapsing.

In a positive, promising situation, reverse takeovers have become a vehicle of choice to obtain liquidity and raise funds for companies that are heavy in intellectual property and have great potential, but are light on current earnings.

We have done valuations to assist a number of such companies in their reverse takeovers, ranging across the spectrum of technology from software and photovoltaic cells at one end, to the manufacture of grain burning stoves at the other. In such deals, the principal shareholding is usually freely tradeable rather than escrowed, as it would be in an IPO. Reverse takeovers can give fair value all around, to the new investors, the existing shareholders of the shell, and the new principal owners. Another factor to consider is that Going Public runs into quite a bit of money, while reverse takeovers can be noticeably cheaper and faster to complete than the traditional IPO.

Going Public is virtually the Good Housekeeping Seal of Approval; it is a well-established fact that a public company is worth at least 1.75 times the value of the same entity when private. With hopes raised high, nothing is too low, too sleazy or too obscure for Going Public; at one time, for a reverse takeover, we valued one of the oldest established permanent floating charitable casinos in town, or actually, its operator.

Matrimonial:

"Tis safest in matrimony to begin with a little aversion", said Mrs. Malaprop, but alas, matrimony frequently ends with a great deal of aversion, and that's where you come in; if you want to do your client some good, that's also where I come in. We have all experienced the spouses who brag about all they are worth, until it comes to dividing it up, when, suddenly, they have hardly a dime.

I also bet many of you would have a thing or two to say about that Alberta farmer, who many years ago refused to give anything to his wife when she wanted a divorce; he certainly started an avalanche, which is still reverberating through today's family law.

In divorce cases, one has to value many types of assets as well as businesses. Again, one values not only the business as it is today, but its expectations for the future. In the past, projections could be easily made as they were mainly based on established trends and relationships; if receivables had averaged forty days sales, there was no particular reason why this should suddenly be different, but not so today.

Old models and relationships are no longer valid. The regulatory situation has changed; due to Free Trade and NAFTA, competition is taking on a whole new meaning, and it is unlikely that firms will get back to the profit margins of the eighties within the lifetime of their present owners. In many cases, companies are merely providing a living for the proprietor, without giving them an adequate return for the large amounts of capital they have invested. In many family businesses, if one was to pay the kind of salaries expected by successful managers, there would be little profits or return to the shareholders.

In such tight situations, divorce suddenly presents the need to extricate funds from the existing business for the equalisation payment; this outflow of cash may weaken the business to such a degree that a comeback is difficult, even impossible. Not only may the marriage be a casualty, but also the business, existing employees, perhaps even a small community; it's just like the proverbial pebble in the pond.

One interesting situation that arose in early 1993 was a nursing home operator who had over expanded. He could not obtain licenses for all the extra beds, and therefore converted them into a retirement home; it shared kitchen and recreational facilities with the nursing home, but had its own staff. This part of the business was owned by the proprietor's two children, a dentist and a school teacher, with father of course running the show.

Then his daughter, the school teacher, decided to ditch her husband, also a school teacher. Splitting up the other assets was easy; house and cottage were sold, each took his own car, and the pensions were approximately the same; the question was, what to do about this retirement home business? Yes, it did make money, but did the profits really come from the retirement home, or were they deftly transferred from the nursing home by an imaginative tax planning CA and a kind father?

As Corporate Valuation Services was called in late, as a sort of last resort after much digging in of heels, we had less than a week to do the complete Valuation Report. The husband had been offered $90,000 by his wife for his half interest in her share, but after research, comparisons and a little reliable gut feeling, we eventually considered it to be worth approximately $250,000; the final settlement was just over $200,000.

I like to put it this way: it gave the husband an annualised rate of return of over 10,000% on his investment in our fees. The wife's family obviously thought it fair, as the matter was settled before going to court. While such results may not be completely to your liking, it may be to the client's advantage, and thereby increase your reputation as having the client's interest at heart, at least whenever practical.

In such circumstances, I am sometimes envious of your right to a contingency fee; alas, this is forbidden for the valuator, who must not only be independent, but must appear to be independent. We agree on a fee, expect a retainer when engaged, and full payment or guarantees before delivery of the signed Valuation Report.

Fees vary with each case, and depend on the time involved as well as the deadline. If anyone must have a number before going to court next Thursday, not only I, but also my staff must put in extra hours, and, just as in the all-day/all-night neighbourhood convenience stores, prices go up when we have to burn the midnight oil or give up week-ends.

Matrimonial litigation may be complicated, but most of the time, we encounter simple, conventional cases, which are speeded up by the necessary valuation of straightforward businesses, plants, the matrimonial home and its contents, etc. A good lawyer frequently offers sympathy in addition to superb advocacy, and must take sides to properly represent his client; the valuator is viewed by most protagonists as impartial, independent, expert and objective.

Real Estate:

For a long time, real estate was considered the safest investment, the most reliable hedge against poverty; sure, houses had been destroyed by bombs and war, but this certainly never applied in Canada, or North America. Buy your own home; buy rental property, and the tenants will give you a nice pension; own the building in which you install your factory; that way, nobody can dislodge you and force the loss of all the improvements you made upgrading it.
Following this credo, many companies took a substantial portion of their profits and invested them in real estate, so as to give long-term security for their owner's retirement, or for the children. The value of all real estate, even the shabbiest hut in the worst district, was on a perpetual upward spiral, and appeared headed for the sky.

And then, Humpty Dumpty had a great fall, and all the Queen's horses and all the Queen's men, and all the Tories and Liberals and certainly not the NDP could put Humpty Dumpty together again, at least not for now. As mentioned before, hanging on by adding or increasing mortgages is not always possible. To quote the actor Ed Wynn when he sold his farm, "every radish I ever pulled up seemed to have a mortgage attached to it".

In a recent conversation, a very senior executive of one of Canada's largest realtors told me that, in his view, it would be fifteen years before commercial suburban Toronto real estate got back to the peak levels of 1989-90; in some circles, this is considered optimistic.

Traditionally, appraisers adopted three methods to determine the value of real estate. These were the replacement cost, comparative sales and capitalised income approaches. Today, for many situations, none of them is applicable. Construction costs have not declined in line with real estate values. For many commercial buildings, if the structure is valued at its replacement cost less physical depreciation, the land has a substantial negative value.

Comparative sales are difficult, as very few transactions are taking place, and many of those are distress disposals under Powers of Sale, or foreclosures by mortgagees.

Capitalisation of income is also difficult, when the net/net rent for new tenancies in many downtown buildings is of the order of $1.00 per sq. ft., and some landlords are prepared to offer zero or negative net/net rents for large tenants, just so that they will absorb operating costs.

Other methods must be found. My approach basically is to look forward to the time when net/net rents for new tenancies will have returned to a reasonable level; this would require a vacancy of less than 5%, and, based on current absorption rates, is likely to take at least five years.

I have mentioned only a few of the eggs we have in our basket; they range from quail to turkey eggs, and we haven't yet come across the lately very fashionable dinosaur egg; neither have we ever laid an egg ourselves. In addition to direct valuations, we can also give you strong litigation support; having done so, I have always been a little suspicious of one of the Big Six, when in connection with the BCI scandal in London they played see no evil, hear no evil, speak no evil.

But then, perhaps I am a cynic, although I do not fit Oscar Wilde's definition: "A man who knows the price of everything and the value of nothing". I assure you, ladies and gentlemen, in my business, I must find out the price of a certain thing and then put the appropriate value on it.

