# VALUATIONS APPROACHING THE MILLENNIUM

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Some sixty years after "The Great Depression", Corporate Valuation Services Limited ("CVS") Canada in the early 1990's went through "A Little Depression", whose effects refuse to fade away. Toronto used to be referred to as Canada's locomotive, now reported unemployment has increased from around 4% to about 10%. Including discouraged job seekers, the real rate is closer to 13%, with many of the unemployed victims of the third Industrial Revolution.

High school history taught us about the original Industrial Revolution, which originated in England during the last quarter of the eighteenth century, when steam replaced animal power; this enhanced the scope of skilled craftsmen, created opportunities for mass production, and moved work from the home to the factory.

The second Industrial Revolution started about a hundred years later and created the "Modern World". Most of its prime movers and shakers hailed from this side of the Atlantic - Edison, electric power, Alexander Graham Bell, the telephone, Henry Ford and the Automobile, and had many other far reaching applications. Developments in this era freed society from geographical confines and, among numerous other benefits, also brought us the one-and-a-half-hour one-way commute.

The third Industrial Revolution started in the late 1960's and is still ongoing. In it, the rates of change of nearly everything increased specialized knowledge, joined labour, capital and resources as the key component of business; the jobs of many skilled tradesmen can be handled more accurately, and certainly more cheaply, by robots. In Japan, there is reputed to be 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. Traditionally, "the past is prologue to the future" assumes the value of a firm could be based on its history. Today, present and future trends are more important to values. We must therefore look beyond historic earnings records 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". This essential truth was not written recently by some smart young Harvard MBA, but over a hundred years ago, towards the end of the first Industrial Revolution, by Karl Marx. With a thoroughly bourgeois background, he certainly knew value, and can be considered a leading participant in the knowledge industry.

As you can see, I and my partner believe that you can learn something from almost anyone, but even with over thirty five years' experience as a valuator, I am not sure how I would value the many of the enterprises emerging in countries that suffered 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 engagements *Valuations Approaching the Millennium*, into three segments where up-to-date technology or the lack of it is very important: Tax Situations, Reverse Take-overs, and Matrimonial, using material drawn from actual tax situations.

**Tax Situations:**

Taxes have been around for a long, long time, causing various degrees of pain, but there is always a new way of looking at this particular curse. 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 nearly always, "perception is reality", but that Revenue Canada has very little connection with reality.

In this valuation, 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 five 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. Each partner owned one share; one partner had two sons, the other none. When the childless partner came to retire in 1990, he sold his single share jointly to his partner's two offspring. No stock split took place, and therefore, each brother had an undivided 50% interest in the single share, with their father owning the other. A short time later, in 1991, one of the sons was killed in an accident.

The elementary reaction is to immediately assume that his heirs owned a 25% economic interest in the business with the same proportion of its value.

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 many cases are limited, and as a result, cash for purchase can usually only be obtained by borrowing.

Due to the recession, profits of the manufacturing company were down quite sharply in 1990, although 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.

CVS was retained to prepare the Valuation Report necessary to establish the 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 half interest in the share.

This rather odd discount is based on the average discount in the United States between the price at which shares of companies were sold when they were private, and the price at the time of their subsequent Initial Public Offering. As I said, this was over five years ago, there has been no inquisition from Ottawa, and everybody is now breathing a little easier.

Later, the shares were split 1,000 for 1, and the heirs of the deceased brother now directly own their rightful 25, with a tax loss to set against gains on the assets. All it took was some imagination.

### Tax Shelters

Last December, the sugarplums in tax shelters was software, as film deals had been effectively outlawed in the 1996 budget. In one case, a 100% write-off in 1996 was being offered to investors who purchased the units by a December 30 closing. Most of these transactions appeared to assume highly inflated values; one put a value of over $30 million for a 50% interest in a systems software programme. This value was obtained by making a number of assumptions that though plausible in themselves, gave rise to a rather unrealistic result. The valuator anticipated that the software would be useful for the next ten years, that interest rates would remain at the current low level for the whole period, and that there would be little risk.

Life isn't like that. In the present era of rapid change, there are innumerable garden shed inventors certain they are on the way to emulate well-known computer success stories. New products appear daily and the principal software packages are almost totally revised every two years, while the old versions just fade away.

Can you remember what 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; today "keyboarding" most certainly is. At that time, I used a Wang, which was totally incompatible with our first PC purchased two years before; Wang's US parent slid into Chapter 11 quite some time ago.

In many of these software tax shelters, there are likely to be reassessments as Revenue Canada, will not easily accept the inflated valuation 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 Miller Thompson 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.

### Reverse Takeovers

An old adage from the recession of the early 1960's was "Go public don't go broke"; today, after the new-issue markets have been hyperactive for several years, 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.

Even though frowned on by the regulators, 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 companies in such transactions, ranging across the spectrum of technology from software and photovoltaic cells at one end, to the manufacture of grain burning stoves and the production of cotton yarn at the other. In such deals, the principal's shareholding can often be freely tradeable rather than escrowed, as it might well be in an IPO. Reverse takeovers can give fair value all around, to the new investors, the existing shareholders of the share, and the new principal owners. Another factor to consider is that a traditional IPO runs into quite a bit of money, while reverse takeovers can be noticeably cheaper and faster.

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 must consider not only the business as it is today, but its expectations. In the past, projections were relatively 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; 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 merely give a living for the proprietor, without an adequate return on capital they have invested. If many family businesses paid the kind of salaries expected by successful managers, there would be little profits for the shareholders.

In such situations, divorce can suddenly present the need to extricate funds from the existing business for the equalization 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; 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, which 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 the 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?

After much digging in of heels, CVS was called in, as a sort of last resort; 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.

Our fee was $30,000; this may sound high, but the husband received an annualized rate of return of over 10,000% on his investment in us for a week. 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 best interest at heart, at least whenever practical.

In such circumstances, I am sometimes envious of our right to a contingency fee; alas, this is forbidden to the valuator, who must not only be independent, but must appear to be so. We agree on a fee, expect a retainer of 50% plus GST when engaged, and full payment before delivery of the signed Valuation Report.

Fees vary with each case, and depend on the professional time involved with our workload as well as the deadline. If anyone must have a number before going to court next Thursday, all of us 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.

I have mentioned only a few of the eggs we have in our basket; they range from those of quails' to turkeys' eggs; while we haven't yet come across the lately very fashionable dinosaur egg, we have never laid an egg ourselves. In addition to direct valuations, we can also give you tax and general litigation support.

Unlike one of the Big Six, in connection with the BCI scandal in London which played "see no evil, hear no evil, speak no evil, we are monkeys of a different sort. On my desk is a casting with examples of our "new improved" monkey. One uses binoculars to see what is going on, the next has her hands behind her ears to hear all that is happening, while the third uses a megaphone to "tell it like it is".