VALUATIONS IN THE KNOWLEDGE ERA

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In a number of interviews, Lawrence Olivier admitted that before every entry he made on to any stage, he suffered a severe case of stage fright, but that the moment he was within reach of the kleig lights, there was not one iota of insecurity left in his talented, well-honed mind and body. I am saying this because, although I had to belong to a variety of debating societies in some rather distinguished schools, my stage fright never leaves me, and I haven't managed to become a good speaker. However, let me assure you without reservations or false modesty, that I am a darn good accountant and valuator.

Some sixty years after The Great Depression, in the early 1990's, Canada went through "A Little Depression", the effects of which still refuse to fade away. Toronto, once The Dominion's economic locomotive, now reports chronic unemployment of around 10%; it used to be 4%. Counting discouraged job seekers, the real rate is closer to 13%, and many of them are victims of The Third Industrial Revolution.

As we learned in high school, the original Industrial Revolution started in England in the seventeen eighties, over 200 years ago. It was the time when steam replaced animal power, creating the basis for mass production, moving work from home to factory, and, for the first time in history allowing reasonably priced, reliable transportation on land and sea.

The Second Industrial Revolution came about a hundred years later; it created the "Modern World" of electricity, cars and planes. Most of its prime movers came to fame this side of the Atlantic, Edison, Alexander Graham Bell, Henry Ford, who could never have fulfilled their dreams in Europe; their efforts had far reaching effects and freed society from geographical confines. Little did they know that it would bring us the one-and-a-half-hour one-way commute.

We are in the middle of The Third Industrial Revolution, the KNOWLEDGE ERA; it started in the late 1960's and is still going on - who knows how long, and with what degree of acceleration. The three elements of economic activity, Land, Labour and Capital, have been joined by a strong fourth force, Knowledge, as the key resource of a business.

Large sectors of The Knowledge Revolution are implemented through computers, allowing the jobs of many skilled craftsmen to be handled more accurately, and certainly more cheaply, by robots, which are still not unionized. We have all heard about the Japanese robot factory working

24 hours a day creating more robots; I have it on reliable authority that being concerned with energy savings, this particular activity takes place with the lights turned off.

This new economy has drastically changed the role of the valuator. While a good valuator, as an outsider, has always been able to open Management's eyes to certain aspects of the firm, it is now of vital importance to take into account a company's intellectual property, understand its technology, possess superb research capabilities to assess the competitive situation, and combine imagination with experience.

In The Tempest, Shakespeare stated that "what's past is prologue to the future"; that held true for many centuries, but today, a valuator's sensitive perception of future trends is more important to his work than plotting changes in Earnings Per Share; he used to search not only for a buried skeleton, but for every individual buried bone. Today we must look beyond historic earnings, and consider many other factors to arrive at the truth.

But, to quote from another wicked Englishmen, Oscar Wilde, "truth is never pure, and rarely simple". Without exaggeration, it takes a near-Renaissance background, imagination and years of experience to read between the lines. Even if a company is not aware of any competitors in Canada, they are surely out there, somewhere in the world. If nobody's out there, we quickly begin to doubt that there is a market. Just to prove my point, in one case, management proudly informed us that they had no competitors; we stopped looking after finding 43 in North America, Europe and Asia.

"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". I presume you will quickly ascribe this essential truth to some smart young Harvard MBA, but it was said over a hundred years ago, towards the end of The First Industrial Revolution, by none other than Karl Marx, the author of Das Kapital. With his thoroughly bourgeois background, he certainly recognised value; if he lived today, he could easily be a leading participant in the knowledge industry.

This brings me to the essential point your clients must understand when dealing with a valuator: give him what he wants. Before your imagination runs away with you as to what goes on in our business, let me say this refers to paper, paper and more paper: Financial Statements, Financial Projections, Business Plans, Contracts, Agreements, Patents, Source Codes, Management CV's and more such good stuff, but also tell him about the bad, such as possible pending law suits, an upcoming divorce, disagreements between partners, etc.

It is equally important to give them to him when he wants them; this simply reduces delays, frustration, and most importantly, fees.

To go into more detail in regard to my topic, “Valuation in the Knowledge Era”, I will use examples from actual situations in four segments: Capital Gains Taxes, Tax Shelters, Reverse Take-overs, and Matrimonial.

Capital Gains Taxes

Taxes have been around for a long time, inflicting various degrees of pain, but there is always a new angle to 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 passionate workers disguised as Indians. However, according to recent studies, the tide was low on that occasion, and the packages were simply dropped into the mud. A few years later, in 1789, Benjamin Franklin coined his famous comment, "in this world nothing can be said to be certain, except death and taxes".

Franklin knew that reality can often be deceiving. Usually, shareholders believe that 10% of the shares represent 10% of the value of the business, but "it ain't necessarily so".

A few years ago, CVS was able to make a strong presentation to Revenue Canada that, as far as taxes were concerned, a 25% economic interest can be worth less than 15% of the total value of a business.

The background is straightforward: 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 retired 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 a single share, with their father holding the other. A short time later, in 1991, one of the sons was killed in an accident; his estate now owned 25% of the business.

Revenue Canada takes the position that in family owned companies, no minority discount can be claimed, as there is always a relative who would willingly purchase the deceased family member's position. This is fine if there are enough shares and enough cash for such a purchase. Nowadays, profits are limited, which means that generally, cash for a purchase can only be obtained by borrowing.

Due to the recession, profits of the manufacturing company were down quite sharply in 1990, although they were expected to improve during 1991, the year in question. An outside buyer would not find it very attractive to purchase the estate's half interest in a single share. Outside of dividends, no benefits could be obtained.

CVS was retained to establish the Fair Market Value of the estate's holding to determine 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 percentage was 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 issue price of their subsequent Initial Public Offering. This matter happened over five years ago, there has been no inquisition from Ottawa, and everybody is breathing a little easier.

When things were looking up, the shares were split, the company went public and the heirs of the deceased brother now directly own their 25%, with a tax loss to set against gains on other assets. It took know-how, bloody-minded research, experience and a lot of imagination.

Tax Shelters

For several years, the tax shelters' sugar plum was software, especially last December, as film deals had been effectively terminated in the 1996 budget. Few valuators know a lot about software. We've paid our dues, as we've completed sixty valuations of software and software developers over the past five years.

To get back to the dreamer, to be kind: one valuator ascribed over $30 million to a 50% interest in a systems software programme. That particular valuator obtained this figure by making a number of assumptions; each of those was perhaps plausible in itself, but together, they led to a rather unrealistic result. For example, he anticipated that the software would be useful for the next ten instead of the maximum of three years, that interest rates would remain at their current low level, and that a discount rate of 10% was appropriate, as there would be little risk.

Sugar plums aren't like that, and life isn't like that. In our time of rapid changes, innumerable garden shed wunderkinder are convinced they are on the way to emulate well-known computer success stories. New products appear daily, and the principal software packages are revised at least bi-annually, with the old versions just fading 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 some time ago.

Many software tax shelters are likely to be reassessed as Revenue Canada, will not easily accept the valuations; they will also question both if the software was "available for use" and whether there was a reasonable "expectation of profits". The result of reassessment is 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 Thomson 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 the Valuator understands the technology and is imaginative, the facts can be presented in a light that gives the best position to your clients without the Valuator crossing the line and becoming an advocate.

Reverse Takeovers:

An old adage from the recession of the early 1960's was “Don’t go broke, Go public". 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 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, while we did not value that particular company; we have 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 strong 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 whole spectrum of technologies 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 the shares of a public company are worth at least 1.75 times their value when private due to the discounts for lack of liquidity referred to under capital gains taxes. With hopes raised high, nothing is too low, too sleazy or too obscure to Go 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 we come in. Everybody has experienced the spouses who brag about all they are worth, until it comes to dividing it up, when, suddenly, they have hardly a dime.

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 change; not so today!

Old models and relationships are often no longer valid. Due to Free Trade and NAFTA, competition is taking on a whole new meaning; 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 now merely generate a living for the proprietors, without an adequate return on capital they have invested. If many family businesses paid the salaries received 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 business for the equalization payment; this outflow of cash may weaken it 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 $15,000; this may sound high, but the husband received an extra $112,000 for an annualized rate of return of over 10,000% on his investment in us for the three weeks between our starting and his receiving his cheque. 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.

Conclusion

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.

In this brief talk, have mentioned only a few of the eggs we have in our basket; they range from those of quails' to turkeys'; 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, which in connection with the BCI scandal in London 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" monkeys. 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".

THANK YOU!