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WBLI is pleased to present the Fall/Winter 2011 edition of our newsletter *ValueAdded@WBLI*, which provides information on current corporate finance, valuation, M&A and litigation support topics to the business, banking and legal communities of Atlantic Canada. If you have any questions, contact any member of our team or the editor Bill Vienneau, CA•CBV, TEP, CF at (902) 493-5466.

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## Capital Markets Update as of September 30, 2011

### Canadian Economy Fairing Well vs. Global Counterparts

- Canada weathered the downturn better than most advanced economies. Canada's unemployment rate was 7.1% in September 2011 – the lowest level since December 2008.
- Canadian tier one banks are among the strongest and most respected in the world, and we have the best fiscal situation among the G7 nations.
- A slow U.S. recovery and elevated global risks are depressing domestic growth. Net exports are now expected to remain a major source of weakness, reflecting modest global demand.
- Overall, the supply and price of credit to businesses and households remain stimulative and the long-term domestic economic outlook is positive.

### Major economic indicators:

	Sep 30, 2011	Sep 30, 2010	Change
CDN\$/US\$	\$0.963	\$0.971	(0.87%)
S&P 500	1,131	1,141	(0.84%)
S&P/TSX	11,624	12,369	(6.02%)
Bank prime rate	3.00%	3.00%	0.00%
LIBOR (90-day)	0.37%	0.29%	29.07%
WTI Crude Oil (US\$)	\$79.20	\$79.97	(\$0.77)

- The CDN\$ has remained strong against the US\$ - although it has slightly lost ground compared to one year ago, the CDN\$ averaged \$1.014 US over the last 12 months.
- The S&P 500 and the TSX both lost ground over the last 12 months, down 0.84% and 6.02%, respectively.
- While crude oil has ultimately finished the last 12 month period exactly where it started, the spring of 2011 saw prices rise to more than \$110 per barrel. The average price over the last 12 months was \$92.81 per barrel.

# Capital Markets Update (cont'd)

## Atlantic Canadian Economy

The Atlantic economy is heavily dependent on the U.S. recovery given the significance of the U.S. market to the manufacturing and export sectors, particularly in Nova Scotia and New Brunswick.

Atlantic Canada has shown an increase in non-residential construction investment that has exceeded the increase in other parts of Canada. By contrast, urban housing starts in Atlantic Canada have not maintained their positive momentum from a year ago – with 3 of the 4 Atlantic provinces recording fewer second quarter housing starts than the same period in 2010 with only Nova Scotia experiencing an increase.

### Non-residential Building Construction Investment (\$MM)

	2nd Quarter 2011	2nd Quarter 2010	% Change
<b>Canada</b>	<b>\$11,219</b>	<b>\$10,609</b>	<b>5.8%</b>
<b>Atlantic Canada</b>	<b>571</b>	<b>467</b>	<b>23.0%</b>
NL	129	71	81.8%
PEI	37	22	73.6%
NS	206	194	7.1%
NB	199	181	10.7%

*Non-residential investment increased by 23% in Atlantic Canada YoY.*

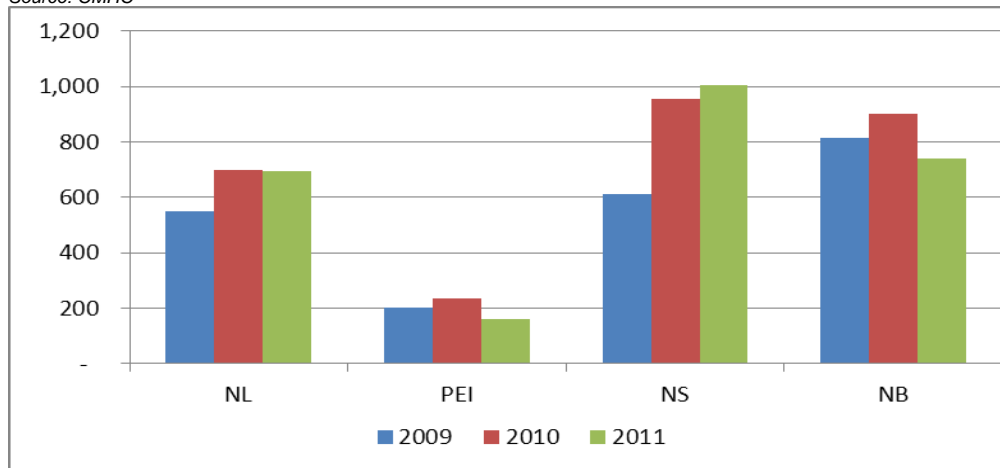
Source: Statistics Canada

- Atlantic Canadian spending significantly exceeded the rest of Canada with a year-over-year (YoY) increase of 23.0% compared to 5.8%.
- Newfoundland and Prince Edward Island account for the bulk of the YoY increase at 81.8% and 73.6%, respectively.

### Housing Starts Atlantic Canada - Urban Starts; 2nd Quarter

	2009	2010	2011
<b>Atlantic</b>	<b>2,180</b>	<b>2,789</b>	<b>2,600</b>
NL	550	697	693
PEI	203	234	161
NS	611	956	1,007
NB	816	902	739

Source: CMHC



*2nd quarter urban housing starts in Atlantic Canada decreased by 7.3% YoY;*

*Nova Scotia housing starts increased by 5.1% YoY.*

- Nova Scotia demonstrated the only YoY increase in urban housing starts in the Atlantic region with an increase of 5.1%.
- As a whole, Q2 Atlantic Canadian urban housing starts decreased YoY by 7.3%, led by PEI with a decrease of 45.3% in Q2 2011.

## Private Company Transaction Multiples

Based on U.S. transactional information compiled by GF Data Resources LLC, the gap still exists between larger and smaller company transaction multiples. Larger companies (based on transaction size) are demanding higher prices in terms of Total Enterprise Value (“TEV”) as a multiple of earnings before interest, taxes, depreciation and amortization (“EBITDA”) due to the inherent risk differences related to financial strength and size. (TEV is equal to the sum of an entity’s invested capital which can be broken into Equity value plus Debt).

The average TEV / EBITDA multiple for all transactions is 5.8x in the first half of 2011, compared to the long-term average of 5.9x. For deals less than \$25M, this multiple is 5.2x in 2011, with a long-term average of 5.4x.

### Transactions Multiples Based on Total Enterprise Value (TEV) / EBITDA

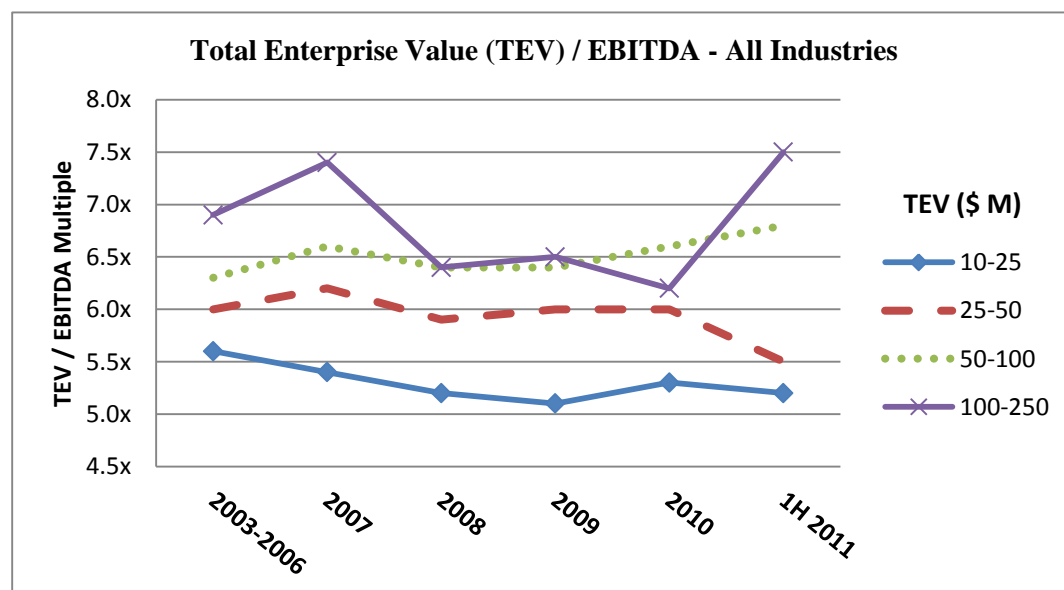
#### Total Enterprise Value (TEV)/EBITDA - All Industries

TEV (\$ M)	2003-2006	2007	2008	2009	2010	1H 2011	Total	# of Deals
10-25	5.6x	5.4x	5.2x	5.1x	5.3x	5.2x	5.4x	491
25-50	6.0x	6.2x	5.9x	6.0x	6.0x	5.5x	6.0x	367
50-100	6.3x	6.6x	6.4x	6.4x	6.6x	6.8x	6.5x	251
100-250	6.9x	7.4x	6.4x	6.5x	6.2x	7.5x	6.9x	83
<b>Total</b>	<b>5.9x</b>	<b>6.1x</b>	<b>5.8x</b>	<b>5.7x</b>	<b>5.8x</b>	<b>5.8x</b>	<b>5.9x</b>	
# of Deals	541	203	150	80	158	60		1192

Copyright, GF Data Resources LLC.

GF Data Resources provides data on private equity sponsored U.S. M&A transactions with TEV of \$10 to \$250 million.

Starting in 2008, transaction multiples started to decline due to lack of confidence in the economy. During the first half of 2011 transaction multiples have increased on deals above \$50M. However, multiples for deals less than \$50M have continued to decrease. The gap between transactions greater than \$100M and deals under \$25M is widening, as highlighted below:



Source: GF Data Resources LLC

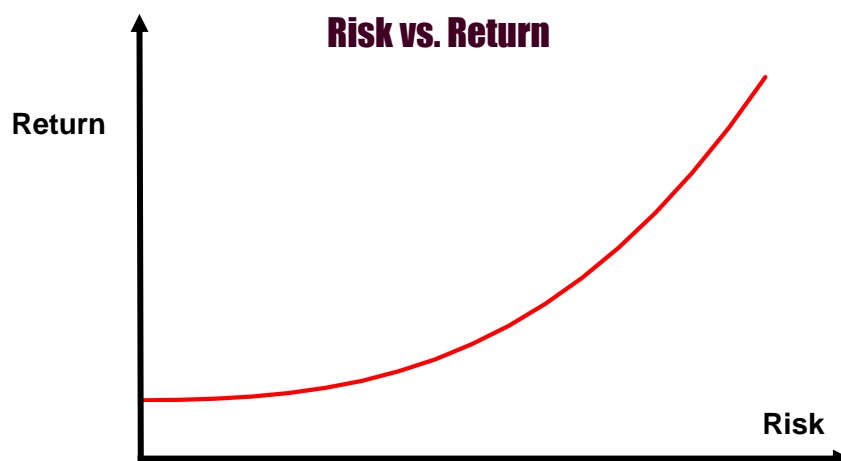
# Multiples, EBITDA and Value

We are often asked “What’s the appropriate multiple to value my business?” Our answer is “It depends” on things such as:

- What income stream will the multiple be applied to: pre-tax cash flow, after-tax cash flow, net income, EBITDA (earnings before interest, taxes, depreciation and amortization), or some other measure?
- Is the income stream supported by the business’ track record or is it based on just the most recent results, or even forecast results?
- What is the nature and value of the underlying assets?
- How strong is the management team?
- How are the customer relationships?
- What does the future of the business hold – steady growth, new competition or significant capital expenditures?
- What is the debt/equity structure of the company? Will buyers be able to further leverage the business or is it already optimally leveraged?

*A valuation multiple or capitalization rate measures the potential risk compared to the opportunity for return*

## Valuation Multiples are a matter of measuring Risk vs. Return



A multiple is simply a valuation/pricing metric that is either a rate of return that accounts for the risks in the business and industry, or alternatively, it reflects market evidence of actual transactions and the implied assessments of risk.

Sometimes a multiple is referenced as an industry rule of thumb, but beware of its accuracy. No two businesses are ever exactly alike. A multitude of factors must be considered, including: differing customer base, capital expenditure requirements, debt/equity structures and growth expectations.

In addition, the expected growth rate can be an important factor. Intuitively, a higher expected growth rate results in a higher value, and therefore, should be reflected in the valuation multiple.

This is just the tip of the iceberg when it comes to the determination of an appropriate capitalization rate or multiple. It is important to understand the relevant factors in determining and defending such a metric, recognizing that ultimately market evidence is the best determinant.

# Multiples, EBITDA and Value (continued)

## EBITDA – Simple but Abused

Clearly, the selection of a multiple is a crucial determinant of value or price. However, in our experience, the base that the multiple is applied to is just as important, and unfortunately, probably even more misunderstood. EBITDA is commonly utilized in the market as both a measure of operating cash flow and as basis for determining business value (including as a measure of ability to fund debt).

While it offers simplicity in terms of EBITDA multiples used to determine value/price; alone it can be dangerous when applied arbitrarily to different businesses in different industries with different capital structures.

EBITDA does not equate to cash flow. However, that has not prevented some entrepreneurs/advisors from focusing solely on EBITDA in all types of businesses (often to their detriment). One should consider:

1. A growing business requires working capital to support growth, and EBITDA alone doesn't factor in working capital needs.
2. Capital expenditures (so-called 'capex') are not deducted in EBITDA (both maintenance capex to support normalized EBITDA as well as growth capex to support any projected growth in EBITDA), but yet for many capital-intensive businesses, funding capex is a real and regular cash issue.

## Level of maintainable earnings – as important as the Multiple

There could be a significant price gap between the vendor's expected selling price and the purchaser's willingness to pay – even when they are using the same valuation multiple!

The base of earnings in this type of 'earnings capitalization' technique is meant to be the level of discretionary earnings expected to continue into the future, i.e. the buyer is paying for future earnings, not historical earnings. Nevertheless, buyers (and hence valuers) look at history as a guide to those future earnings because recent history can be a strong predictor of future performance. In addition, in cyclical or widely fluctuating industries using an average of recent historical earnings can sometimes represent a proxy for expected future earnings.

## Enterprise Value Multiples

Many buyers will focus on base measures of profit such as EBITDA. This has become a commonly-used measure of operating cash flow, at least in part because it measures the success of a business before considering the impact of financing and capital investment decisions.

In our experience, one of the most common pitfalls of entrepreneurs planning for a sale is applying EBITDA multiples that are being quoted for their industry (and are meant to determine Enterprise Value) to their own expectations for a share sale – the essential difference being that the recognition of the debt. Buyers either insist on the debt being paid off prior to the transaction which is a direct reduction from Enterprise Value to arrive at the Share Value.



*Determining the Base level of EBITDA is as important the appropriate valuation multiple*

## Multiples, EBITDA and Value (continued)

The table below shows a simple example of how EBITDA multiples are used to derive Enterprise Value and ultimately Share Value. (*Note: the specific EBITDA multiple typically comes from research into actual transactions involving comparable businesses in the same industry.*)

*A multiple of EBITDA derives Enterprise value and debt must be deducted to arrive at Share Value (Equity Value).*

<b>Maintainable EBITDA</b>	<b>\$ 800,000</b>
<b>Enterprise value to EBITDA multiple</b>	<b>4.5x</b>
<b>Enterprise value</b>	<b><u>3,600,000</u></b>
Less Debt:	
Average operating line of credit	(700,000)
Long-term debt outstanding at the valuation date	<u>(200,000)</u>
<b>En bloc share value (Equity value)</b>	<b><u>\$ 2,700,000</u></b>

It's sometimes shocking for business owners to learn that when an EBITDA multiple is used to value their business, the debt must be subtracted from that result to arrive at share value.

## Understanding Your Balance Sheet – a Strategic Approach to Capital

*“What is a typical capital structure for my industry, and the optimal structure for my business?”*

*“Should I carry more or less debt on my balance sheet?”*

*“How will a lender view my company?”*

*“What’s the best way to finance the growth of my business?”*

The financial world can be complicated. Intensifying markets demand smarter and faster financial guidance. The credit environment has become more conservative for borrowers, as terms are tightening, requirements are increasing, and companies are being forced to diversify their banking relationships – all while trying to run the day-to-day business operations, manage working capital and focus on the future of the company.

Anticipating the optimal financial structure and resources required to run a business and having them both in place on a timely basis are among the keys to managing cash flow. The creation of a sound financial platform takes careful analysis and an in-depth knowledge.

*Owner-managers should focus on the Balance Sheet as well as the Income Statement*

### Ways to Improve Working Capital

Examine various ways that cash management could be improved at your organization. The following are considerations that could improve the working capital in your business:

#### Procurement

- Improve vendor terms and maximize for volume consolidation
- Establish and adherence to payment targets and ensure appropriate processes and controls are in place to ensure payments are processed appropriately
- Ensure that purchase discounts are used and choose vendors who allow best terms
- Review Accounts Payable database for duplicate payments, invoice errors, etc.
- Review procedures for timing of tax & duty payments
- Intelligently increasing the days of accounts payable outstanding

# Understanding Your Balance Sheet – a Strategic Approach to Capital

The following are considerations that could improve the working capital in your business:

## Inventory

- Eliminate “just in case” buffer stock ordering
- Ensure sales and demand forecasting process is linked to inventory purchasing

## Billing / Receivables / Cash

- Ensure that invoices are issued at the time or shortly after the goods are sold or services rendered
- Consider offering early payment incentives. Ensure that collection representatives contact customers promptly for over-due invoices
- Have performance measures in place that monitor and are acted upon to improve debtor days, daily collection, and the aged debt balance

## **Understanding your Capital Structure**

Understand how adjusting the capital structure can help provide flexibility within your business.

- Capital must optimize the long-term capital structure, balancing cost and risk, thereby maximizing shareholder value.
- As the amount of leverage increases, financial risk increases, and lenders require a higher return. The amount of lender return affects the return that is available to equity holders.
- That amount of leverage that maximizes return on equity but minimizes the overall cost of capital, considering the cost of debt and tax shield, effects an optimal capital structure.

## **WBLI's industry knowledge and technical expertise help to ensure success**

WBLI offers an extensive range of advisory services including:

- Assistance in determining your optimal capital structure and financing options
- Assisting and advising on appropriate lines of credit and long-term debt financing
- Financial modeling – to assist with budgeting and projecting future period financial statements and to consider impact on financial covenants
- Assisting with succession plans, including planning for a transition to the next generation and / or to a qualified management team

WBLI can help. We've worked with companies of all sizes, industries and market sectors. We've learned market-leading lessons along the way and we use them to further improve your balance sheet, bottom line, diversify your risk, and plan for the future. Whatever phase your business is in, we can help you:

1. Grow via merger or acquisition
2. Assist to turn around a business or advise to avoid a decline in the first place
3. Improve operational effectiveness through performance enhancement
4. Transition the business over time to a Management team or family members

## **WBLI** **Chartered Accountants**

### **Bedford Office:**

Governor's Place  
26 Union Street  
Bedford, NS B4A 2B5

Phone:  
(902) 835-7333

Fax:  
(902) 835-5297

### **Truro Office:**

Sun Professional Bldg  
640 Prince Street  
Truro, NS B2N 5V2

Phone:  
(902) 897-9291

Fax:  
(902) 897-9293

### **Halifax Office:**

1657 Bedford Row  
Halifax, NS B3J 1T1

Phone:  
(902) 482-2000

### **Contacts:**

Bill Vienneau, CA•CBV, TEP, CF  
(902) 493-5466  
[bvienneau@wbli.ca](mailto:bvienneau@wbli.ca)

Jerry Inman, FCA, TEP  
(902) 493-5464  
[jinman@wbli.ca](mailto:jinman@wbli.ca)

Brad Langille, FCA, CF  
(902) 493-5451  
[blangille@wbli.ca](mailto:blangille@wbli.ca)

Craig Maloney, MBA, CA•CBV  
(902) 493-5430  
[cmaloney@wbli.ca](mailto:cmaloney@wbli.ca)

Jonathan Gallant, CA•CBV  
(902) 493-5471  
[jgallant@wbli.ca](mailto:jgallant@wbli.ca)

[www.wbli.ca](http://www.wbli.ca)

## **WBLI Corporate Finance and Advisory Services**

- Are you an owner/manager that wants to sell your private, mid-market business but aren't sure how to do it while maintaining focus on the business and **maximizing your selling price & terms**?
- Are you an entrepreneur who wants to build wealth, but do not have the experience/expertise in **targeting, negotiating & closing acquisitions**?
- Does your private, mid-market business require assistance in **negotiating debt/equity financing** for working capital, growth or acquisition?
- Are you a litigation lawyer who must argue in court on the **quantification of losses** for your business clients?

We help entrepreneurs (and their advisors) buy or sell private and mid-market businesses, including assisting with targeting, valuation, negotiation, sourcing financing and due diligence. In addition, we assist entrepreneurs (and their legal advisors) by quantifying business losses for expert witness testimony in a variety of litigation disputes.

If we can help you or your clients, please contact any one of our Corporate Finance professionals for a complimentary consultation.

***“It's far better to buy a wonderful company at a fair price  
– than a fair company at a wonderful price.”  
- Warren Buffet***

*The comments in this newsletter should not be construed as specific business advice; please consult your business or legal advisor. WBLI Chartered Accountants accept no liability or responsibility for actions undertaken based on the suggestions in this newsletter and without proper business and legal advice.*

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## **About WBLI Chartered Accountants ...**

WBLI Chartered Accountants has been helping businesses succeed in Atlantic Canada for over 35 years. We have grown to be the region's largest independent firm of chartered accountants, with offices in Bedford, Halifax and Truro, NS. We are a full service firm, offering both depth of experience and specialized knowledge in the areas of assurance, accounting, taxation, business valuations, litigation support, and mergers & acquisitions transaction advisory services. Our affiliate, WBLI Incorporated, is one of the leading insolvency/bankruptcy firms in Nova Scotia.

Through our membership in DFK Canada and DFK International, we are able to meet the needs of clients with interests across the Atlantic region, Canada and around the world.