



CBV INSTITUTE: 2023 INSIGHTS

A Compendium
of CBV Institute's
Thought Leadership
in 2023





CBV INSIGHTS: COMPENDIUM 2023

CBVs are at the forefront of fast-moving business change and are highly qualified to share expertise and opinions on factors and conditions impacting the business world. CBVs' unique valuation lens provides insights which are in-demand for today's complex business challenges. As experts in their field, CBVs are continuously building specialized expertise and knowledge across increasingly diversified practice areas, areas of business, and industries.

CBV Insights is a resource to share the expert voice and views of Chartered Business Valuators, experts in all matters of business valuation, on topics of relevance to business.

In 2023, the following Insights were authored, and we are pleased to share them in this Compendium.

Supporting Success: The Importance of CBVs in Succession Planning
February 2023

Valuation in the Brewery Industry
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Valuation of Sports Teams and Franchises
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CBV INSIGHTS

FEBRUARY 2023

SUPPORTING SUCCESS

THE IMPORTANCE OF CBVs IN
SUCCESSION PLANNING

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INTRODUCTION

The Canadian Federation of Independent Business (CFIB) recently released a highly-anticipated research report, *Succession Tsunami: Preparing for a decade of small business transitions in Canada* (the “CFIB Report”). To put it mildly, the results of the report were staggering. Of note:

- 76%¹ of owners plan to leave their business within the next 10 years (15% within 1 year, 41% within 1 to 5 years, and 20% within 6 to 10 years), *and*
- The value of assets changing hands over the next 10 years is potentially over \$2 TRILLION, *yet*
- Only 1 in 10 owners have a formal business succession plan in place!

In other words, a massive transfer of wealth is imminent, but the vast majority of business owners do not have a formal succession plan in place.

From a valuation perspective, the CFIB Report also noted that *43% of business owners cite valuing their business to be an obstacle, and 84% noted it was very or somewhat difficult to determine the value of their business*. This paper outlines why the valuation of a business is a perplexity to so many business owners, and how Chartered Business Valuators (CBVs) can play a key role on any business owner’s multi-disciplinary succession planning team.

WHO ARE CBVs?

CBVs are accounting, finance and business professionals who have received extensive formal education and accreditation in business valuation from CBV Institute, and must comply with ongoing professional obligations, including professional development, a Code of Ethics and Practice Standards, and a mandatory practice inspection program².

The CBV education program provides depth and breadth of content in business valuation in both public and private businesses, but the emphasis is on private business valuation, which is what most of our small businesses in Canada are.

CBVs have been providing specialized business valuation services in Canada and around the world for over 50 years, and work in a variety of roles – anywhere a conclusion of value is needed – including business advisory, litigation support, transactions, financial reporting, corporate finance, private investments, corporate development, etc. The list of CBV workplaces is extensive.

SUCCESSION PLANNING – FRAMING THIS PAPER

A very simple definition of “succession planning” is used in the context of this paper – succession planning is the process and strategy of transitioning a leadership/ownership role in a business due to an exit of the owner. Inherent in succession planning is the orderly transfer of assets. In many cases, a business is transferred to new owners which could include an external third party buyer, or an internal party such as a business partner, family member or key employee. From the owner’s perspective, succession planning ensures their lifelong goals and objectives are met upon exiting the business.

While succession planning is a complex process (as opposed to a one-time event) that necessarily involves a multi-disciplinary team, for the purposes of this paper we’ll focus on what happens when a business is involved in the succession planning process.



WHY IS VALUING A BUSINESS SO DIFFICULT?

A common misconception is that the valuation of a business can be as simple as applying a rule of thumb, such as multiplying cash flows by a cash flow multiplier. If this was always the case, then 84% of business owners wouldn't feel that it is difficult to determine the value of their business! The reality is that there are complexities involved with the valuation of ANY business, regardless of its size, industry, or life stage.

Value is forward-looking in nature. At a very high level, a CBV's job is to:

1. Assess a business' potential cash flows,
2. Assess the business' risk of achieving said cash flows, including an assessment of internal risks such as financial, operating, governance, and strategic risks; and external risks such as industry, economic and geopolitical risks, and
3. Effectively communicate how they arrived at a certain value.

This may sound straightforward, but there are numerous technical and professional complexities involved with the valuation process.

TECHNICAL COMPLEXITIES

From a *technical perspective*, business valuation is becoming more and more complex in many ways. Three examples are outlined here.

One, a common adage is that valuation is “part art, part science”. While cliché, it's also true. The “science” part of a valuation is usually more straightforward – inputting numbers into a model does not require specialized knowledge or expertise per se. However, in most cases, the science part of a valuation is not where a valuation will fall apart – it's in the “art”. And in many cases, valuation is actually more art than science. The art involved in a valuation is the informed (subjective) professional judgement that goes into calculating value (e.g. risk assessment, reasonableness of underlying assumptions, etc.) – and this can only be gained through the knowledge development as a result of comprehensive training and valuable experience.

Circling back to the science part of a valuation – while this is usually the more straightforward part of a valuation, as of late (with market and macroeconomic conditions rapidly changing due to COVID, high inflation, supply chain disruptions, geopolitical unrest, etc.) the considerations and assumptions in a valuation that were historically fairly clear-cut (such as the long-term equity risk premium, projected inflation and interest rates, a business' projected growth rates) are now no longer straightforward matters.

Two, businesses in certain sectors are increasingly using measures of value that are specific to that industry and/or are non-traditional in nature. For instance, e-commerce companies may use customer conversation rates or unique visitors as valuation metrics. Other industries have specific terminology and metrics that are used to ascertain value, such as the auto dealership industry which refers to goodwill as “blue sky” and has generally accepted formulae and risk factors considered to determine the blue sky value. And even within these industries, for the reasons noted above and others, these metrics are in a state of flux.

Three, as a result of increased digitization and data (and many other factors), balance sheets are changing – a business owner might not even be aware of certain internally-generated intangible assets that a business might have – and this intangible asset value could be significant. Internally-generated intangible assets are assets that a business has not acquired in a transaction, but has developed (knowingly or unknowingly) on its own as a result of its method of operations and/or strategy. Most business owners may not know how to value (or even recognize) such assets, but they could have significant value. For example, everyone is aware of the resources (time and money) it takes to hire, train, and retain staff. And everyone can recognize that there are inherent efficiencies within a broad team that has gelled and works well together (i.e., an “established workforce”). There is certainly value in an established workforce that an external purchaser would likely be willing to pay for, but how do you quantify it?

Each of these points underlines the need to use an expert in business valuation (such as a CBV) to value a business. Relying on a value that has been calculated using a rule of thumb (which are developed based on historical, and likely outdated, data) is irrelevant at best and misleading at worst. Similarly, relying on a practitioner who is not engaged in business valuations and transactions on a regular basis, is not up to date on relevant metrics, and/or does not know the right questions to ask (particularly when selling to an informed external party) could lead to money left on the table in the case of an external sale. A trained and experienced business valuator can bring clarity to a multifaceted process.



PROFESSIONAL COMPLEXITIES

It's clear that business valuation can be extremely complex from a technical sense. Turning to the professional aspects of performing a business valuation, CBV are trained to be independent and objective professionals. These characteristics are extremely important to the

succession planning process regardless of the party to whom the business is being transferred. Further, many CBVs might say that the more challenging part of their job is communicating how or why they arrived at a particular value. More about both of these skills is outlined below.

TYING COMPLEXITIES TO DIFFERENT TYPES OF PURCHASERS

The CFIB Report outlined the various reasons why a business owner may wish to exit their business, the most common reason (with 75% of responses) being retirement.

There are several ways by which a transfer of assets could occur. Regardless of what type of succession measures a business owner is taking, a well-performed assessment of value (including the calculation of value and the communication of the value) will be required.

The CFIB Report notes that 49% of respondents indicated that they intend to sell their business to an unrelated (external) party(ies), 24% indicated that they intend to sell to a family member(s), and 23% intend to sell to an employee(s). To whom an owner transfers their shares (i.e., the "best" successor) will differ on a case-by-case basis, depending on the current owner's goals and motivations. There are commonly acknowledged pros and cons with each type of transfer, which we won't repeat here. Rather, the focus below will be with regard to how a CBV could maximize the succession experience.

UNRELATED/EXTERNAL PARTY

When selling to an external party, an owner may only get once chance to sell. This means that (1) value must be maximized so that money isn't left on the table, (2) value must be reasonable and supportable so the potential purchaser views it as a good investment opportunity and does not walk away from a potential deal, and (3) there must be a party who can effectively negotiate and communicate with potential purchasers.

We discuss how an owner can prepare their business for sale (and maximize their proceeds) later. In short, in order to maximize value on a sale, a business' financial results need to be clearly articulated, and may need to be interpreted or framed in a specific way. This is particularly important given that the pandemic may have impacted a business' cash flows and risk in unexpected ways. A CBV is able to assist a business owner in telling the story of their business pre-COVID, during COVID, and post-COVID, in order to maximize value.

In terms of effective negotiation and communication, a common occurrence is that there is a large gap between the owner's perceptions of what their business is worth and what the purchaser is willing to pay. If this gap is too large, negotiations could break down and the purchaser could walk away. An objective professional will assist an owner in understanding how much their business is really worth, which can help level-set the owner's expectations and assist in smooth negotiations. CBVs involved in transactions on a regular basis are aware of how businesses in particular industries are valued and can help an owner be on the same page as a potential purchaser when it comes to assessing value drivers and risk



FAMILY MEMBER

Historically, if a business owner sold their shares of a small business to a family member, the business owner was at a disadvantage, tax-wise, compared to if they sold such shares to an unrelated party. Sales to unrelated (“non-arm’s-length”) parties are taxed as capital gains (against which the selling owner could apply the capital gains exemption and reduce the taxable base), whereas sales to related (“arm’s-length”) parties were taxed as dividends. The result was that taxes paid on a sale of shares to a related party (i.e., family member) were much higher than taxes paid on a sale of shares to an external party.

Bill C-208, which passed royal assent in June 2021, enacted changes that allowed a business owner to sell the shares of a small business to a non-arm’s length purchaser (such as their child) and treat the transaction as a capital gain instead of a dividend (which put the owner in the same place as if they had sold their shares to a non-arm’s-length party). While many business owners did take advantage of C-208 in 2021, in the time since there has been some confusion on its application and what the legislation will and will not permit, resulting in the easing of activity. Amendments are anticipated, which will bring clarity to certain aspects of the bill. It is important to note that, as it stands right now, Bill C-208 requires an *independent assessment* of the fair market value of the shares to be provided to the Canada Revenue Agency.

Another option for a business owner to transfer shares in a business to family members is via an estate freeze, wherein the fair market value of the common shares of a private company are “frozen” in order to attribute future growth to new common shares of the private company. In estate freezes, the transferor does not sell their shares, but instead defers the income taxes on the capital gain of their shares to the time of their actual or deemed disposition³.

Business transitions to family members are a nuanced situation, and engaging the services of an independent CBV who does not have a historical business relationship within the family could serve as an important proof point to family or outsiders that the owner is approaching the succession planning measures in good faith. As discussed earlier, independence is an important aspect of CBV training. CBVs can satisfy independent requirements in the Income Tax Act (including Bill C-208 as noted above) and can provide impartial input and opinions to family members to ease or prevent family disputes in a situation where emotions may already be heightened.



EMPLOYEES

A third group of potential successors are employees, who can purchase the shares of a business via an employee buyout or an Employee Ownership Trust. In the case of an employee buyout, the purchasing employees may need to use and raise capital from various sources (i.e., personal funds, external lenders, the seller).

Similar to with family members, a CBV who does not have a historical business relationship with the owner could serve as an important proof point to employee purchasers that the owner is approaching the succession planning measures in good faith. Further, a CBV is able to provide an independent report to a bank to arrange vendor financing if requested.

BUSINESS PARTNER

For companies with multiple shareholders, another potential purchaser could be a business partner (or another shareholder). For these companies, it is vital to have a shareholder agreement in place complete with an effective buy/sell clause which stipulates the process for determining value/price in the event of a future purchase of shares by the company or another shareholder (upon what is often referred to as a triggering event such as death, disability, dispute, divorce, etc.).

The key to success in these situations is to ensure the buy/sell clause sets out the process for determining value, such as having a pre-determined CBV conduct an independent valuation on a periodic basis (such as every 1 or 2 years), and does not simply rely on a potentially outdated fixed price per share or valuation formula.



TO-DOS FOR BUSINESS OWNERS – FROM A BUSINESS VALUATION PERSPECTIVE

The CFIB Paper offers great recommendations to business owners who are starting (or contemplating starting) their succession planning journey. Rather than rehash these suggestions (many of which involve interpersonal, legal, or tax aspects which are best served by other qualified professionals on an owner's succession planning team), the focus here is on *how an owner can maximize the value of their business, assuming that they: (1) sell their shares, and (2) want to maximize the proceeds from the sale of their shares (i.e., not leave money on the table).*

It's also important to note that regardless of the type of business transition being contemplated, a CBV or business valuator is only one key member of a trusted succession planning team. A CBV can provide a sound assessment of value and can participate or lead the divestiture process, but they must work closely with a business owner's wealth advisor, assurance/tax service provider, and legal counsel. Because a CBV's job is to understand what elements of a business contribute to value, they also understand what elements of a business need to either be cleaned up, eliminated, or enhanced to create value; and what needs to be done to "prove" the value of a business to an end user.

In general, an owner should begin the succession planning journey (including obtaining the services of a business valuation professional) well in advance of their retirement/transition date – optimally, 3-5 years, and set a clear schedule with timelines and milestones with respect to the business transition. The CFIB Report indicates that 15% of owners plan to leave their business within 1 year, 41% within 1 to 5 years, and 20% within 6 to 10 years. Despite so many owners planning on exiting within a relatively short window, the CFIB Report indicates that only 16% of owners planning on leaving within 1 year have a formal succession plan (11% for those with a 1-5 year window, and 6% for a 6-10 year window), and it is likely that even fewer have included a formal business valuation in this plan.

In the context of maximizing business value, a 3-5 year time horizon is essential because most of the tactics that can be employed to maximize the value of your business (outlined below) will require a multi-year time span which can serve as proof of historical precedent and/or demonstrate improving trend lines. Further, a multi-year timeline may be necessary to take advantage of certain income-tax minimization strategies. More on both of these points below.

In terms of maximizing business value, owners should consider the following:

1. Clean up cash flows so that a trend of stable or improving future potential earnings are clear and attractive to a potential purchaser. This can include:
 - Removing personal spending from business accounts
 - Diversifying revenues when possible
 - Investing in new equipment to minimize repair costs
 - Creating income statement budgets/forecasts to measure actual performance against and demonstrate to a potential purchaser the future growth potential of the business
 2. Mitigate business risk where possible. Specifically, knowledge that resides solely in the owner's head should either be documented or shared with continuing employees (e.g. integral processes and procedures, important customer relationships, etc.). "Key person reliance or dependence" occurs when a business relies too heavily on the knowledge, ability, or relationships of one person. In such cases, a purchaser will significantly discount the price they are willing to pay for the business because the exit of that key person (typically the owner) means the loss of important knowledge, relationships, and cash flows (i.e., it increases the risk of the business).
- Another way to mitigate business risk is to reduce the dependence on one or few customers and strive to secure long-term customer contracts that create a recurring source of revenue, where possible. Further, the transition plan should be communicated to all key stakeholders (customers, suppliers, employees, etc.) to ease the continuity of operations (which reduces risk). The transfer of information and relationships can take years to be done properly.
3. Structure the business so that income taxes that will be incurred on the sale of the business are minimized. The business should be incorporated if it is not already, so that the business can qualify as a Small Business Corporation (SBC), and the owner can take advantage of the Lifetime Capital Gains Exemption. To qualify as an SBC, 50% of the business' assets must be used for business purposes in Canada for 24 months before sale, and 90% at time of sale (this is called "purifying the balance sheet"). This means that personal or redundant assets must be transferred from the business at least 2 years ahead of an owner's exit if they comprise more than 50% of asset value at that time.

TO WRAP UP...

With so much wealth being transferred in Canada over the next few years, it is essential that succession planning is done in a responsible way as there are implications not only to the business owner and other individuals, but from a macroeconomic perspective as well. The difficulty for business owners to understand and estimate the value of their business seems to be a major obstacle preventing them from creating a formal exit/succession plan, or even beginning the process. There is a huge opportunity for business owners to rely on CBVs to overcome this obstacle at a time where \$2 trillion of business wealth is expected to change hands over the coming decade.

While this paper focused on the importance of business valuation from the owner's perspective, properly-planned succession initiatives will also benefit the business itself, family members, employees, as well as the business' community and the Canadian economy.

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- ¹ This number is consistent with PWC's recent *Once in Lifetime* report, which reported that 70% of Canadian private company owners are planning to sell or pass on their businesses in the next few years.
 - ² For more information, see <https://cbvinstitute.com/become-a-cbv/>.
 - ³ Note that there are intricacies involved and other scenarios such as setting up trusts, etc. that are not explored here.



CBV INSIGHTS

JULY 2023

VALUATION OF SPORTS TEAMS AND FRANCHISES

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INTRODUCTION

During times of global and regional division, sports are one of the few constants that bring us together. Transcending language, borders, and cultures, sports help to bring a common ground for otherwise different communities. Sport truly is a unique and unifying platform for communities, cities, and countries. However, the business aspects driving valuations are not widely understood. As fans cheer for their favourite teams and players, an entirely unique economic ecosystem makes it all possible. Over the past couple of decades, the growth in the value of sports franchises has noticeably outperformed the S&P 500¹, driven by increasingly lucrative media rights deals, the globalization of content, and an overall resilience to macroeconomic downturns. As such, sports assets are attracting increasing attention from institutional investors.

Growth in Sports Franchise Value²

(USD billions)



Media rights, revenue sharing, salary caps, luxury taxes, collective bargaining agreements: these are all terms that the casual sports enthusiast might hear, but how does it all come together in valuing a sports franchise?

The difficulty in estimating the value of a sports franchise lies in the inherent opacity of the industry. With a limited number of franchises in every major league, and with only a few of those companies publicly releasing their financial statements (if any), it is relatively difficult to understand the key financial drivers of a sports franchise, and more importantly to identify and compare subject companies against relevant guideline public companies.

However, this article aims to demystify the economics of sports franchises and provide an introduction into the world of sports franchise valuations.



Common valuation approaches and methodologies

In the context of sports franchise valuations, the market approach, specifically the precedent transactions method, is typically used as the primary valuation approach. This is primarily driven by the fact that the intrinsic value derived from the income approach is an imperfect way to capture the value ascribed to sports franchises observed in market transactions.

Additionally, some sports franchises fail to generate consistent and reliable positive operating cash flows, or they generate marginally positive operating cash flows, which make an income approach difficult to implement in most situations.

This disconnect between a sports franchise's intrinsic value derived using the income approach and transacted values observed in the market can be attributed to a variety of factors unique to sports franchises such as:

- Trophy asset / emotional value - An investor's passion for the sport, specific locale, franchise and/or the prestige associated with owning a sports franchise can drive the price paid for a sports franchise up significantly.
- Scarcity value - Sports franchises are relatively unique in that there are a finite number in any given league, and only a few of these may be available for sale at any given time. Combined with the sustained high level of investor demand, this scarcity creates a supply / demand imbalance, which has ultimately driven strong value appreciation of sports franchises over time.

In this manner, the prices that are transacted in the market may oftentimes be impacted by non-quantifiable factors, biases, or synergies such as those listed above, which ultimately drives the inherent disconnect between "price" and "fair market value".³





Market Approach

GUIDELINE PUBLIC COMPANIES

Before getting into the precedent transactions method, it is worth addressing the guideline public company method, although its use is relatively limited. There are a small number of publicly traded sports franchises, most of them being European soccer clubs. Even when valuing a European soccer club, implied valuation multiples from guideline public companies tend to exhibit a significant discount relative to transacted values in the market. This is primarily driven by a minority discount inherent in public markets. Most publicly traded sports franchises have a relatively small trading float and more importantly, have a small number of controlling shareholders. These controlling shareholders tend to hold their stakes for long periods of time and control the day-to-day operations of the franchise. Therefore, the discount applied in public markets reflects the limited ability for minority shareholders to maximize value and liquidity through a private buyout.

PRECEDENT TRANSACTIONS

Turning back to precedent transactions, the most common valuation method in the world of sports franchises, the starting point is identifying transactions with readily available and reliable data for comparable sports franchises.

Screening for guideline transactions and sourcing reliable data

Screening for guideline transactions typically begins with sourcing transactions in the same league.

Given the degree of public interest in sports, sports franchise transactions tend to be relatively easy to identify, with headline prices typically shared in the public domain. With that said, it can be challenging to verify the accuracy of reported prices without access to confidential transaction details, and it may be unclear whether headline prices reported are an equity price paid or an enterprise value.

In addition, most sports franchises are privately owned businesses and therefore, sourcing reliable and accurate financial information to derive implied valuation multiples can be difficult. With that said, publications like Forbes and Sportico publish headline financial information that can be used to calculate broad (or general) implied valuation multiples.

Recent select sports franchise transactions^{4, 5, 6, 7}

TEAM	LEAGUE	DATE	REPORTED PRICE (USD)
Washington Commanders	NFL	May 2023	\$6.0B
Nashville Predators	NHL	April 2023	\$0.9B
Phoenix Suns	NBA	December 2022	\$4.0B
Denver Broncos	NFL	June 2022	\$4.7B
New York Mets	MLB	November 2020	\$2.4B
Kansas City Royals	MLB	November 2019	\$1.0B
Brooklyn Nets	NBA	August 2019	\$3.3B

Determining implied multiples

As previously mentioned, some sports franchises are either loss making or generate marginally positive operating profits. As a result, it is often difficult to determine an implied earnings-based multiple (e.g., EBITDA) and therefore, the default implied multiple is typically an enterprise value (EV) to revenue multiple.



Normalized revenue

With guideline transactions screened, reliable data sourced and implied valuation multiples derived, the next step is to determine normalized revenue for the target sports franchise. Typically, last-twelve-months (LTM) revenue is used as a starting point for most sports franchises with normalization adjustments made to reflect the steady-state, long-term revenues generated by the target sports franchise. These normalization adjustments can relate to several franchise and/or league-wide developments such as:

- Adjustments for a new broadcasting or sponsorship deal that has been secured but has not come into effect in the historical period;
- Non-recurring fees received, e.g., one-off expansion fees from creation of a new franchise that are distributed to existing teams;
- Participation in playoff games (or lack thereof); and
- Adjustments for any changes in run-rate ticketing, gameday or sponsorship revenue from progressed improvements to the target franchise's stadium / arena.

Calibration of market multiples

Arguably the most difficult part in any market approach valuation is the calibration of observed market multiples to the target business. The same can be said, and is likely exacerbated, when it comes to sports franchises. Conceptually, this part of the process involves comparing the target sports franchise against its peers across key value drivers and from this analysis, selecting an appropriate multiple or range of multiples. The key value drivers that are most relevant will vary by sport and geography but broadly speaking, a potential buyer would seek to assess the strengths and weaknesses of the target sports franchise relative to the comparable sports franchises at the time of their respective transactions, across the following key value drivers:

- Quality, degree of ownership and economics of stadium / arena infrastructure;
- Strength and growth trajectory of the league in which the franchise participates;
- Strength and size of local market;
- Strength and size of fanbase;
- Brand value;
- Operational efficiency;
- Profitability;
- Salary cap / financial regulation compliance;
- Collective bargaining risk / security;
- Historical team performance;
- Strength of players and associated player value;
- Strength of management team; and
- Player development strategy, track record and infrastructure.

Another important consideration in respect of sports franchise valuations is the interplay between real estate and sports franchises. Oftentimes and especially prevalent for North American sports franchises, real estate adjacencies will exist within transactions that warrant some distinct, if not significant value considerations. These real estate adjacencies can take the form of tangible, income-producing real estate assets that are not used for sporting purposes. On the other hand, these real estate adjacencies can also come in the form of perceived synergies whereby a sports franchise has a strong relationship with local stakeholders, which can result in public funding for a new stadium or public support for future income-producing real estate developments.





Income Approach

While the market approach is generally the main valuation approach used for sports franchises, the income approach may provide an important sanity check on valuation conclusions. Additionally, the income approach, specifically a discounted cash flow analysis, may be more appropriate for smaller sports franchises that are not as frequently transacted by third parties.

As with any income approach analysis, the valuation outputs are only as reliable as the inputs, and as such, high levels of scrutiny must be applied to the value drivers of the franchise. The following section will highlight key considerations for an income approach valuation using a discounted cash flow analysis.

REVENUE

Sports organizations generally share similar revenue streams, irrespective of their sport, and size. These revenue streams are:

Ticketing	Revenue related to the sale of tickets for live games in the form of season tickets, single game tickets, suite sales, and other forms of ticketing.	<ul style="list-style-type: none"> • Ticket volumes are generally estimated as a percentage of maximum capacity. • Depending on the team, ticketing volumes and prices will have varying degrees of elasticity depending on team success.
Broadcasting / League Distributions	<p>Revenue related to league-wide TV deals with national broadcasters and sponsorship deals managed and distributed by respective leagues.</p> <p>In addition, franchises will generate revenues from regional broadcasters, which vary by franchise.</p>	<ul style="list-style-type: none"> • Broadcast figures are generally large, multi-year contracts. • Renewal estimates, including both term and amount, can be uncertain and can be impacted by a number of factors.
Game day	Revenue related to other commercial aspects of game days, such as concessions.	<ul style="list-style-type: none"> • Attendance numbers are generally projected by applying a 'turnstile' factor to the ticketing estimate used to drive ticketing revenue. • Certain teams may have licensing agreements with venues and/or retailers, and receive only a portion of sales.
Sponsorship	Revenue related to sponsorship deals that leverage the team's tangible and intangible assets	<ul style="list-style-type: none"> • Estimates of future sponsorship generally correlate to expected attendance, and therefore, team success. • Most teams, irrespective of sport or league, will have a minimum number of sponsorships that are secured by long-term contracts (e.g., stadium naming rights, title sponsors, etc.)
Merchandise	Revenue related to the sale of team-branded merchandise	<ul style="list-style-type: none"> • Certain teams and leagues may have licensing agreements with retailers and manufacturers to outsource merchandising business secured by long-term contracts

The value drivers noted above will vary in terms of relevance across leagues and franchises. As an example, NHL franchises are much more reliant on ticketing and game day revenue in comparison with NFL franchises that tend to rely more on broadcasting revenue as part of their overall economic model.

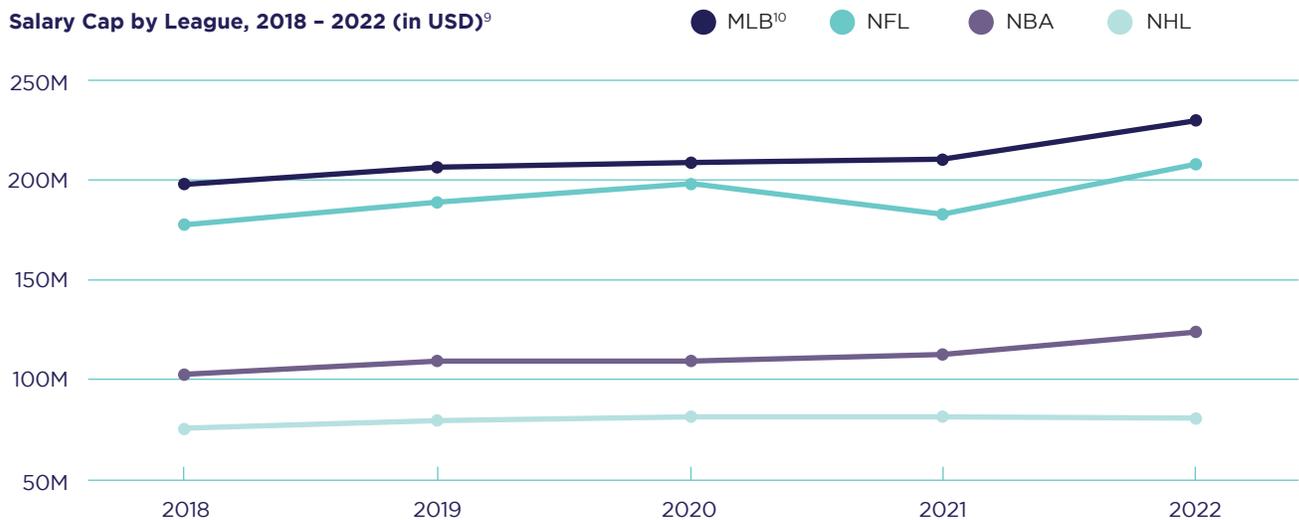


EXPENSES

The expenses for sports organizations are generally comprised of two major categories: team expenses and business expenses.

Team expenses typically constitute the largest portion of total expenses, as they include the annual amounts of the contracts paid out to players. In most North American leagues, a league-wide salary cap sets the ceiling for the total annual player-related expenses⁸, while in other leagues, organizations must use discretion and optimize their decisions to field the most competitive, but fiscally responsible roster of players.

Salary Cap by League, 2018 - 2022 (in USD)⁹



We can look to publicly traded sports franchises, most of which play in top-tier European soccer leagues, to get a sense of how much teams are generally willing to spend on their players. We highlight, however, that most European soccer leagues do not implement a direct salary cap, and as such, these values may not be comparable relative to those observed in North American sports leagues.

Select Player-Related Expenses by Team, as at June 30, 2022 (USD)¹¹

TEAM	ANNUAL PLAYER-RELATED EXPENSES	% OF TOTAL REVENUE
Manchester United	\$401.8M	65.7%
Juventus	\$326.0M	71.3%
Borussia Dortmund	\$242.5M	55.9%
Ajax	\$114.7M	57.8%
Benfica	\$118.1M	66.5%

While player salaries comprise the largest component of team expenses, a major business expense for sports franchises is venue cost. Most professional sports franchises will either own or lease their arena / stadium venue. This is a key distinction that not only affects the related expenses, but also impacts the fee structure of certain revenue streams.

Additionally, there are further considerations, such as staffing levels during game days, insurance and health benefit requirements for players, travel and lodging expenses, and administrative staff required for the operations of the organization. Certain organizations may have minimum requirements as mandated by the league, or a collective bargaining agreement.



CASH FLOW ADJUSTMENTS

Given that many sports organizations sell tickets in advance, working capital adjustments may be required depending on the valuation date.

The impact of capital expenditures for most sports organizations will be determined by their venue ownership strategy. To the extent that franchises lease their venues or investments have recently been made to stadium / arena infrastructure, capital expenditures may be minimal.

DISCOUNT RATE

While there is always subjectivity when it comes to estimating an appropriate discount rate to apply in a DCF-based valuation, forecasting cash flow for major sports franchises is fairly straightforward. Excluding potentially large and unpredictable swings in broadcasting and sponsorship revenues, most other key assumptions can be supported by historical analysis. While fledgling leagues and organizations will likely have more difficulty attracting fans and viewers in their early years; this emphasizes the importance of conducting adequate due diligence in advance of investing in and understanding the pathway to profitability for the team.

EXIT MULTIPLE

For major sports franchises, the true difficulty in applying an income approach analysis is determining an appropriate exit multiple. Generally, the practice in the industry is to assume the sale of an organization within 10 - 15 years, rather than apply a constant rate of growth, such as is done with the Gordon Growth Model.¹²





Concluding Thoughts

With so many tailwinds in respect of sports investment trends, whether it be the rise of women's sports, sports betting, the proliferation of sports-focused private equity funds, or others, the valuation of sports franchises will continue to be a hot topic. Stakeholders may require a robust valuation for a variety of different reasons, which can range from tax, financial reporting or M&A purposes. As a result, and keeping in mind the nuances and considerations that are unique to the sports industry, sector-specific knowledge is vital in order to provide accurate insights needed to arrive at a robust and sensible valuation conclusion.

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2. Data is based on valuations conducted annually by Forbes and represents the average of the five most valuable franchises as at each date. Team values are enterprise values (equity plus net debt) and include the economics of the team's stadium (but exclude the value of the real estate itself), based on comparable transactions.
3. Fair Market Value is defined in the International Valuation Glossary as the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, each acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or to sell and when both have reasonable knowledge of relevant facts. (International Valuation Glossary - Business Valuation, updated February 24, 2022 p. 5: https://cbvinstitute.com/wp-content/uploads/2021/11/International-Valuation-Glossary-Business-Valuation_EN.pdf).
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8. We highlight that the salary cap does not equate to the cash payroll paid by a team. A contract's impact on the salary cap is calculated by dividing the total value over the length (average annual value, or "AAV"), while the payment structure itself may be different (i.e., front-loaded, etc.).
9. Source: www.spotrac.com.
10. The MLB does not have a salary cap. The numbers presented in this table represent the luxury tax threshold.
11. Source: Capital IQ; financial statements of companies. Figures have been converted based on the exchange rates as at June 30, 2022 of €1.0000:\$1.0489, and GBP1.0000:\$1.2159
12. The Gordon Growth Model is a formula used to determine the value of a stock based on a future series of cash flows that grow at a constant rate, and is typically used to estimate a terminal multiple.



CBV INSIGHTS

APRIL 2023

VALUATION IN THE BREWERY INDUSTRY

Spencer Gunning, CBV





INTRODUCTION

The brewery industry is one of the oldest industries in Canada. When assessing the value of breweries, there are several business considerations unique to the industry that are important to understand. Although it is largely agreed that the industry is “mature” in terms of its life cycle, the brewery industry continues to evolve via forces such as growing craft beverage demand, shifts in consumer demand preferences, and increased focus on sustainable and innovative packaging solutions. This article will highlight, discuss, and explore several topics unique to the brewery industry, with an emphasis on how these topics can affect brewery valuation. There are many situations which may require the valuation of a brewery business. The presence of special interest purchasers (“SIPs”)* is a very real possibility, as existing breweries may look to consolidate and achieve synergies, given these unique industry characteristics.

This article addresses special topics unique and fundamental to the brewery industry and then discusses how these topics would be relevant to an assessment of value from the lens of a Chartered Business Valuator (“CBV”). A discussion of specific valuation approaches and methodologies used by CBVs to value breweries are outside the scope of this article, however there are multiple valuation approaches that should be considered when conducting a formal valuation of a brewery, given it is a capital-intensive and asset-heavy business. Value at its core, however, is forward looking in nature, and this article will focus on the importance of having a robust understanding of the underlying business fundamentals of a brewery business and that business’ ability to generate cash flow in the future.



Catalina Miranda, CBV, Vice-President, Regulatory & Standards, CBV Institute, sits down with Spencer Gunning, CBV, to chat about valuation in the brewery industry.

* Special interest purchasers are defined as entities or individuals that are willing to pay a premium or higher price for a company due to reasons that include potential post-acquisition synergies or strategic advantages through the combination of the business or asset with existing resources. SIPs are usually willing to justify paying above otherwise fair market price because of the inherent incremental value they expect to generate.



INDUSTRY TRENDS & THE IMPORTANCE OF MARKET POSITIONING

The brewery industry in Canada has undergone several significant trends in recent years, including growing demand for craft beverages, a significant shift in market share towards ready-to-drink (“RTD”) and low-alcohol and non-alcoholic options, and an increased focus on sustainable brewing and packaging practices. Industry participants that have a strong ability to adapt to ever-shifting consumer trends and government regulations will be better-positioned to defend and potentially increase market share. When valuing a company in the brewing industry, understanding how the company has positioned itself to adapt to factors such as the above, is essential in properly assessing the ability of the company to generate cash flow in the future. This is likely seen via innovation in product offerings beyond traditional beer, whether it be innovation within craft beer or ventures into other RTD beverages such as spirit- or seltzer-based mixed beverages.

Craft beer has become increasingly popular as a share of total beer consumption in Canada, with a growing number of microbreweries and brewpubs opening across the country in the last nine years. According to trade association Beer Canada, the number of breweries per 100,000 legal drinking age adults in Canada almost tripled from 1.4 in 2012 to 4.0 in 2020.^{1,2} However, beer consumption per capita (based on the legal drinking age population) has fallen from 83.4 litres in 2012 down to 69.3 litres in 2020, a 16.9% decrease over same the period.^{1,2} The stark increase in breweries relative to the decline of beer consumption in Canada frames a compelling picture of future market consolidation, as fighting to earn market share is set to become increasingly difficult in an already competitive segment.

Another significant trend directly affecting the brewery industry is the rise of RTD and low-alcohol and non-alcoholic beer beverages as a total percentage of alcohol consumption. Consumers are prioritizing taste in flavored malt and spirit-based beverages and at the same time, becoming much more mindful of their alcohol and caloric consumption. According to a report by Statistics Canada, Canadians bought \$2.1 billion worth of ciders and coolers (both RTD-type beverages) between April 1, 2021 and March 31, 2022, up 13.5% from the previous fiscal year.³ In contrast, while Canadians bought four times as much beer, \$9.1 billion worth, beer sales were down 0.7% from the previous fiscal year.⁴ A report compiled by J.P. Morgan with data from Euromonitor forecasts that RTD, cider and pre-mixed cocktails will continue to grow in popularity, at a global 2019-2025 CAGR sales volume growth rate of 8.5%,⁵ a stark contrast in comparison to the decreasing beer consumption trends mentioned above.

Not dissimilar to many industries across the globe, sustainable practices are becoming increasingly important in the brewing industry, as both consumers and regulators continue to place pressure on brewers to minimize waste and environmental impact of the production and packaging of their products. In June 2022, the Government of Canada began officially rolling out a ban on single-use plastic products, including most notably, a ban on the manufacturing, import, export, and sale of plastic ring carriers.⁶ These plastic ring carriers are the most commonly found packaging method for beverages in a 6-pack type format but have been mandated to be replaced by alternative packaging methods. Brewing industry participants that are well-capitalized with access to capital are going to be best positioned to react to these types of significant changes in government regulation, as it is capital intensive to purchase, sell, and re-configure packaging capabilities to comply with such drastic and important changes. Not only is such a change significant from a capital expenditure point of view, it also affects product margin as brewers will be forced to find other, likely more cost-intensive, packaging alternatives on a per unit basis.

We observe these prominent industry trends because they can affect a subject company’s position within the brewery industry, and its risk profile, which would impact the valuation both qualitatively and quantitatively. A CBV will assess such factors when determining an appropriate discount rate to apply to future cash flows as part of the valuation or pricing analysis. Breweries that are able to continuously innovate with new products in response to shifting consumer tastes are much more likely to be able to defend and/or grow their revenues. Continuously shrinking beer consumption and increased RTD and low/no-alcohol demand warrants a broader portfolio of products if breweries want to increase their potential consumer base, and a business that can do so will only inevitably have a much greater chance of continuing to generate cash flow in the future.

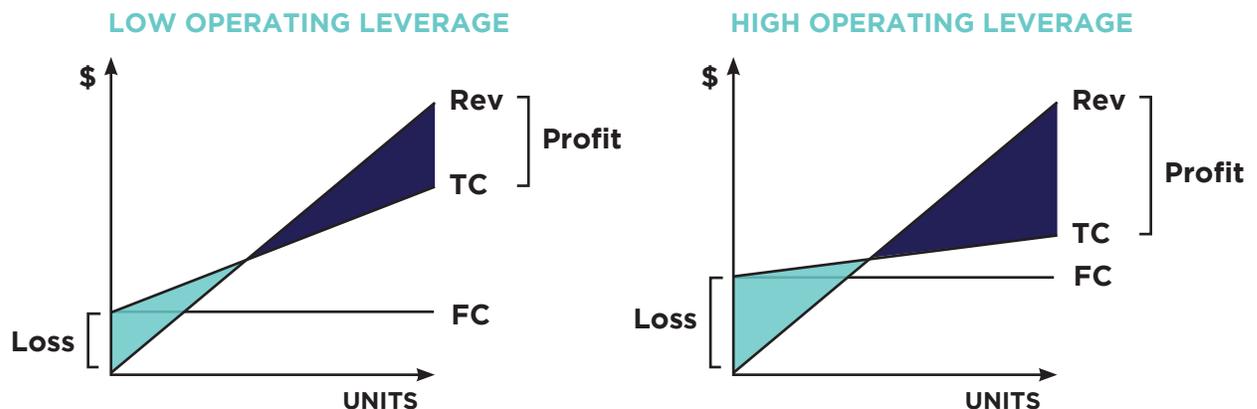


OPERATING LEVERAGE & THE VALUE OF CONTRACT BREWING

OPERATING LEVERAGE DEFINITION

The concept of operating leverage is relatively well-known among those familiar with manufacturing companies. Essentially, operating leverage is the measure of the proportion of fixed operating costs of a company in relation to its variable operating costs.⁷ The degree of operating leverage impacts profitability. Small to medium sized breweries have a high degree of operating leverage because they have a high proportion of fixed costs (e.g. the building and the specialized brewing equipment) relative to variable costs (e.g. containers and ingredients). Once fixed costs are recouped by initial beer sales, the relatively low variable cost to produce each unit of beer becomes a small hurdle to overcome in generating positive cash flow. Quickly, the brewery begins to benefit from greater incremental profits on a per unit basis. This is further illustrated in Figure 1 (FC = fixed costs, TC = total costs, Rev = revenue), which holds variable per unit costs constant for illustrative purposes.

Figure 1 – Low vs. High Operating Leverage



BREWERY EFFICIENCY & OVERHEAD ALLOCATION

For example, “Brewing Company A” utilizes its labour force and capital assets in the form of an annual schedule in shifts to brew and package product. This schedule creates a predictable, fixed cost structure; this structure is also commonly referred to as manufacturing overhead, and can oftentimes include other largely predictable pieces such as utilities, maintenance expenses, etc. If “Brewing Company A” can become more efficient in producing *more* units per shift, via (i) less plant downtime, (ii) increased capacity via capital expenditure, (iii) proficiency in the labour force, or in most cases, (iv) some combination of these, the company will be able to “spread” this fixed manufacturing overhead over *more* product, reducing the total cost per *unit* of manufacturing overhead. This is the basic premise of overhead allocation in a manufacturing business and is important to understand when analysing the value of efficiency and capacity to a brewing business.

From a valuation perspective, management’s intent surrounding the company’s operating leverage and overhead allocation rate demonstrates strong competence and industry knowledge and will inherently assist in generating positive cash flow and creating underlying value for their brewery. Manufacturing expertise is important when it comes to being able to create value in a brewery business, as any earnings- or cash flow-based valuation method that a CBV applies will result in a higher valuation if there is either (i) a path to increased cash flow or (ii) increased confidence around existing cash flow.



THE VALUE OF CONTRACT BREWING

Now that we understand operating leverage and overhead allocation as they relate to the profitability of a brewery, we can conclude that generally speaking, greater utilization of production volume as a percentage of total capacity, equates to greater profit margins. In many cases, the path of least resistance to attaining more volume is via contract brewing for a third-party beverage company. Specifically, if a brewery can “tuck-in” contract brewing volume, using their pre-existing fixed cost structure, this assists in further driving profitability across the entire business via enhanced overhead allocation.

Given the contractual nature of this revenue, the margins are often lower than true owned volume, but come with greater certainty of volume and thereby, revenue (via annual minimum requirements). Additionally valuable, contract manufacturing revenue almost always comes with little to no working capital strain, given no need for finished goods warehousing, and raw material oftentimes being provided by the customer.

Contract brewing can bring significant value to a brewery if executed upon properly. Understanding and analyzing either (i) the current state and proportion of contract brewing present in a brewery business, or (ii) the potential to add in contract brewing revenue to a brewery business, can be extremely helpful in depicting and identifying value within a brewery. Contracted revenue generally carries less risk than traditional revenue segments given the greater certainty around volumes, and as a result a lower discount rate would be applied to the resulting cash flow. Qualitative factors such as this are critical in determining the appropriate discount rate and can instill more assurance in a business’ ability to continue to generate said cash flow, inevitably assisting in increasing valuation.

WHY A VALUATION SHOULD FACTOR FOR EFFICIENCY & OPERATING LEVERAGE

Regardless of the purpose of the valuation, any stakeholder will want to understand how efficiency and operating leverage have been reflected in the valuation of their business. A solid understanding of historical efficiency as well as opportunities for improvement will better enable business owners to strategize how to potentially create value in the future. There can be a significant financial benefit if a brewery business is able to enhance their ability to increase sales and production in a high operating leverage environment, as the increased profitability should translate to an increased valuation.

The concepts of efficiency and operating leverage also come into play when considering strategic or synergistic buyers. Other craft brewers or larger mainstream brewers may be considering the acquisition for competitive or other strategic reasons. In relation to operating leverage, CBVs may consider a scenario in which synergies could arise from optimizing the target and the acquirers’ combined manufacturing capacity. Identifying synergies can be significantly accretive to cash flow and deal value, leading to higher valuations and ultimately, enhancing shareholder value.





GOVERNMENT REGULATION & TAXATION

Breweries operate in a heavily regulated environment. As a result, it is crucial that an understanding of the ever-changing regulatory and political landscape remains current. Elections come and go, and breweries are subject to changing policy at both the federal and provincial level; these changes can warrant shifting taxation structures and while some changes may be minor, some changes can be significant, in some cases affecting the profitability of operations.

For example, the Government of Canada began rolling out a ban on single-use plastic products in June 2022, and while this change was announced in advance (giving producers time to prepare), not all regulatory changes provide so much lead time. Any brewery business that sells product in plastic ring carriers is now faced with a looming change that requires machinery investment, packaging line re-configuration, and potentially higher unit costs as these businesses will be forced to find a more sustainable packaging replacement.

From a taxation perspective, breweries in Canada face two separate points of taxation; one being at the federal level, known as excise tax, and the second being provincially, known as provincial markup. From a valuation perspective it is important to understand how both taxation mechanisms work, as excise tax is based on incremental levels of *production* volume, whereas provincial markup varies province to province in terms of structure and is based on sales volume. Some provincial markup structures opt for a percentage-based approach based on sales totals, whereas others opt for an incremental step system, where the markup rate per litre increases as sales volumes increase.

As one can imagine, analysis and understanding of taxation both federally and provincially needs to be kept in mind as breweries look to grow or potentially merge, as tax implications can significantly alter profitability and margins. As an example, federal excise tax has just been recently amended and effective April 1st, 2023, will increase on a per hectolitre basis across all alcohol levels of beer.⁸ On beer containing more than 2.5 % alcohol by volume, the rate 0 to 2,000 hectolitres is \$3.701 per hectolitre; if a brewery is to make one incremental hectolitre, that rate jumps to \$7.402 for any incremental volume up to 5,000 hectolitres.

CAPITAL REQUIREMENTS & CYCLICALITY

It likely comes as no surprise that operating, maintaining, and growing a brewery is a relatively capital-intensive endeavour. While there are of course ways to “bootstrap” and remain lean in terms of minimizing packaging capability and brewing assets, capital requirements pose a large barrier to entry for new market entrants. In a survey conducted by MNP between November 2021 and February 2022, 50% of Alberta craft breweries cited access to capital and financing as the primary challenge they face with respect to growth and profitability.⁹ This barrier to entry has simultaneously been a key catalyst in the growth of asset-light, brand-focused businesses that rely on contract brewing agreements with full-service breweries for their production. The degree of access to cost-effective capital is an important factor to be wary of when evaluating a brewery business, as a strong balance sheet with financing flexibility will always prove advantageous to adapt to the ever-changing dynamics of the industry.

In North America, beverage alcohol is a cyclical business with a “peak” season spanning spring-summer and a “shoulder” season spanning fall-winter. As a result of this, breweries will have ebbs and flows on their working capital requirements. An experienced management team will understand the peaks and valleys of demand, and thereby, periods in which the business is able to generate excess cash flow. It is quite common for breweries of various sizes to burn cash in the shoulder season, via the combination of a dip in sales and a pre-emptive inventory build for the peak season, and rely upon increased periods of demand in peak season to generate their fiscal year’s cash. Breweries must be diligent in managing their inventory, receivables, and payables throughout the year as working capital can easily become stressed by seasonal fluctuations. It is common practice for breweries to use a revolving debt facility to assist in smoothing working capital, as this provides a relatively low cost of capital option for easing the effects of seasonality.



CONCLUSION

Breweries are subject to unique considerations that can significantly affect their cash flows and value. The topics that have been discussed in this article are not exhaustive but do represent some of the more crucial factors that should be considered in any robust valuation or deal pricing exercise. Although a mature industry in classical terms, the brewery industry continues to change quickly via a combination of shifting trends in consumer demand and evolving government and regulatory changes. The boom of craft beer and innovation has spurred significant growth in Canadian microbreweries and brewpubs, placing market share pressure on all participants given continually declining beer consumption trends. With more breweries emerging and less volume to get a piece of, this picture of inevitable market consolidation continues to be painted; CBV's are being called upon as financial advisors for strategic transactions in the brewery space, and this article can hopefully provide guidance as to where to start. While quantitative analysis will always be crucial, business valuation is about so much more than strictly numbers, and a well-informed qualitative understanding will greatly assist in providing a robust and thorough valuation conclusion.

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CBV INSIGHTS

SEPTEMBER 2023

CROSS-BORDER
M&A AND THE
CURRENT
ECONOMIC
ENVIRONMENT

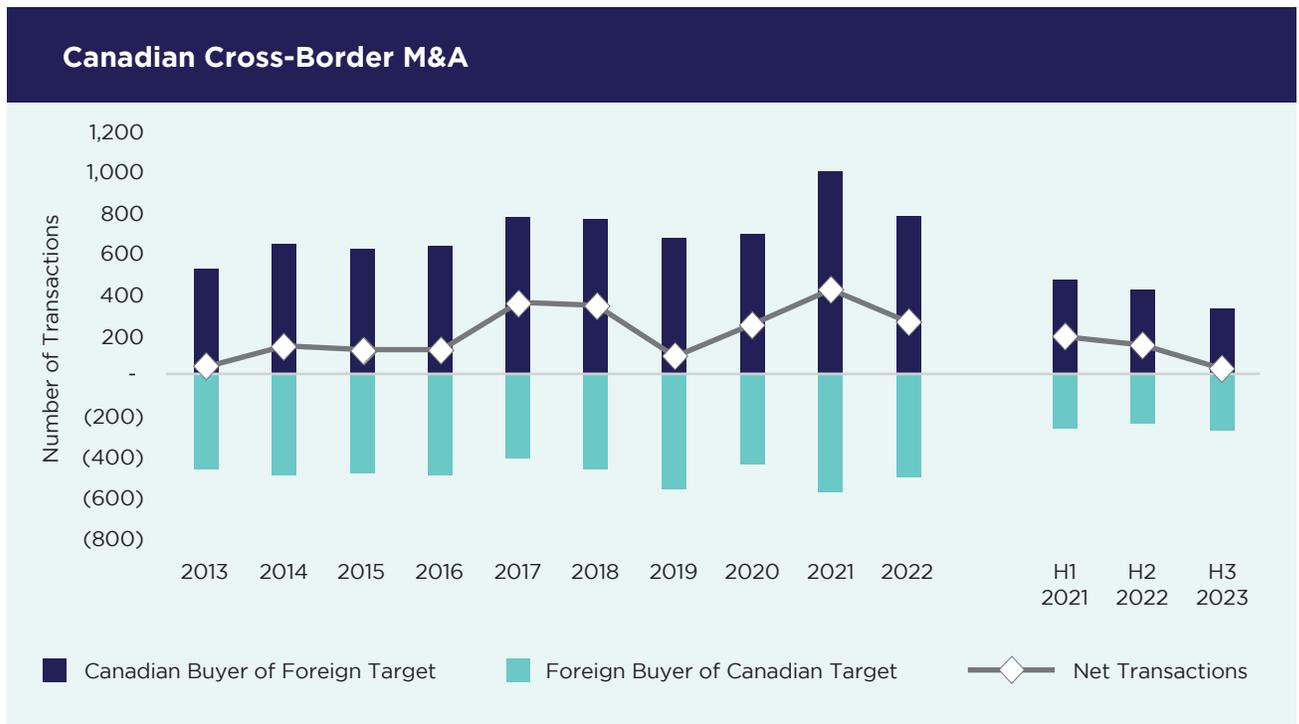
Stephanie Lau, CFA, CBV



INTRODUCTION

Over the past 10 years, foreign investors have represented approximately 30% of the total buyer pool of Canadian company acquisitions¹ – and despite a slowdown in the overall deal market in late 2022 and early 2023, foreign buyers of Canadian companies remained resilient.

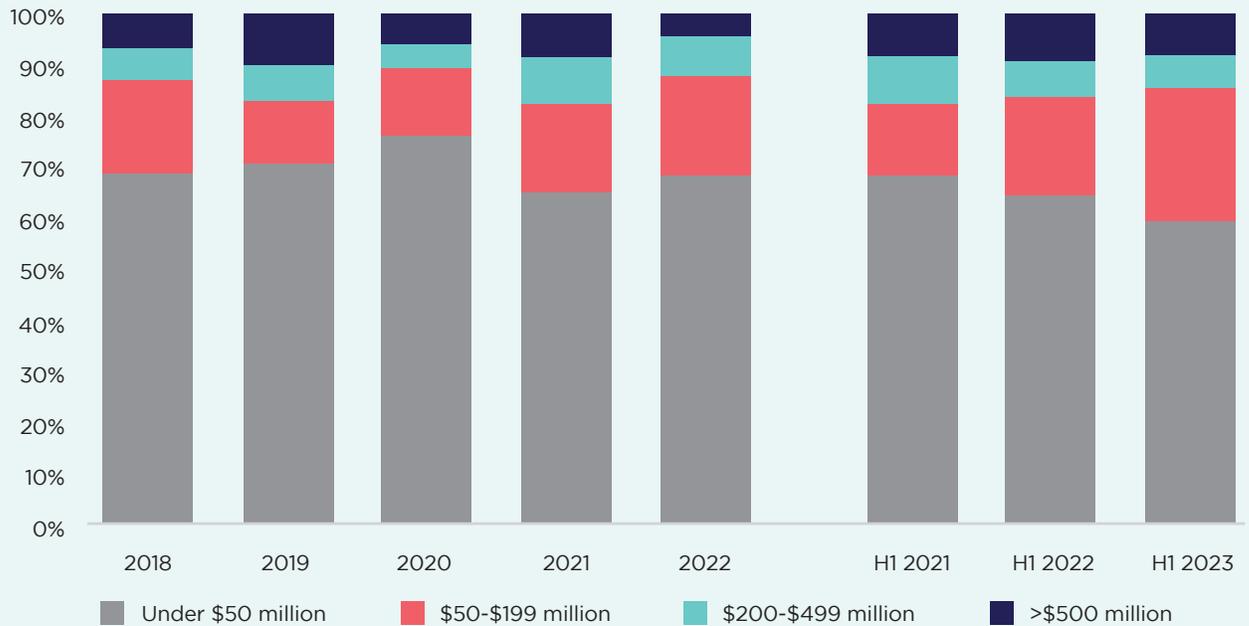
In the first half of 2023, there were 282 foreign buyers of Canadian companies, a slight increase over the 259 deals completed in the prior year.² Canadian buyers, on the other hand, were more hesitant in acquiring companies in general with 875 acquisitions completed compared to 1,068 in the same period as last year. Even when they were looking to buy companies, Canadian buyers focused on local companies with investments in foreign companies dropping by 15% in H1 2023 while local acquisitions only fell by 8.3%.



The Canadian M&A market predominately involves small and medium sized businesses with approximately 95% of Canadian sellers with a Total Enterprise Value (“TEV”) of under \$500 million.³ Cross-border transactions involving a Canadian seller is no different, with deals under \$50 million, \$200 million and \$500 million representing 59.2%, 26.3% and 6.6% of the market respectively in H1 2023. Recently, foreign buyers have moved up market with Canadian targets between \$50-\$199 million representing a larger proportion of deals when compared to the past five years.



DEAL VOLUME BY IMPLIED EV



This article will look at the cross-border deal market in Canada and the effects of recent economic events on the merger and acquisition (M&A) process. With the pandemic pushing deal processes to be more online, significant capital waiting to be deployed, and with increased globalization, foreign buyers continue to be interested in acquisition opportunities in Canada—especially our neighbors south of the border.

A More Online Deal Process

The COVID-19 pandemic caused a significant ripple in the market, the effects of which are still seen in 2023. In a post-pandemic world, the deal process has evolved into a hybrid approach, utilizing both the convenience of video conferencing and the more thorough and efficient nature of in-person meetings.

There are several advantages to a more online deal process. By distributing marketing information electronically, sellers can easily share detailed information (e.g. video footage of facilities and operations) and simultaneously gather data on each buyer's level of interest based on open rate and view time. And, during the initial marketing phase of the deal process, management can present the investment opportunity by webinar and answer frequently asked questions. This helps potential buyers get a better understanding of senior management's vision and personalities without the need to travel.

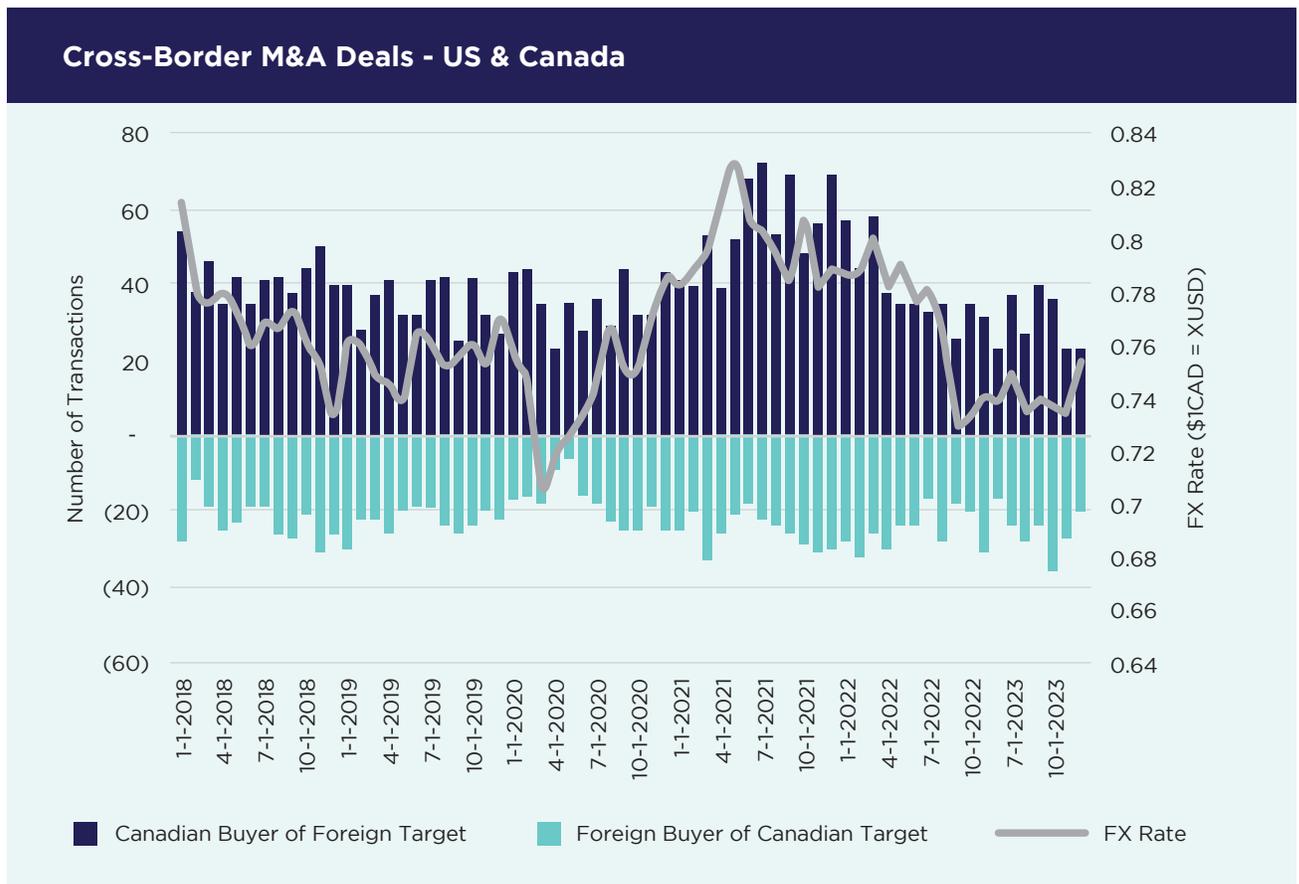
Further discussions after receiving indications of interests ("IOI") have reverted to an in-person format, as an in-person meeting allows both sellers and buyers to get a better sense of their compatibility and ability to partner in the future. After the management meetings are complete and a letter of intent ("LOI") is signed with one exclusive party, the process tends to revert to a hybrid model. Specifically, many due diligence streams aside from operational diligence have come to rely heavily on video calls and screen sharing, limiting the number of in-person visits to one or two, if needed at all.

Moving forward, the hybrid approach will provide foreign buyers with more access to management and increase information flow, lessening the local buyer advantage during the initial marketing phase; however, once IOIs are received and the field of candidates is narrowed to a handful of parties, in-person meetings will remain an important part of the deal process.



The Effect of Exchange Rates on Cross-Border M&A Between U.S. and Canada

Historically, as the Loonie strengthens against the U.S. dollar, investment from Canadian companies into the U.S. has increased. The top half of the below chart shows this trend,⁴ particularly in 2021 and 2022. This correlation meets a common-sense expectation that Canadian firms with increased buying power will take advantage of it. But surprisingly, the same cannot be said of U.S. firms – they are not always cross-border shopping for Canadian companies when their dollar strengthens relative to Canada’s.



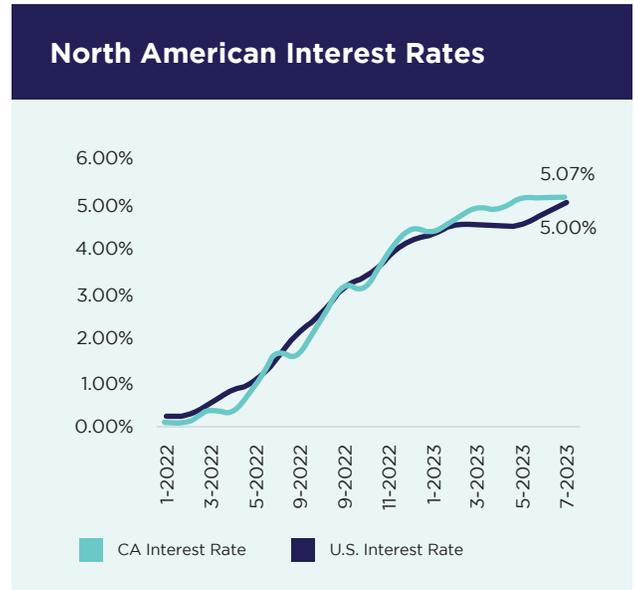
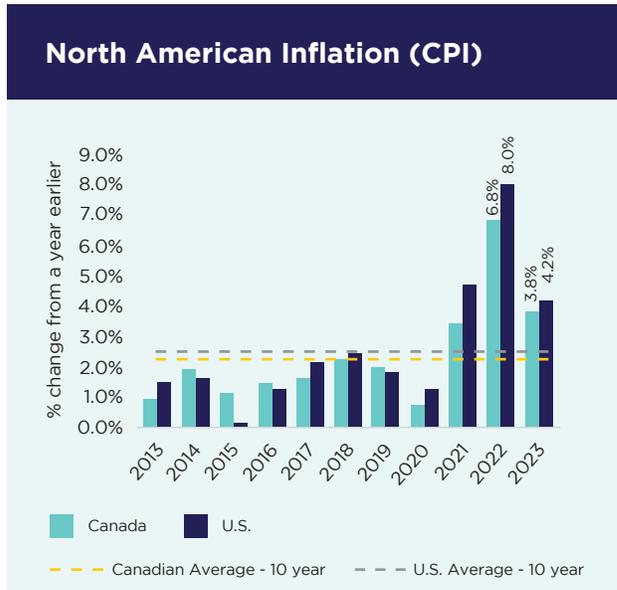
Instead, investment from U.S. companies into Canada shows an ambiguous correlation to the exchange rate, as shown in the bottom half of the chart.⁵ A few academic studies have investigated this phenomenon. A study published in the *Canadian Journal of Economics* found evidence that a real depreciation of the Canadian dollar will increase U.S. acquisitions of Canadian companies in Research & Development (R&D) intensive manufacturing industries.⁶ However it found no significant correlation for manufacturing industries with low levels of R&D intensity. Instead, low R&D industries demonstrated a stronger correlation to other influences such as U.S. domestic M&A activity.

What does this ambiguity mean for Canadian buyers and sellers in today’s economy? With the Canadian dollar reverting close to the long-term average against the U.S. dollar as of June 2023, investment in U.S. companies from Canadians has slowed compared to 2021 highs, while U.S. investment in Canadian companies remains resilient. While the exchange rate may be a factor to Canadian buyers looking to invest abroad, Canadian sellers should not base their exit timing solely on the strength of the Loonie. Instead, sellers should focus on building a differentiated business with growth opportunities that a buyer can execute on.



Inflation and Interest Rates are Tightening Wallets

Rising interest rates in both Canada and the U.S. caused a contraction in the deal market starting in 2022. The Canadian and U.S. governments issued 10 rate hikes each as of June 30, 2023, with the potential of additional rate hikes on the horizon. With a significantly higher cost of borrowing, buyers have become more selective with their investments.



As a result of the volatility and increased uncertainty in the market, buyers now demand a more thorough due diligence process which has extended the deal timeline. Financial sponsors and buyers alike are questioning potential “COVID-bumps” in historical performance. There is an increased focus on a company’s implementation of mitigating factors for supply chain disruptions as well as a company’s ability to manage profitability and volume sales amid increases in input costs. Improvements to financial performance (e.g., volume increases, margin improvements, cost reductions) are met with a skeptical lens and thoroughly stress tested to meet the more stringent requirements of financing partners. Quality of earnings (“QoE”) reports, a detailed analysis of the underlying drivers of a business’ performance, are being updated through to signing the purchase agreement, where previously a larger gap between the QoE and signing date was standard.

In response, sellers need to build more robust forecasts that include various stress tests and mitigation strategies including the use of currency and commodity hedging, matching customer and supplier contract durations and implementing redundancies to avoid service disruptions. Data availability is important now more than ever to provide quantitative proof that the company’s financial performance is defensible. Abnormal and non-operating expenses need to be properly documented and justified. Additionally, a strong monthly financial close process is crucial in avoiding delays in transaction closings.



Looking Ahead

Canadian M&A Transactions



Deal flow remained relatively stagnant to start the year, as parties on both sides sat on the sidelines with 848 transactions completed in the first half of 2023 compared to 925 deals over the same period last year.⁷ Potential sellers turned their focus on operations to stabilize their business and waited for the deal market to improve before starting a sale process. Resilient companies adapted their business to better handle the current economic climate (e.g., hedging supplier costs, renegotiating customer contracts), providing a clearer and more defensible forecast for the remainder of 2023 and beyond. With fewer quality deals in the market, strategic buyers – or buyers in the same industry looking for inorganic growth opportunities – were more selective in their acquisitions, focusing on organic growth and limiting acquisitions to specific target categories. Financial buyers – investors looking to buy and grow a company as an investment – took stock of the performance of their existing portfolio companies, preferring add-on opportunities to new investments.

As the year has progressed, it's become clear that a reversion back to 2022 deal activity and valuations is unlikely to occur in 2023. Instead, concerns of selling at depressed valuations have been abated as interest rate hikes began to slow and economies started to stabilize. Market activity showed that high-quality assets will still receive premium valuations, given the flight to quality by investors and lenders alike.

Valuations aside, the standard motivations continue to lead owners to consider a sale, including retirement, a focus on other business ventures, liquidity needs and burnout. Approximately 61.5% of small- to medium-sized businesses in Canada have a primary decision-maker over the age of 50, with 14.6% of businesses with a primary decision-maker over the age of 65.⁸ As business owners continue to age, transition plans become increasingly important as key man risk⁹ and a lack of business continuity post-transaction will negatively impact the company valuation.

Buyers continue to sit on a significant amount of cash that they are looking to deploy. Private equity firms, in particular, are behind on deployment of capital and are looking for quality companies to invest in. U.S. middle-market private equity groups have noted a higher deal flow in Q2 2023 compared to Q1 2023 and are eager to deploy capital in Canada. Cross-border M&A, especially interest in middle-market Canadian assets by foreign investors, will remain elevated through 2023 and into 2024.



Other Key Considerations

As foreign buyers continue to show significant interest in the Canadian market, sellers should be aware of several cultural differences between Canadian and international markets. For example, labour laws in Canada tend to be stricter than those in the U.S. (e.g., Canadian employees are entitled to severance pay when terminated while there is no federal law mandating severance pay in the U.S.). The seller should be able to explain how aspects such as severance are normally dealt with in a process to avoid alarming buyers at a later stage of the deal process.

Another common concern with international buyers is the issue of customer concentration, especially within sectors such as food and beverage and telecom, where there is a smaller customer base than foreign buyers are accustomed to. When approaching a foreign buyer on this subject, it's important to describe the marketplace in Canada—even if it seems obvious to local buyers. It's these differences, however, that generally make foreign investors a compelling partner. An international buyer's understanding of its local market is advantageous to the seller if the company is looking to grow its operations internationally.

The prevalence of cross-border M&A has also led to increased adoption of Representation and Warranty Insurance (“RWI”)—previously more popular in the United States. RWI is an insurance policy that generally covers most, if not all, of the seller's indemnification obligations for losses stemming from breaches of, or inaccuracies in, seller representations and warranties.⁷ According to Woodruff Sawyer, a U.S.-based insurance agency, 75% of private equity transactions and 64% of larger strategic acquisitions are insured.¹¹ There has been an increase in the usage of RWI in Canadian deals, especially those that involve a U.S. buyer, to help mitigate risk allocation and reduce the percentage of the transaction value held in escrow. Canadian RWI tend to have a longer coverage period of 12-24 months, compared to 12-18 months for U.S. RWI.¹² While RWI does provide risk mitigation, insurance underwriters require a more exhaustive QoE compared to uninsured processes. If a business owner is not prepared for the added scrutiny from the addition of RWI, the time to close will be extended as the company searches for the information required to satisfy the underwriter. Despite this, the demand for RWI in Canada, especially in cross-border deals, is expected to grow as the benefits of RWI outweigh the costs.

Cross-border M&A transactions also tend to have more complex tax structures compared to deals done with a local party. For example, Canada does not have entities similar to American LLCs that can be used as an acquisition vehicle. Foreign buyers generally want to incorporate a Canadian acquisition company that allows for the pushdown of any acquisition financing and Canadian tax-efficient repatriation of funds up to the purchase price without being subject to Canadian withholding tax. Business owners thinking of starting a sale process should consider speaking with a tax specialist to ensure their company is properly positioned to allow for a more streamlined and tax-efficient sale process.



Concluding Thoughts

Cross-border M&A has always been a significant part of the Canadian deal economy. With the recent push for a more online deal process, high cash availability in the U.S., a flight to quality, and a strong supply of Canadian companies hitting the market, the prevalence of cross-border transactions is expected to expand over the next several years. While there are added complexities to a cross-border deal compared to a localized deal spanning legal, tax and cultural differences, the benefits of a foreign buyer including their experience and connections internationally, a more competitive process involving more parties, and potential synergies through geographical expansion are key considerations when looking for the right partner.

In the realm of cross-border transactions, where diverse business practices, economic factors, and regulatory environments come into play, the insight and expertise provided by CBVs is invaluable. CBVs bring to the table a meticulous, standardized and analytical approach to valuing businesses that ensures stakeholders are equipped with accurate, reliable valuations. As foreign investment continues to rise, especially in the Canadian market, the role of CBVs becomes increasingly essential, offering assurance and credibility to international deal-making processes. The expertise of CBVs guarantees that both buyers and sellers can navigate cross-border M&A activities with confidence, understanding, and trust.

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CBV INSIGHTS

NOVEMBER 2023

UNDERSTANDING
VALUE IMPACTS
ON PRIVATE
COMPANIES
THROUGH AN
ESG LENS





INTRODUCTION

In April 2023, the Bank of Canada released its first annual climate risk disclosure report as a supplement to its annual financial statements.¹ The Bank of Canada provided two reasons for enhancing its financial disclosure with climate-risk information – to be accountable to Canadians, and because it wants others to do the same so that we can all make better decisions.

What lesson can private company owners and executives learn from the Bank of Canada’s message? The short answer is that it signals a shift in stakeholder and shareholder expectations. There’s now an increased demand for high quality information about sustainability-related business risks, as well as the financial impact of those risks.

But the Bank of Canada is not the driving force in this shift. For example,

- asset owners and asset managers have been reporting on climate-related matters as recommended by the Task Force on Climate-related Financial Disclosures (TCFD) since 2017; and
- larger publicly listed corporations have been issuing sustainability reports listing their UN Sustainable Development Goals (SDGs) since 2015.

Building from these efforts, international regulatory and accounting bodies have progressed from climate-focused disclosures to a broader definition of sustainability, an umbrella term that includes ESG (Environmental, Social and Governance). **IFRS Sustainability Disclosure Standards** (ISSB Standards) will come into effect in January 2024 for public companies and large private companies in several jurisdictions. In the first year of implementation, only climate-related disclosures will be mandatory; sustainability-related disclosures will become mandatory in the second year. We note that while ISSB Standards are not currently mandated in Canada, the Canadian Securities Administrators (CSA), who determine the reporting requirements for Canadian public companies, is considering ISSB and U.S. developments and is expected to align with international requirements.

Canada’s family-owned and private companies are not presently the target of these disclosure requirements, but there is no doubt that ESG considerations are set to impact every player in the Canadian economy. For one, the ripple effects of ESG practices and disclosures will be felt throughout the supply chain, flowing from larger public companies down to private enterprises.

Understanding the financial impact of ESG factors is key to appropriately quantifying and understanding the risks, making better business decisions, and turning them into opportunities for value creation.



WHAT DO BUSINESS OWNERS AND EXECUTIVES NEED TO KNOW ABOUT ESG?

ESG stands for environmental, social, and (corporate) governance. Investors, lenders and other stakeholders are increasingly considering ESG factors in their analysis to understand the impact and sustainability of a company's action. ESG factors may impact business valuations both from a qualitative and quantitative perspective.

Chartered Business Valuators (CBVs) seek to identify which ESG factors pose material risks and growth opportunities to businesses, and which may drive and create business performance and value.

ESG includes a broad array of topics and issues, and there is no definitive list. It can be challenging to classify an ESG issue as only an environmental, social or governance issue because they are often interrelated. Some key ESG factors (posing risks and opportunities) are included in the below table.

ENVIRONMENT

- air & water pollution
- biodiversity
- climate change (current and future risks)
- clean water & sanitation
- carbon & other gas emissions
- deforestation
- natural disaster
- resource efficiency (i.e., energy, water, raw materials)
- waste management

SOCIAL

- human rights in the supply chain
- community relations
- conflict
- customer satisfaction
- labour relations
- employee health, safety & well-being
- development of human capital (health & education)
- employee engagement
- equity, diversity & inclusion (EDI)

GOVERNANCE

- corporate governance
- board diversity & structure
- audit committee structure
- business ethics
- bribery & corruption
- data security & privacy
- ESG integration with financials
- executive remuneration
- management succession planning
- transparency & communication

Further complicating things, ESG is often used interchangeably with sustainability, despite having distinct meanings and implications. One distinction is that ESG is used as a structured framework for evaluating specific business performance criteria, while sustainability takes a broader, holistic view, connected to a company's ability to deliver long term value for its investors. For example, a business may have a sustainability program that addresses specific ESG factors over the short, medium and long term.



WHY SHOULD PRIVATE BUSINESS OWNERS CARE?

Strong ESG practices mitigate risks, open doors to new opportunities, drive innovation, attract top talent and strengthen our communities.

— Export Development Canada²

Few small and midsize business owners in North America feel they have the bandwidth to create a strategic climate plan for their business, while they remain preoccupied with the challenges posed by inflation, supply chain and labour issues.³

And for now, sustainability disclosure requirements mostly affect publicly listed companies and large international corporations.

But Chartered Business Valuators (CBVs), Canada's leading finance professionals with extensive knowledge and expertise in the specialized field of business valuation, are witnessing a trickle-down effect impacting private companies. Investors, lenders, and customers are increasingly asking companies of all sizes for their sustainability goals, management succession plans, disaster preparedness, ESG regulatory costs, etc. The following pages feature some lessons learned from CBVs who have been successfully guiding their private company clients through this “new normal.”

Ultimately, however, this “new normal” is about more than just satisfying information requests. Investors are no longer looking at ESG initiatives as a sunk cost or trade-off – some specifically use money to influence ESG efforts, such as investing in sustainability-linked loans. There is now an expectation that companies tackling sustainability issues will deliver better commercial returns over the long term. But with limited time and resources, which ESG initiatives are worth tackling first? This is where CBVs enter the picture. CBVs understand value-drivers. They work with management to create shareholder value, the primary objective of any enterprise. CBVs also understand business risk. They employ a variety of analytical approaches to address how risk affects cash flows and corporate values, including ESG considerations. A CBV can help translate the impacts of specific risks on financial performance and offer valuable advice to maximize the value of your business.

WHAT HELP CAN CBVs OFFER PRIVATE BUSINESSES?

CBVs play a critical role in providing independent analysis and advice to private companies. On the following pages, CBVs share insights from their experiences advising private companies on ESG issues that have arisen in ownership disputes and buyouts, deals, transaction due diligence, private investments, and even ESG-related legal claims. Read on to learn more about how considering ESG factors may drive long-term corporate value at your company, enhance operations, and boost confidence when interacting with stakeholders.



ESG ISSUES ARE BUSINESS ISSUES, AND THEY ARE HERE TO STAY

Should having a sustainability strategy in place matter to private companies? For those of you looking for the quick answer – it should. If you'd like to know why, read on.

IT'S HERE TO STAY

Sustainability issues are business issues, and they matter. As a Chartered Business Valuator, I see value through a lens of risk and future benefit. All other things being equal, a decrease in risk will result in an increase in value, provided of course the cost of decreasing the risk doesn't offset the benefit. Having a sustainability strategy in place will give you a better understanding of the risks that your stakeholders view as material and ways to mitigate them.



Having a sustainability strategy in place will give you a better understanding of the risks that your stakeholders view as material and ways to mitigate them.

— Mark Weston, CPA, CA, CBV

STAKEHOLDERS AND RISK

For private companies, stakeholders can be shareholders, lenders, customers, suppliers, employees or even the community you operate in. Risks can be environmental, relating to how you're sourcing and using natural resources, disposing of waste or dealing with the impact of floods or fires on supply chains or distribution networks. Risks can also be social in nature, relating to the health and wellbeing of your employees or the potential of losing favour with customers or the support of the community at large.

THE IMMEDIATE BENEFITS

At some point most private companies will be asked whether they have a sustainability strategy in place. The question might be asked by a banker, potential investor, an individual customer who cares about sustainably sourced products or a large corporate customer. Remember small companies sell to bigger companies, and bigger companies often have mandates to ensure they are sourcing from companies that are sustainable and have sustainability strategies in place.

More than likely the question will come from the new engineer, scientist, or marketing intern that you're eager to hire. By the way, Gen Z's – those enthusiastic and innovative employees that everyone is trying to hire and retain – care about sustainability. Companies have reported that securing and retaining talent is one of the key benefits of having a sustainability strategy in place.

Understanding sustainability and having a strategy in place won't guarantee you that financing, get that extra dollar of revenue or land that recruit. However, for those customers, potential investors or employees that care, having a strategy in place could possibly be the difference between them doing business with you, or turning to a competitor.

Sustainability. There's never been a better time to start thinking about it.

Mark Weston is the leader of Davidson & Company's ESG Advisory Services practice.



ESG IS MAINSTREAM IN DEALS AND CAPITAL ALLOCATION

ESG has transitioned from a risk mitigation strategy to a key driver of sustainable value creation. While ESG was once relegated to activist stakeholders, embedding sustainability via identifying and then incorporating industry specific ESG value levers into core strategic, operational, and financial decisions is now far more mainstream.



Dealmakers should be aware that intangible ESG attributes – such as employee morale and a reputation as a green company – are affecting value in SME deals and capital allocation decisions. Value levers are modernizing; we can now quantify many of these elements.

– Miriam Pozza, FCPA, MBA, CBV

Dealmakers and capital providers are expanding their due diligence to evaluate risks and opportunities related to ESG issues, like unethical marketing, reputational risks, supply chain vulnerabilities, workforce engagement, measurement of sustainability goals, and disclosure transparency. More specifically, decision makers seek to avoid regulatory penalties and loss of revenue from unethical behavior, identify deeper company issues, build resilience into supply chains, and boost retention through a strong company culture. Post-transaction, they are monitoring companies to **ensure deals truly deliver on ESG promises**, and fully leverage value creation opportunities.

These value levers are maturing into a set of ESG due diligence criteria with important implications across the M&A landscape, from raising financing, to capital allocation, to carrying out acquisitions and divestitures. This ongoing transition will require evolving capital allocation decision frameworks, to take fuller account of intangible attributes that matter to value. For example, what is the value of high employee morale, or diversity of thinking in an innovation process, or an enhanced reputational brand value as a greener company? These sorts of attributes can be quantified, and linked directly to cash flow forecasts that drive enterprise value.

In summary, understanding the broader ecosystem of risks and opportunities at work in every company - which is not a new concept to valuations - is truly fundamental to navigating the complexity of these ESG factors. There is a need for more **discipline when assessing the impact, both tangible and intangible, on enterprise value**. We are no longer focused on improving shareholder value but focused on considering all elements that can influence stakeholder value.

Miriam Pozza leads the Deals ESG practice globally and in Canada at PwC. She also leads the Transaction Services teams in Quebec.



INSTITUTIONAL INVESTORS EXPLICITLY CONSIDER SUSTAINABILITY-RELATED FACTORS

There is a growing view that companies with leading sustainability practices attract premium valuations, as they are better equipped to manage the related risks and capitalize on opportunities, leading to improved financial performance in the long run. At CPP Investments, we allocate capital with a long-term horizon and we view sustainability-related considerations as business critical. We partner with portfolio companies to create long-term value by integrating material sustainability-related risks and opportunities in all phases of the investment life cycle.



CPP Investments is proactively monitoring and tracking sustainability-related factors that are material to long-term success, with a current focus on climate change and the transition to net zero by 2050.

— Emily Tse, CFA, CBV, FRM

In light of this, CPP Investments recognizes the importance of incorporating sustainability into our valuation practices. We have implemented frameworks and policies to proactively monitor and track sustainability-related factors that are material to the long-term success of our portfolio companies, with a current focus on climate change and the [transition to net zero by 2050](#). Today, where sustainability-related factors are material to the investment, we are starting to explicitly consider these factors to the extent that decarbonization plans exist. We also qualitatively incorporate other sustainability-related risk factors in determining discount rates and multiples.

Looking ahead, we endeavor to capture the sustainability-related impact on valuations in a more systematic and data-driven way, in conjunction with more robust and consistent sustainability disclosure which we expect will be facilitated with the broad adoption of the recently released [International Sustainability Standards Board standards](#). Specifically, enhanced disclosures by companies will allow investors to better assess and value the impact of sustainability-related factors on company performance. This ultimately helps valuers assess comparability of companies from a sustainability perspective and calibrate valuation assumptions accordingly.

***Emily Tse** is the private investments valuations team leader at CPP Investments and a member of the [Business Valuation Board](#) at International Valuation Standards Council (IVSC).*



PREPARE TODAY FOR ENHANCED M&A ESG DUE DILIGENCE

ESG factors are **redefining value and risk** in business. Organizations that build ESG into the M&A process, from establishing strategy, to due diligence, post-acquisition and exit strategy, are best positioned to maximize shareholder returns and safeguard from value erosion.



CBVs in M&A advisory are seeing growing investor interest around ESG, leading to a notable increase in ESG due diligence. As a result, it is critical that SMEs are prepared to answer ESG-related questions.

— Anne-Julie Souchereau-Renaud, CPA, CBV

No matter what step of the M&A process you need to tackle, we recommend taking a pragmatic approach and determining the material ESG considerations relevant for your industry, jurisdictions, and operations. You can leverage frameworks such as Sustainability Accounting Standards Board (SASB), which focuses on financially material **considerations by industry**. For example, a professional service firm would mostly focus on DEI, business ethics and data security, while an industrial machinery company would focus on energy management, health & safety and material sourcing.

In a buy-side context, we recommend following a similar approach; identify the material ESG risks and opportunities for the target company, discuss with management and review documentation to understand how material considerations are managed and integrated into their business. This will help determine the impacts on the transaction value and the appropriate post-closing strategy to protect value and/or generate incremental revenues and cost synergies.

In a sell-side context, it is critical to recognize the material ESG considerations impacting your business and to have a strategy in place for mitigating risks and capitalizing on opportunities. You should also reflect your approach to ESG governance as well as ESG key value drivers in the deal story.

Organizations that are not ready to answer ESG questions in a sell-side process could potentially drive away prospective buyers, ultimately reducing competition and lowering the sale price. As an example, through ESG diligence on a renewable energy business, we identified that several solar energy assets were exposed to an increase in the frequency of extreme heat waves. This posed the risk of degradation of solar equipment, shortening capital replacement cycles and increasing operational costs. The seller was unable to provide their view on these risks or a mitigation strategy and our client ultimately did not proceed with the transaction.

In summary, our advice is to get started on your ESG journey now. This will ensure you do not overlook material risks and opportunities for new acquisitions and can maximize value in the sell-side process by being prepared to answer questions on ESG. The biggest mistake you can make today isn't getting ESG wrong - it's overlooking it completely.

Anne-Julie Souchereau-Renaud is a lead for Deloitte Canada's ESG Mergers & Acquisitions practice.



THOUGHTFUL GOVERNANCE POLICIES HELP PRESERVE AND CREATE VALUE

There is a trend towards private companies implementing stronger governance to preserve and create value. In simple terms, governance refers to the process enabling decision-making. In a public company or institutional setting, governance is often regulated or legislated. In a private setting, governance is frequently informal, inconsistent, and sometimes non-existent.

Potential buyers value indicators of strong governance – a clearly defined strategy, objective decision making and predictable cash flow, to name a few. In contrast, poor governance can result in undesirable conditions including dysfunctional management, poor quality reporting, and lack of dividends. Having supported many business owners through ownership succession, disputes and buyouts, I have witnessed the profound impact of governance. Additionally, lacking governance may result in the breakdown of familial or business relationships, resulting in a loss beyond financial value.



Thoughtful governance policies should consider all stakeholder perspectives and be revisited often.

— Alana Geller, CPA, CBV, CFF

The loss of value often stems from poor communication. Consider a family with two children who inherited a family business. One sibling runs the business, and the other works outside of the business. Under the management of the first generation, the family lived modestly, reinvesting most profit.

Today, the business is worth many hundreds of millions of dollars. The owners should be celebrating, but instead, there is a lack of trust among stakeholders. Why?

- 1) Lack of independent board members to provide objectivity.
- 2) No forum to resolve conflict or conflicts of interest.
- 3) No formal reporting aside from financial statements and tax returns.
- 4) Lack of alignment on vision, values, and strategy.
- 5) Management team includes family members with perceived limited experience and unfair compensation.
- 6) No dividend policy, cash distributions are unpredictable.
- 7) Outdated shareholders' agreement.

Having only a few of the above characteristics is a recipe for value erosion. How can you protect your business and your relationships?

- 1) Enact a board (advisory or fiduciary) with independent members to provide objectivity, address conflict directly, and hold management accountable.
- 2) Communication and regular reporting are paramount, especially when conflictual.
- 3) Align on a vision, values, and strategy and revisit often.
- 4) Enact a family employment policy.
- 5) Enact a dividend policy.
- 6) Negotiate a shareholders' agreement, including exit mechanisms.

Private businesses require thoughtful governance policies to preserve and create value. I have outlined some best practices, but a tailor-made solution will be most impactful. Governance policies should be revisited often and consider all stakeholder perspectives. Consider obtaining support from professionals with deep governance expertise to help your business sustain and create value over time.

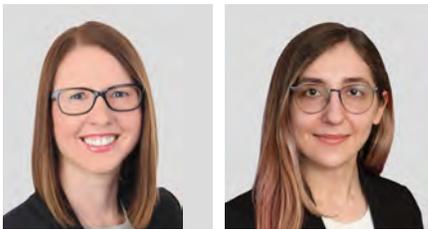
Alana Geller is a partner at Richter advising clients and the legal community on valuation, ownership and dispute matters.



ESG LITIGATION IS ON THE RISE

KPMG in Canada's recent [Future of Litigation](#) survey of litigation lawyers in Canada found that more than half of respondents expected the following types of ESG-related legal matters to increase:

- ESG-related securities and other class actions (e.g., allegations of “greenwashing” or other unsubstantiated or misleading ESG claims).
- Investor and consumer protection claims (e.g., claims related to the environmental impacts of an organization's products).
- Property remediation and environmental impact (e.g., a landowner facing civil claims brought by tenants, neighbours or future owners, for contamination on or sourced in its property).
- Insurance matters triggered by ESG-related claims (e.g., Director & Officer insurance claims related to the above matters).
- General ESG-related breaches (e.g., liability for human rights issues at foreign operations).



To prepare for increased ESG litigation, identify the greatest risks (financial and non-financial), and strategically implement the relevant internal controls and monitoring strategies.

— Becky Seidler, CPA, CA, CFF, CBV, MFAcc

— Ana Rusu, CPA, MAcc, MFAcc

ESG litigation is both costly and time consuming for an organization and is exacerbated through the associated reputational damage. To effectively mitigate the risks and potential impacts, organizations should:

- 1. Perform a risk assessment** – This entails understanding the types of ESG litigation to which the business may be most susceptible, the likelihood, and the impact. Organizations also need to be cognizant of ESG impacts and risks both up and downstream their value chain. This risk assessment should involve the appropriate perspectives, including from legal counsel and other subject matter experts. CBVs can assist in estimating the potential impact of identified risks in terms of possible financial damage exposure, cash flow, and business valuation.
- 2. Implement internal controls and monitoring strategies** – This may involve gathering data from and implementing internal controls in areas of the business that have not historically had a rigorous internal control structure, compared to finance/accounting where strong internal controls are more commonplace. A data driven approach to monitoring (including compliance with ESG expectations of relevant parties) can be effective in detecting anomalies early, enabling an organization to remediate and possibly avoid litigation.
- 3. Be prepared to respond strategically to claims should they arise** – ESG litigation may differ from claims organizations could have faced in the past. Often, multiple experts are required to assess both liability and potential damages. Depending on the claim, a satisfactory outcome may be a monetary award, or a simple agreement that the organization will act more in line with stakeholder ESG expectations - another reason to ensure you have the right expertise at the table to assist in determining financial and non-financial impacts.

In summary, a well-balanced approach to ESG practices, disclosures and related litigation risks can help to preserve and create shareholder value.

Becky Seidler and Ana Rusu are forensic and dispute advisors at KPMG LLP.



THE PRIVATE LOAN MARKET IS OFFERING INCENTIVES FOR SUSTAINABILITY ACHIEVEMENTS

Sustainability-linked loans (SLLs)—where a loan’s economics are tied to the borrower’s achievement of certain ESG key performance indicators (KPIs)—are becoming popular in the private loan market. [Debtwire](#) reported that one-fourth of privately negotiated loans in Europe contained ESG triggers in the first three quarters of last year.⁴ With their growing prevalence, private debt valuation teams are refining their approach to assessing fair value for less liquid SLLs.



SLLs can incentivize borrowers to achieve meaningful ESG objectives in a transparent and measurable way, offering the opportunity to enhance both reputation and value.

— Cheryl Cheng, CPA, CA, CFA, CBV

In most SLLs, the lender(s) and borrower establish KPIs and sustainability performance targets (SPTs) tied to those indicators. If the borrower achieves the SPTs, it is rewarded with lower interest, and if it falls short, it pays higher interest.

For SLLs, valuation methodologies and processes are essentially the same as for loan agreements with performance-based pricing grids tied to credit quality. The pricing grid will account for meeting or not meeting the KPIs. However, valuations will require comparing the SPT-driven pricing grid to the current market. As the SLL market for private loans continues to develop, pricing services and valuation agents will begin to better track pricing for SLL loans to have adequate benchmarks.

VRC views the SPT and margin adjustments as part of the underwriting calibration, like other pricing grids. All else equal, if an issuer moves within the pricing bands, VRC would generally apply a similar margin adjustment in line with the pricing grid. As a result of the offsetting adjustment, changes would be value-neutral.

VRC may view the pricing grid as value-impacting if the pricing for market clearing SLLs, margin ratchets, or SPTs materially changes from the calibration. A more common example would be for a leverage-based pricing grid where the market reduces allowable leverage limits after issuance and, therefore, the original leverage limits are not representative of market terms. In that case, we would adjust the credit spread to reflect the higher relative risk of the existing pricing grid versus the “market” pricing grid.

SLLs are becoming increasingly common in the private credit market as borrowers and end investors look to leverage their ESG credibility. A CBV with expertise in the concepts of performance pricing with respect to leverage ratios can help guide your understanding of these new private debt instruments.

Cheryl Cheng is a leader in portfolio valuation at VRC.



ESG TOPS THE AGENDA FOR MINING AND METALS LEADERS

By some accounts, the term ESG was coined in 2003. And yet the term social licence to operate (SLO), which addresses many elements of ESG, was first used by the mining industry in 1997. SLO must be earned — and maintained — on the basis of delivering profits and value to shareholders, establishing trust and maintaining effective communication with all stakeholders. The SLO roadmap provides a working understanding of how to approach ESG.



Learning from the mining industry, a strong focus on stakeholder relations can help to address many elements of ESG while creating or preserving value over the long term.

— Jay Patel, CPA, CA, CBV, ACCA (UK)

It's important to note that mining's SLO focus remains true to Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders. Such focus improves sustainability of mining operations by lowering risk as the following examples reveal:

- **Environmental** – Deploying technologies to reduce or reuse scarce resources, such as water, leads to improved process plant availability and processing volumes.
- **Social** – Building hospitals and schools leads to improved employee welfare, which enhances attendance and engagement.
- **Governance** – Growing local managerial talent leads to better community and country relations over the longer term.

The above are great examples of how a long-term, sustained ESG focus can deliver true performance improvements, enhance credibility with stakeholders, reduce risk and ultimately drive long-term value creation or preservation. While value drivers in other sectors will differ from mining, the focus on the relevant ESG initiatives to either improve cash flow or mitigate risk will always be a prudent measure to enhance a company's performance over the long term.

Today, ESG issues are regarded as the mining industry's **number-one** source of risk and opportunity. Considered integral to corporate strategy and almost every aspect of operations, ESG's foothold in the mining industry is firm, and it is broadening in scope.

My advice to SMEs? Look to mining for lessons on how to build trust with stakeholders and achieve sustainable profitable growth, and adapt these lessons to your respective industry.

Jay Patel is a Partner and the Mining & Metals Transactions and Valuation Leader at EY Canada.

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