



**CAMPBELL VALUATION
PARTNERS LIMITED**

34 ST. PATRICK STREET, SUITE 400
TORONTO, ONTARIO M5T 1V1
416-597-1198
FAX 416-597-9779
www.campbellvaluation.com

Ian R. Campbell
Howard E. Johnson
H. Christopher Nobes
Chris P. Polson
Dennis Leung

Business Valuation in the Context of Estate Planning

H. Christopher Nobes C.A., C.B.V.

Partner

Campbell Valuation Partners Limited

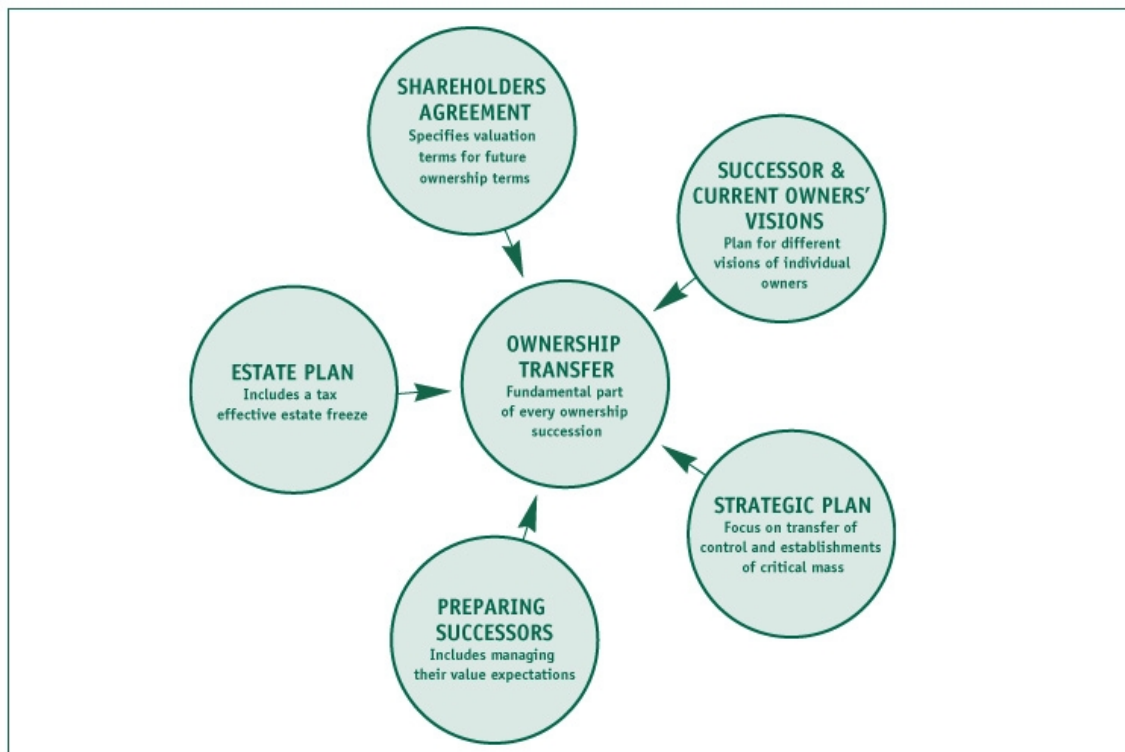
H. Christopher Nobes is a partner of Campbell Valuation Partners Limited ('CVPL'), Canada's longest established business valuation consulting firm and specialist in mid-market business acquisitions and divestitures. A significant portion of Chris' practice involves advising business owners on valuation matters that arise in the context of estate planning. The following table illustrates some examples of his recent estate planning business valuation experiences.

<p>2nd Generation Family</p> <p><i>Acquisition of Minority Shareholders</i></p> <p><i>Drafting of Valuation Provisions in Shareholders' Agreement</i></p>	<p>2nd Generation Family</p> <p><i>Interfamilial Share Transaction</i></p>	<p>6th Generation Family</p> <p><i>Annual Valuation Pursuant to Provisions in Shareholders' Agreement</i></p>	<p>Large Multi-National Family Owned Business</p> <p><i>Dispute with CRA Over the Fair Market Value of the Canadian Component of an Arm's Length Global Acquisition</i></p>
<p>2nd Generation Family</p> <p><i>Dispute Over the Entitlements of a Key Employee Pursuant to the Terms of the Founder's Will</i></p>	<p>2nd Generation Family</p> <p><i>Fair Market Value Determination in Respect of Shares Owned by Person Who Became a Non-Resident of Canada</i></p>	<p>2nd Generation Family</p> <p><i>Exclusive Advisor Retained to Sell Business to a Third Party</i></p>	<p>Several Family Businesses</p> <p><i>Annual Valuation Provisions in Shareholders' Agreement</i></p>



1. INTRODUCTION

Income tax planning is an important aspect of estate planning but it is not the only aspect. As illustrated in the following diagram there are several components of an effective estate plan that require consideration and attention by business owners and their estate planning advisors.



Every estate plan should ultimately accommodate a transition to the next group of owners whether that next group is a third party, management or the next generation of an existing family ownership group. Business valuation is at the core of every ownership transfer and hence every estate plan. In the context of:

- an estate freeze, the objective of a business valuation is to reasonably and objectively determine the fair market value of the 'frozen shares' so as to avoid potential double taxation and to allow prospective value enhancement to accrue to the newly issued 'growth' shares;



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- inter-shareholder share transactions, the objective of a business valuation is to reasonably and objectively determine the fair market value of the shares to be exchanged so as to avoid, as much as possible, any perceived unfairness to those with a stake in the transaction; and,
- selling a business to a third party, the objective of a business valuation is to set reasonable expectations on the part of the vendor and to assist in negotiations so as to enhance the probability of maximizing the selling price obtained in the open market.

The extent to which a business valuation is successful in serving its intended purpose is a direct function of the independence, objectivity and due diligence of its creator. Estate planners and business owners should be able to review a business valuation and feel confident that the valuer thoroughly understood the business being valued, its prospects, its strengths, weaknesses, opportunities and threats, and the industry in which it operates. Without the foregoing, estate planning advisors and the principles at the root of an estate plan run the risk of being ill advised by a flawed business valuation that may reflect a bias towards a value conclusion that serves a short-term objective (e.g. maximizing an income tax deferral) rather than being objective. In my experience these flawed valuations have a tendency to resurface at a later date under different circumstances and often cause more problems for business owners than the short-term benefits they originally created.

2. VALUATION APPROACHES AND METHODOLOGIES

2.1 Components of Open Market Transaction Prices

When dealing with 100% of the outstanding shares or net assets of, or a control shareholding in, a business that is valued on the assumption that it will continue to operate as a going concern, and where post-acquisition synergies are expected, the two possible components that comprise any given open market price are:



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- that reflective of the value of the all of the outstanding shares, or net assets of the business viewed on a stand-alone basis. That is, the value of the business interest assuming the business will continue to operate ‘as is’ absent a divestiture of all or part of it. This value component often is referred to as intrinsic (or ‘stand-alone’) value. Intrinsic value is comprised of three distinct components:
 - tangible operating assets, net of liabilities, required to carry on the business,
 - identifiable intangible assets (if any), which may include brand names, patents, copyrights, franchise agreements, trademarks, and so on,
 - where applicable, non-identifiable intangible assets which is referred to as goodwill.

The term goodwill is commonly used in open market transactions to include both the value of identifiable and non-identifiable intangible assets and seldom are the two quantified separately. Rather, the global perceived value of such assets normally is included as part of generic ‘intangible value’ or ‘goodwill. Separate quantification of identifiable and non-identifiable intangible assets may, however, be required for income tax purposes or to satisfy Canadian generally accepted accounting principles (‘GAAP’); and,

- an incremental value over stand-alone, or intrinsic, value perceived by a purchaser at the time of acquisition comprised of purchaser-perceived post-acquisition economies of scale and/or strategic advantages. The quantification of this incremental value is unique to each potential purchaser. Examples of post-acquisition economies of scale include incremental revenue opportunities, cost savings and overall risk reduction that the purchaser expects will result from combining the acquired business with its existing operations, and so on. Examples of purchaser-perceived strategic advantages include post-acquisition business combination opportunities that otherwise would be unavailable to the purchaser, scarcity value perceived by the purchaser, enhanced post-acquisition management depth and critical mass, and so on. These benefits are collectively referred to as either ‘post-acquisition net economic value-added’, or

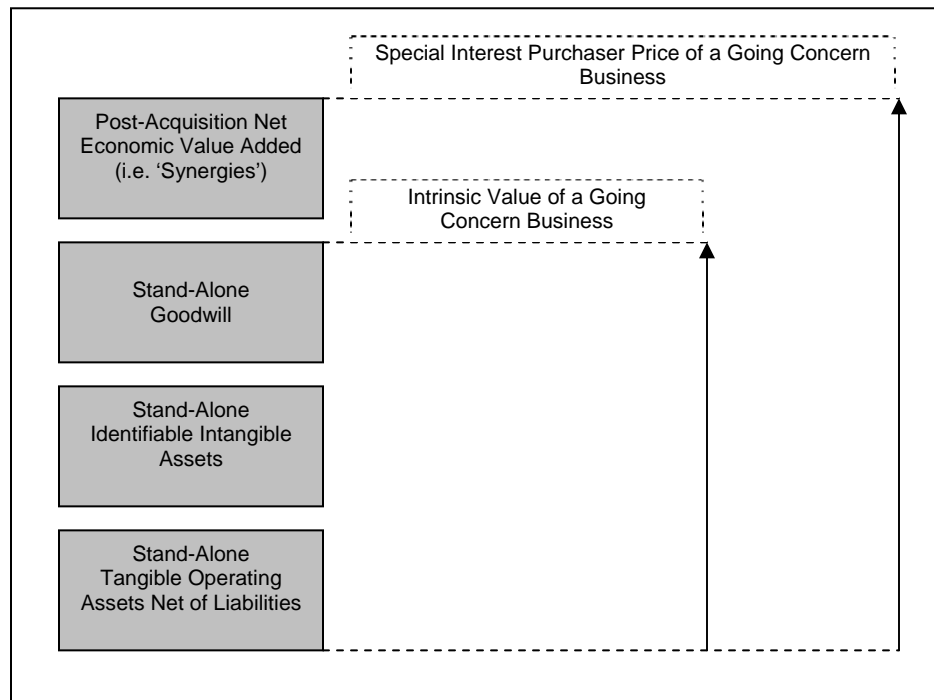


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simply 'synergies'. Purchasers who anticipate synergies often are referred to as 'special interest purchasers'.

As illustrated in the following diagram, the combination of 'intrinsic value' and 'synergies' is referred to as 'special interest purchaser price'.

Chart 1 – Components of Open Market Transaction Price



When determining fair market value in a notional context, it is necessary to address the question of possible open market prices that might be paid by so-called special interest purchasers. Since open market negotiations current to the required date of value typically have not taken place, it often is difficult:

- to identify possible purchasers who might be interested in acquiring a given business interest;



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- where such possible purchasers are identified, to determine which of them would be considered to be ‘qualified’ purchasers who have both the appetite for, and financial capability to effect, a transaction;
- to identify post-acquisition value-added benefits each ‘qualified’ purchaser might enjoy;
- importantly, to quantify the identified post-acquisition value-added benefits that might be realized in different degrees by each ‘qualified purchaser’; and,
- to assign a probability to the likelihood of the business interest being sold at a price which would include some or all of said possible post-acquisition value-added benefits.

Further, where values are determined pursuant to business re-organizations, estate planning, inter-shareholder (including both related and non-related parties), Family Law requirements and so on, and an attempt is made to quantify an incremental amount over intrinsic value to account for possible purchaser-perceived post-acquisition net economic value-added, the potential exists for significant business disruption. This is particularly the case where monies to fund an acquisition must be extracted from the operating assets of a business (i.e. ‘internally financed’), which could restrict the companies ability to sustain or grow its prospective operations. For this and other reasons, such valuations are typically completed on an ‘intrinsic’ (or stand-alone) basis. In the context of an estate freeze, Canada Revenue Agency (‘CRA’) typically accepts ‘intrinsic value’ as an appropriate value basis.

2.2 Overview of Business Valuation

When determining the value of a particular business, an assessment must be made as to whether a liquidation or going concern approach should be the primary method of valuation. The primary method that should be adopted is the one that yields the greatest net contribution to the equity owners. This can be measured by comparing:



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- the present value of the estimated prospective discretionary after-tax cash flows to be generated by the business; and,
- the estimated net proceeds which could be attained by disposing of the underlying net assets of the business, where both amounts are after income tax effected in a consistent manner.

This paper has been written in the context of going concern business valuations. As previously noted, the en bloc intrinsic value of the outstanding shares or net assets of a business that is a going concern may include the net tangible assets required to operate the business, identifiable intangible assets (where they exist), and where applicable, non-identifiable intangible assets (where they exist). Going concern value generally is determined on a composite basis, and then if necessary (e.g. for purchase price allocations pursuant to the Business Combinations Section of the CICA GAAP Handbook) that value determined on a composite basis can be allocated to identifiable and non-identifiable intangible assets to the extent that they exist.

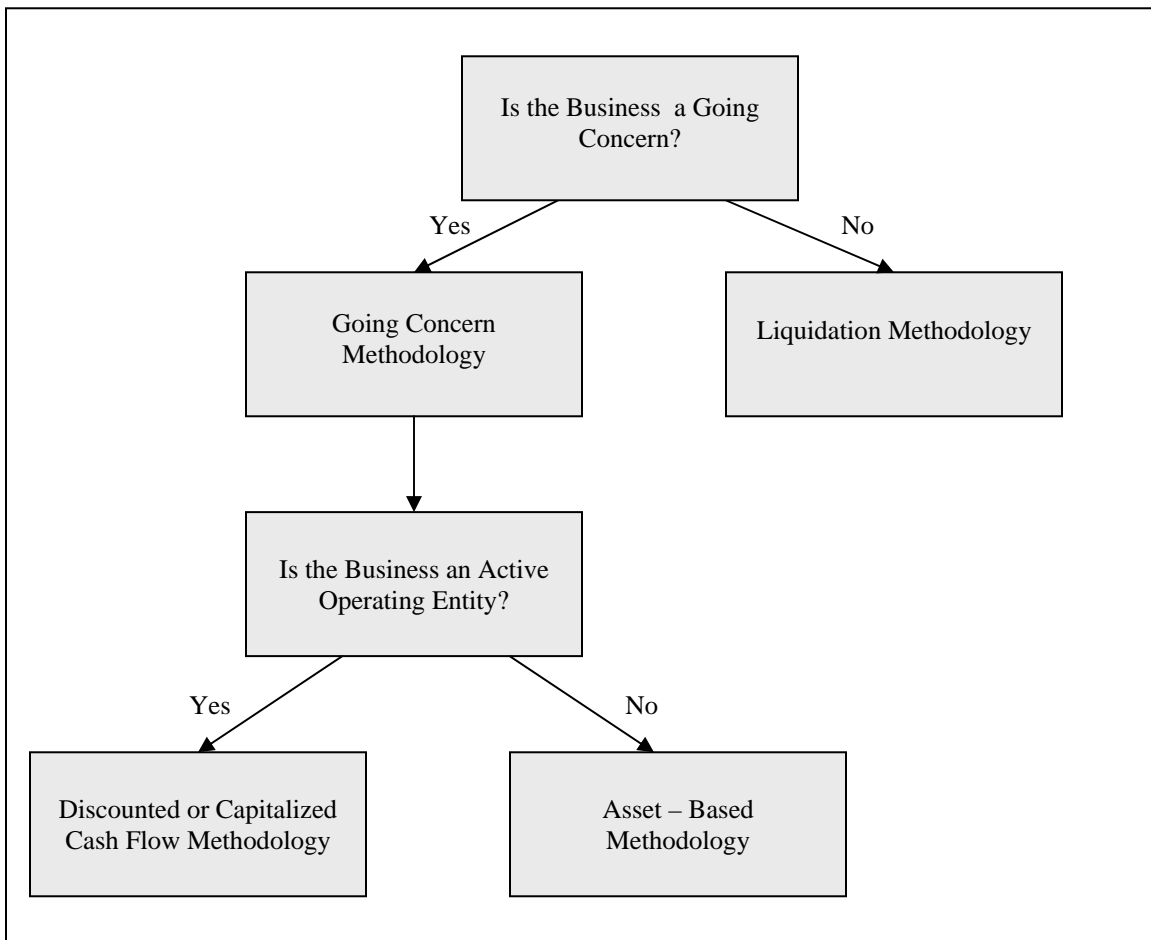
The most common going concern valuation methodologies include the discounted discretionary cash flow methodology and the capitalization of discretionary cash flow methodology. Often these are supplemented by alternative 'test' methodologies, comparing values determined pursuant to either cash flow methodology to 'so-called' public company comparable and open market transaction comparable multiples of revenue, multiples of EBITDA (earnings before interest, tax, depreciation and amortization), and multiples of EBIT (earnings before interest and tax). Although these test methodologies may provide a test of reasonableness, they more often than not are not meaningful because the so-called comparable company or acquired company upon which they are based usually are not truly comparable to the business that is the subject of valuation. Further, unless the valuer had intimate knowledge of a particular so-called comparable public company or acquired company, it is difficult if not impossible to credibly rely on such multiples as anything more than perhaps a test of the values determined by an objectively applied cash flow methodology. This is because, as a practical matter, corporate acquirers generally are interested primarily in perceived prospective discretionary cash flows that a business can generate, not so-called comparable company multiples. That said, where the business that is being acquired is a



holding company, corporate acquirers generally apply an asset-based valuation methodology where the operating company subsidiaries of that holding company are generally valued pursuant to a cash flow methodology, the values of which are rolled-up into the asset based values of their parent holding companies.

The following diagram summarizes the decision making process in determining an appropriate primary valuation methodology to adopt.

Chart 2 – Determination of Primary Valuation Methodology





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The determination of going concern value where the business is an active operating entity normally is best developed pursuant to a cash flow based methodology. Various cash flow and other going concern valuation methodologies exist, each requires:

- an assessment of the future prospects of the business that is subject to valuation. This normally is taken to be the amount of discretionary cash flow which the business prospectively is expected to generate based on its operating assets and perceived prospects;
- an assessment of the risk of achieving those assessed prospects. This assessment is reflected in the discount or capitalization rate, as the case may be, which is applied to the estimated discretionary cash flows; and,
- that redundant assets be identified and segregated. Redundant assets are those not required to generate the assessed prospective cash flows of the business that is subject to valuation. Redundant assets are assumed to be liquidated, and their net realizable value at the corporate level is added to the going concern value of the business.

Simplistically, if a business has redundant assets valued at \$2 million (net of selling and corporate tax costs on notional disposal), is expected to generate \$1 million in discretionary after-tax cash flows, then the 'value' of the business would be determined as follows.

Chart 3 – Simplistic Business Valuation Calculation

Prospective Discretionary After-Tax Cash Flow	\$1 million
Divided by the Required Rate of Return	<u>10%</u>
Equals the Going Concern Value Before Redundant Assets	\$10 million
Add: Net Realizable Value of Redundant Assets	<u>\$2 million</u>
Equals the en bloc fair market value of the equity of the business	<u>\$12 million</u>



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In the context of business valuation the prospective discretionary after-tax cash flows of the business and the rate of return applied thereto are interdependent. That is, if the 'correct value' of the going concern value of the underlying operations was thought to be \$10 million (i.e. before consideration of redundant assets), that figure could be derived by:

- capitalizing discretionary after-tax cash flows of \$1.5 million at a 15% return;
- capitalizing discretionary after-tax cash flows of \$800,000 at an 8% return; or,
- an infinite number of other combinations.

Simply stated, as a general rule, the more aggressive the discretionary cash flow assumptions, the greater is the risk in achieving them and the higher should be the adopted rate of return. In the end, selection of these key variables must recognize their reciprocal relationship, and must be based on experience and judgment resulting in a 'value' or 'price' determination that is not merely arithmetic.

2.3 Discretionary Cash Flow

When determining value or price, the discretionary after-tax cash flow that a business is expected to generate is of primary importance. After-tax earnings (or profit after tax) determined pursuant to GAAP generally is less important, except perhaps to public company acquirers that do consider (in addition to a target companies discretionary cash flows) post-acquisition consolidated after-tax earnings when making acquisition decisions.¹

The aggregate after-tax cash flow generated by a business typically has both a non-discretionary and a discretionary component. Non-discretionary after-tax cash flow is defined as that component of aggregate after-tax cash flow that must be reinvested to

¹ This is because public company acquirers estimated post-acquisition consolidated earnings per share to determine whether the acquisition is expected to be accretive or dilutive to their reported earnings per share in the near-term following closing.



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sustain the existing business volumes, competitive abilities, and so on at current levels of cash flow generation. Because this cash flow component must be reinvested to enable the business to sustain itself, in both theory and practice it does not provide the business owner(s) with a return on investment. The business owner's return on investment comes from the remainder, or discretionary component, of the aggregate after-tax cash flow. The discretionary cash flow component can be withdrawn from the business without impairing prospective operating results, or alternatively can be reinvested in the business to generate growth and incremental financial returns.

2.4 Capitalized Discretionary Cash Flow Methodology

As a general rule, when valuing or pricing the outstanding shares or net assets of business the 'discounted cash flow methodology' should be adopted. Pursuant to this methodology, a forecast of revenues and non-discretionary expenses is developed, the resultant after-tax discretionary cash flow is then discounted to present value, and a post-forecast period value (often referred to as 'terminal value') is developed at the end of the forecast period and likewise discounted to present value. Post-forecast period value typically represents a significant portion of the total value developed pursuant to the 'discounted cash flow methodology' and it is generally developed pursuant to a 'capitalization of discretionary cash flow methodology'. In some cases the 'capitalization of discretionary cash flow methodology' is used on its own to develop business value.

The mechanics of the capitalization of discretionary cash flow methodology are illustrated in the following chart.



Chart 4 – Mechanics of the Capitalization of Discretionary Cash Flow Methodology

	Estimated Maintainable Discretionary Cash Flow before Interest, Tax, Depreciation and Amortization (i.e. Discretionary EBITDA)
Less	Income taxes
Equals	Net Discretionary After-Tax EBITDA
Less	Sustaining Capital Reinvestment Net of the Present Value of Tax Shield from Capital Cost Allowance ('CCA') Tax Deductibility Thereon
Less	Annual Incremental Net Trade Working Capital Requirements (Where Applicable)
Equals	Estimated Maintainable After-Tax Discretionary Cash Flow
Divided by	Capitalized Rate Developed as a Weighted Average Cost of Capital ('WACC')
Equals	Capitalized After-Tax Discretionary Cash Flow
Plus	Present Value of Tax Shield from Existing CCA Tax Pools
Plus	Net Realizable Value (to the Corporation) of Redundant Assets (if any)
Plus (Less)	Other Adjustments as Appropriate, Generally Being One-Time After-Tax Benefits or Costs
Equals	Enterprise Value
Less	Outstanding Debt or Debt Equivalents (e.g. Shareholder Loans)
Equals	En Bloc Fair Market Value of All of the Issued and Outstanding Shares of a Business



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Maintainable discretionary EBITDA represents the amount of operating cash flow the business is expected to prospectively generate consistently (or on average) year over year. That capitalization of discretionary cash flow methodology assumes either a:

- constant level of discretionary EBITDA is generated each year into perpetuity; or,
- base level of discretionary EBITDA that grows at a constant rate into perpetuity where growth is incorporated in the capitalization rate adopted.

Although absolute consistency is not a plausible assumption, maintainable discretionary EBITDA represents the point estimate (or range) that is reflective of average operating cash flow expectations. As a result, this valuation methodology does not account for timing differences that prospectively may result from 'average' but 'uneven' future cash flows.

A reasoned estimate of maintainable discretionary EBITDA requires an understanding of prevailing and prospective relevant economic, industry and business factors, and a thorough and objective assessment of the historical, current and prospective financial position and operating results of the business that is subject to valuation.

When adopting historical results to estimate maintainable EBITDA there should be reasonable assurance that historical results likely are reflective of future maintainable results. Further, historical results should be adjusted to exclude unusual, non-recurring items and should reflect non-arm's length transactions at arm's length equivalent amounts. Also, where significant changes have occurred in past years, historical results may not be indicative of prospective results and accordingly should either be excluded from analysis or should be adjusted to properly reflect prospective expectations. Examples of adjustments that are commonly made in practice include the following:

- owners of privately-held businesses frequently draw compensation and benefits disproportionate to the time and effort they expend in the business. Excessive drawings are a form of return on invested capital as contrasted with being a return on



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managerial efforts. The component of the compensation that represents a return on invested capital is discretionary and should be included in maintainable discretionary EBITDA. Likewise, where an owner/manager's salary is below an arm's length equivalent amount, EBITDA should be adjusted to reflect an arm's length equivalent when estimated a business' maintainable discretionary EBITDA;

- businesses often implement new strategies that impact a business' prospective cash flow generating ability (e.g. capacity expansion, new product lines, new customer contracts etc.). Where such a strategy has been recently implemented, historic EBITDA (i.e. prior to the new strategy being implemented) might require adjustment to exclude non-recurring start up costs or losses and also to reflect the incremental EBITDA expected from the new strategy;
- there may be other non-recurring revenue and expense items that require adjustment. These could include things such as moving expenses, losses caused by labour problems, pension plan past service liabilities, and so on;
- where a business deals on a non-arm's length basis with others, it often is difficult to ascertain whether costs and revenues equivalent to arm's length costs and revenues are being paid and received. Where non-arms' length transactions are being consummated at non-commercial rates, appropriate cash flow (and possibly asset) adjustments are necessary;
- revenue and expenses related to redundant assets should be removed from historical and hence prospective results. This is because the net realizable value of redundant assets is added to capitalized cash flows. Inclusion of income and expenses related to redundant assets in a capitalized cash flow would be a double-count; and,
- historical results are stated in nominal dollars (i.e. inclusive of inflation). It is generally appropriate to adjust normalized historical EBITDA for the effects of inflation. For example, normalized EBITDA from 3 years prior to the valuation date generally should be adjusted for 3 years of inflation to reflect that normalized EBITDA in current 'valuation date dollars'.



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Although an analysis of historic operating results is important in estimating the prospective cash flow generating abilities of a business, such an analysis should always be done in the context of what the future holds in store for the business. Management of many businesses annually prepare ‘business plans’ that often include financial projections. The selection of maintainable discretionary EBITDA levels typically is aided by thoughtfully and objectively developed financial projections. That said, where discretionary EBITDA varies significantly from year to year and meaningful projections are available it usually is appropriate to adopt a discounted discretionary cash flow methodology. The capitalization of discretionary cash flow methodology normally is appropriate where meaningful projections are not available. When assessing management’s forecast EBITDA, care must be taken to ensure that expected operating cash flows are plausible and that the assumptions underlying the forecast are reasonable and have been consistently applied. Further, care must be taken to adjust forecast EBITDA amounts to exclude unusual, non-recurring items and should reflect non-arm’s length transactions at arm’s length equivalents.

2.5 Discounted Discretionary Cash Flow Methodology

The discounted discretionary cash flow valuation methodology arguably is the most theoretically sound of the valuation methodologies currently utilized. This is because it forces detailed analysis of key forecast and valuation variables and hence facilitates an understanding of important external and internal business drivers, revenue and expense behavior, and business risks. Accordingly, where meaningful financial projections are available or can be prepared, the discounted cash flow methodology generally should be adopted, either by itself or in conjunction with other valuation methodologies.

The discounted discretionary cash flow methodology, in many ways is an extension of the capitalization of discretionary cash flow methodology, is premised on:

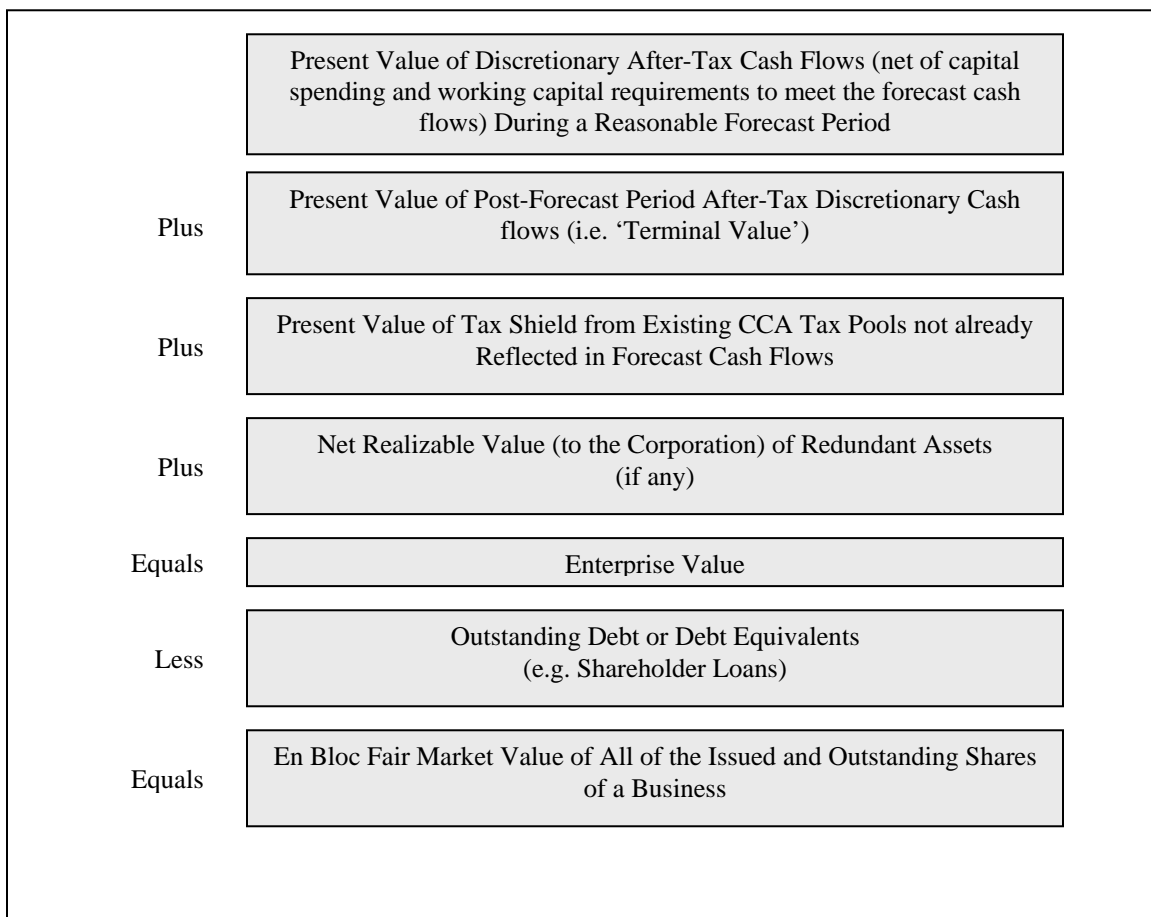
- an assumed realization of redundant assets on hand at the beginning of the cash flow period;
- a forecast of prospective discretionary cash flows;



- the application of a discount rate to those cash flows to determine their present value; and,
- an assumed realization of terminal value of the business in the last year of the cash flow forecast based on a post-forecast value calculation using the capitalized discretionary cash flow methodology.

The mechanics of the discounted discretionary cash flow methodology are illustrated in the following chart.

Chart 4 – Mechanics of the Discounted Discretionary Cash Flow Methodology





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An objective and detailed assessment of forecasted income statements, cash flow statements and balance sheets is important. These forecasts are fundamental to the discounted discretionary cash flow methodology. When analyzing a long-range forecast, consideration should be given to the following:

- who prepared the forecast and for what purpose;
- the time period of the forecast;
- the key variables and underlying economic drivers;
- underlying assumptions and internal consistency; and,
- whether inflation has been built into the forecast (i.e. is it expressed in real dollars or inflation adjusted nominal dollars).

2.6 Rates of Return

The terms 'discount rate' and 'capitalization rate' are related, but are not interchangeable. A discount rate is the rate of return used in a discounted discretionary cash flow methodology to convert a series of forecasted discretionary cash flows to a present value. The discount rate is a function of perceived risk related to whether the business being valued will underachieve, achieve, or overachieve projected levels of discretionary cash flows in comparison to the return on a benchmark 'risk-free' stream of cash flows (e.g. government debt).

A capitalization rate is the rate of return used to convert estimated maintainable discretionary cash flow to present value. There is an inherent assumption that the cash flow that is capitalized will be generated to perpetuity. The capitalization rate is derived when a growth factor is deducted from the discount rate, where appropriate. Depending on industry-specific and company-specific circumstances the growth factor normally is comprised of expected long term inflation, and may in some circumstances appropriately include an incremental real rate of growth or other adjustments. It is also possible that a



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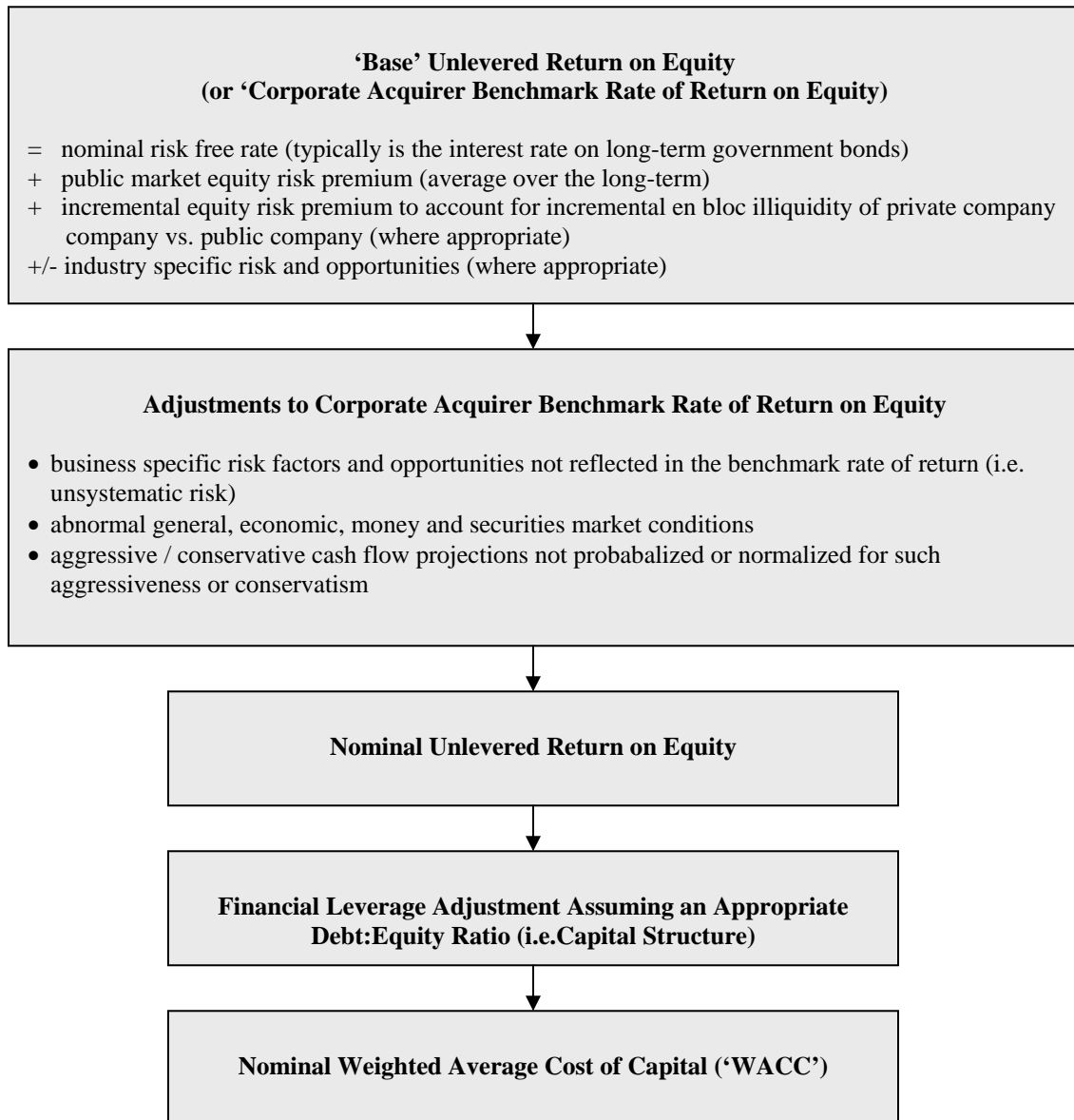
real rate of decline is appropriate. The inverse of a capitalization rate is referred to as a 'multiple', as in 'cash flow multiple', 'earnings multiple', and so on.

Discount and capitalization rates usually are expressed either as a weighted average cost of capital or as a levered return on equity. A weighted average cost of capital is a function of the relative mix of debt and equity and the appropriate returns on each.

The starting point in discount rate determination is to estimate an appropriate unlevered rate of return on equity. Appropriate unlevered rates of return on equity are 'point in time specific'. The unlevered rate of return on equity reflects the risks attached to achieving the projected discretionary cash flows, before consideration of debt servicing costs (interest expense and changes in debt principal outstanding). It follows that the unlevered rate of return on equity should appropriately reflect the degree of operating attached to the business and hence to any projection of its unlevered discretionary cash flows (i.e. discretionary cash flows before debt service costs). The following chart illustrates the components of an unlevered return on equity and the adjustments that are necessary thereto to determine an appropriate weighted average cost of capital.



Chart 5 – Discount Rate Determination



If the projected cash flows that are being discounted to present value exclude inflation (i.e. are projected in 'real' current dollars) than it is appropriate to deduct from the nominal WACC an amount equal to an appropriate inflation rate to determine a 'real' WACC. That is a 'real' WACC should be applied to real forecast cash flows and a

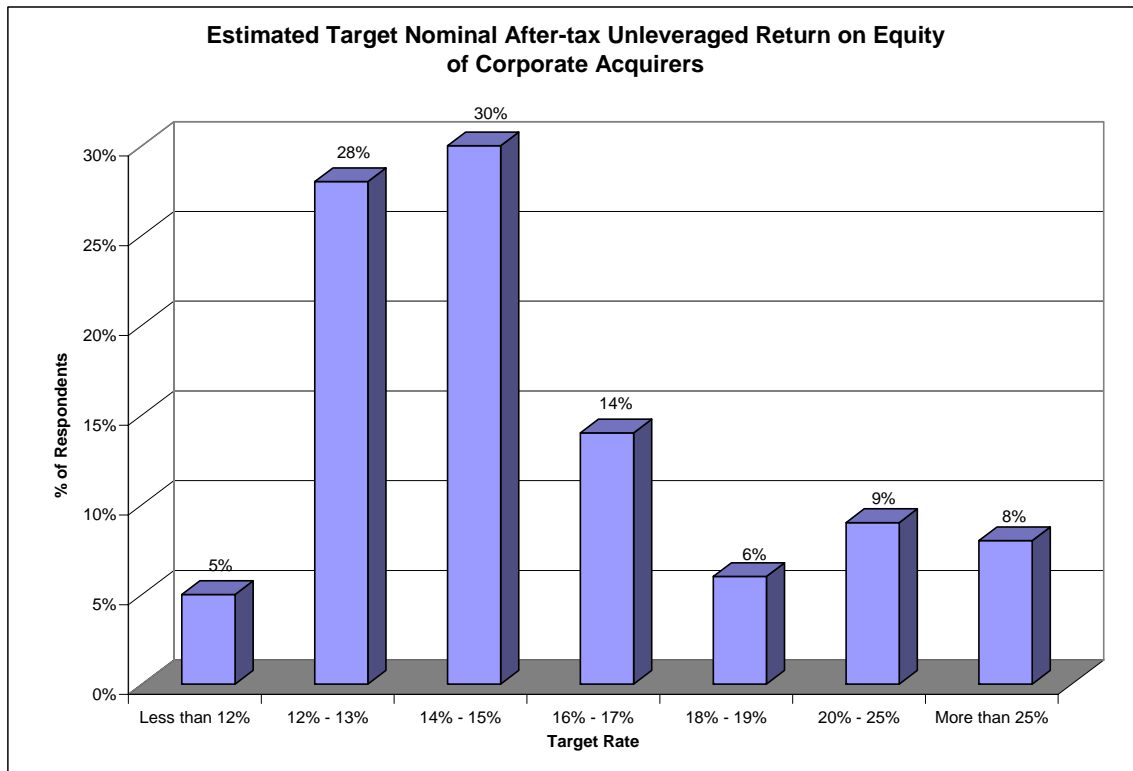


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nominal WACC should be applied to nominal forecast cash flows. Also, the WACC should be an 'after-tax' WACC when applied to after-tax cash flows and a 'pre-tax' WACC when applied to pre-tax cash flows.

Our experience suggests that at the time of writing this article corporate acquirers typically had benchmark rates of return on unlevered equity in the range of 12% to 15%, which are then adjusted accordingly. This is supported by a survey of corporate acquirers that Campbell Valuation Partners conducted in 1998. The unlevered return on equity criteria of those Canadian corporate acquirers that participated in this survey are summarized in the following chart.

Chart 6 – Survey Data on Canadian Corporate Acquirer Hurdle Rates



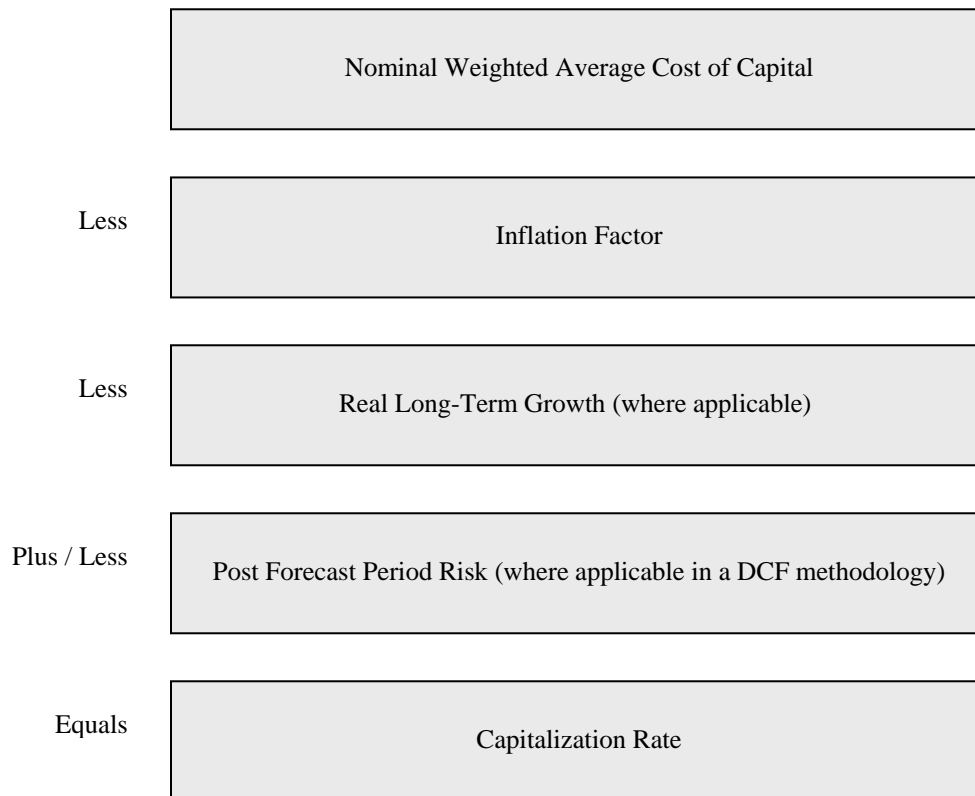
A capitalization rate is applied in the capitalization of discretionary cash flow methodology and the terminal value component of the discounted cash flow



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methodology. A capitalization rate is derived by deducting a growth factor from the discount rate. The growth factor generally is comprised of an inflation factor and may incorporate an additional adjustment for real growth, if appropriate. Further, where a capitalization rate is used to develop the post-forecast period component of a discounted cash flow, a further adjustment for business and time specific risk beyond the forecast period may be necessary to convert a discount rate into a capitalization rate. The relationship between a discount rate and a capitalization rate is summarized in the following chart.

Chart 6 – Capitalization Rate Determination





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3. TEST METHODOLOGIES

We are currently in a period where information availability is developing rapidly. Detailed quantitative and qualitative information on public companies and the industries in which they operate available today was not available in the past. As the 'information age' develops increased public disclosure of business information, legislative actions, actions of securities regulators and Court decisions almost certainly will occur. As a result, there may come a time when available economic, industry, competitive and transactional information will enable a more meaningful comparative analysis than can be done today to test value conclusions derived from the application of a cash flow based valuation methodology. Having said that, terms such as 'comparable analysis' and 'comparable companies' long have been encountered in both notional market valuations and open market pricing exercises. The two most common types of 'comparative analysis' are:

- 'comparable public company multiples' analysis whereby public equity market data is used to calculate multiples (of EBITDA, EBIT and so on) for public companies in the same industry as the company that is subject to valuation. The objective is to provide an indication as to the value and price relationships, and the rates of return sought by public company participants; and,
- 'comparable transactions analysis' whereby publicly available information on acquisitions of companies sufficiently similar to the company being valued are analyzed to calculate multiples (of EBITDA, EBIT and so on). The objective is to provide an indication of the rates of return that corporate acquirers are seeking and the extent to which post-acquisition synergies are being paid for in a given industry.

As a practical matter, and as a general rule, only in very limited situations can the results obtained from analyzing data of so-called 'comparable' companies be meaningfully applied when determining business value other than a possible 'test of value' otherwise determined. This generally is because, among other things:

- in the context of comparable public company multiples:



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- there rarely is a truly ‘comparable’ public company that is sufficiently similar to the subject business to draw a meaningful analysis,
 - there are fundamental differences between the dynamics of the public markets and the market for private companies, and
 - publicly available information is often inadequate to assess the comparability of the public company to the subject company; and,
- in the context of comparable transaction analysis, without being intimately involved with the transaction itself it is difficult if not impossible to understand the full dynamic and economics behind the transaction. Accordingly, analysis multiples derived from such transactions may inherently reflect components of value that are not applicable to the business that is the subject of valuation.

The application of a ‘comparative analysis’ normally is limited, at best, to providing a general understanding of the risk-reward dynamics of a given industry, and in assessing the overall reasonableness of valuation and pricing conclusions otherwise derived. Estate planners and shareholders undergoing an estate plan should read valuation reports that place an undue over-reliance on comparative analysis with caution.

4. MINORITY INTERESTS

4.1 Overview

Estate plans often involve the creation of new classes of shares, changes in dividend policies, the buy-out of both arm’s length and non-arm’s length minority shareholders, and so on. Where minority shareholders exist, estate planners and business owners should understand the rights of minority shareholders in the context of their proposed estate plan. Such an understanding will better enable planners and business owners to foresee and prepare for the possible reactions of minority shareholders to the proposed plan upon implementation.



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It is not uncommon for business owners preparing for ownership succession to embark on a plan to acquire minority shareholders, some of whom may also be employees of the company.² Business owners should obtain legal advice prior to such an acquisition strategy to assess the likelihood of a vending minority shareholder successfully claiming a right to an ‘oppression remedy’ (see Section 4.3) and/or a ‘dissent or appraisal remedy’ (see Section 4.4). Although a controlling shareholder will want to acquire a minority shareholding at the lowest possible price, the greater a minority shareholder’s ability to successfully litigate an oppression and/or an appraisal action the greater the probability that a higher price will be struck than otherwise would be the case. This is because such a shareholder is in a stronger bargaining position than otherwise would be the case, and arguably the value of that shareholder’s shares include an element of what is referred to as ‘nuisance value’.

4.2 Rights of Minority Interests

In valuing a controlling or minority interest, it is important to be cognizant of the various factors that not only protect minority shareholders but may also place certain restraints on the ability of the majority shareholder to control the company. The value of either a controlling or minority interest in a corporation must be assessed in light of:

- the corporation’s constitution, including its Articles, By-laws, and so on;
- the statute under which it is incorporated; and,
- relevant case law.

At a given point in time, the provisions of the corporation’s legislation pursuant to which the company is incorporated, and the related body of jurisprudence, establish the basic rights and protections that universally are available in that jurisdiction. Minority shareholders in publicly traded companies can also look to the provisions of the

² Accordingly, planners and owners should also be aware of such a person’s employment rights in addition to his or her rights as a minority shareholder.



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PARTNERS LIMITED**

prevailing securities legislation in the jurisdictions where a market for the shares is made. Further rights and/or restrictions that may affect the value of a shareholder's interest may be documented in the incorporating Articles and By-laws of the specific company or in a Shareholders' Agreement or Unanimous Shareholders' Agreement if one exists.

It is a culmination of the facts derived through an investigation of the above items (as they relate to each and every valuation exercise), which provide the necessary set of criteria to assess the appropriate discount, if any, to be applied to the ratable portion of en bloc value when valuing a minority interest.

4.3 Oppression Remedy

An oppression remedy is a protection afforded minority shareholders pursuant to the CBCA and each provincial corporations act other than Prince Edward Island and Quebec. This right can be triggered by a minority shareholder where the affairs of the company have been conducted to the prejudice of that party's interest.

Courts have a broad discretion to make any interim or final order they see fit to deal with oppression remedy applications, including ordering the corporation to purchase the minority shareholder's shares, and / or ordering the corporation to be wound up. Although the statutes do not specify the valuation basis pursuant to which a minority shareholder's shares are to be repurchased, the jurisprudence appears to support the application of a 'fair value' concept.

According to the CBCA, grounds for an oppression remedy application arise where:

- an act or omission of the corporation; or
- the manner in which the business or affairs of the corporation is carried on; or
- the manner in which the powers of the Directors are exercised,



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PARTNERS LIMITED**

is oppressive, is unfairly prejudicial to, or unfairly disregards the interests of any security holder past and present, or any creditor, Director or Officer, former Director or Officer, or any other person who the Court decides is a proper person to make the application.

Although the oppression remedy is available in a very broad range of situations, in general terms jurisprudence indicates that the oppression remedy is available where it is shown that:

- the actions of the majority excluded the minority from participation in the management of a closely-held corporation;
- shares were issued for other than legitimate business reasons to the disadvantage of the minority;
- the majority treated the corporation as its own private company in a manner that unfairly disregarded the interests of the minority; or,
- there was a denial of a legitimate expectation of the minority.

Where the Court has determined that oppression has occurred, it has broad statutory scope in making an interim or final order. That said, where an order is made for the company to acquire the shares of the oppressed minority, Canadian Courts generally has determined fair value as a ratable portion of en bloc fair market value (i.e. no minority discount). However, the Courts appear to have left open the possibility of awarding a discounted amount where the actions of the minority warrants such treatment.

4.4 Dissent Remedy

A dissent remedy is a protection afforded minority shareholders pursuant to the Canada Business Corporations Act ('CBCA') and each provincial corporations act other than Prince Edward Island and Quebec. This right enables a shareholders to require the company in which he or she holds shares to purchase them at 'fair value', where the company initiates certain 'fundamental changes' from which he or she dissents.



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PARTNERS LIMITED**

Exercise of a dissent right enables minority shareholders to withdraw from the corporation rather than be subjected to 'fundamental changes' proposed by the majority. At the same time, the majority is permitted to carry out such changes if it is willing to risk that minority shareholders will exercise their right of dissent. The triggering events specified in the Federal legislations are set out in the CBCA, section 190. The same criteria have been adopted in the other jurisdictions, which provide a dissent remedy.³ Under these jurisdictions, the circumstances which create a dissent right are:

- the passage of an amendment to the Articles to add, change, or remove any provisions restricting or constraining the issue, ownership, or transfer of shares or any restriction upon the business or businesses that the corporation may carry on;
- an amalgamation with a corporation other than its wholly owned subsidiary, its parent corporation if it is a wholly owned subsidiary, or its sister corporation, if both are wholly owned subsidiaries of the same corporation;
- the continuation of the corporation under the laws of another jurisdiction;
- the sale, lease, or exchange of all, or substantially all, of the corporation's property; and,
- an amendment to the incorporating Articles or Memorandum which diminishes the rights or conditions attached to a class or series of shares, which amendment otherwise creates an entitlement to a class vote.

When dissent remedy is activated, the corporation statutes in Canada require the shares of the dissenting party to be purchased at 'fair value', a term that is not defined in the Federal or any of the Provincial Corporations Acts. Hence, the concept of fair value has been the subject matter of litigation both as to its interpretation as well as its quantification. In dealing with dissent cases under the CBCA, Canadian Courts generally have accepted the premise that it is the duty of the Court to determine what fair value is.

³ There are additional provisions in the British Columbia Companies Act.



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PARTNERS LIMITED

Although there is some disparity in the interpretation of fair value, Canadian Courts have generally found that:

- fair value and fair market value are not necessarily synonymous;
- the en bloc value of the outstanding shares of the subject company generally is to be determined under the assumption that the company is a going concern, rather than under the assumption of a liquidation of the company's assets;
- in circumstances where en bloc value is determined separate from stock market price, no minority discount generally is applied when determining the fair value of a minority shareholder;
- stock market price, generally being lower than stand-alone (or intrinsic) value, by itself is not representative of fair value, particularly when trading is thin or sporadic;
- post-amalgamation benefits may be taken into account where the dissenting party was forced out, and not given the opportunity to participate as a shareholder. Conversely, participation in post-amalgamation benefits is less likely where the dissenting party had the opportunity to continue with its participation and elected not to;
- a so-called 'premium for forcible taking' has seldom been found to be applicable; and,
- the specific facts underlying a given dissenting shareholder appraisal action may influence the interpretation of the meaning of fair value pursuant to that action.

4.5 Discounts for Non-Control and Illiquidity

The determination of the en bloc value of a business inherently presumes the ability to both control the business pursuant to the election of the majority of the Board of Directors, and to be unrestricted in its disposition. Where a given shareholder is viewed in isolation and either the unilateral ability of the shareholder to:



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PARTNERS LIMITED

- control absolutely the strategy and operations of a business on one hand; or,
- deliver the shareholding free and clear of all encumbrances on the other

is fettered, a discount from a pro-rata portion of en bloc value to reflect one or both of these things may be warranted.

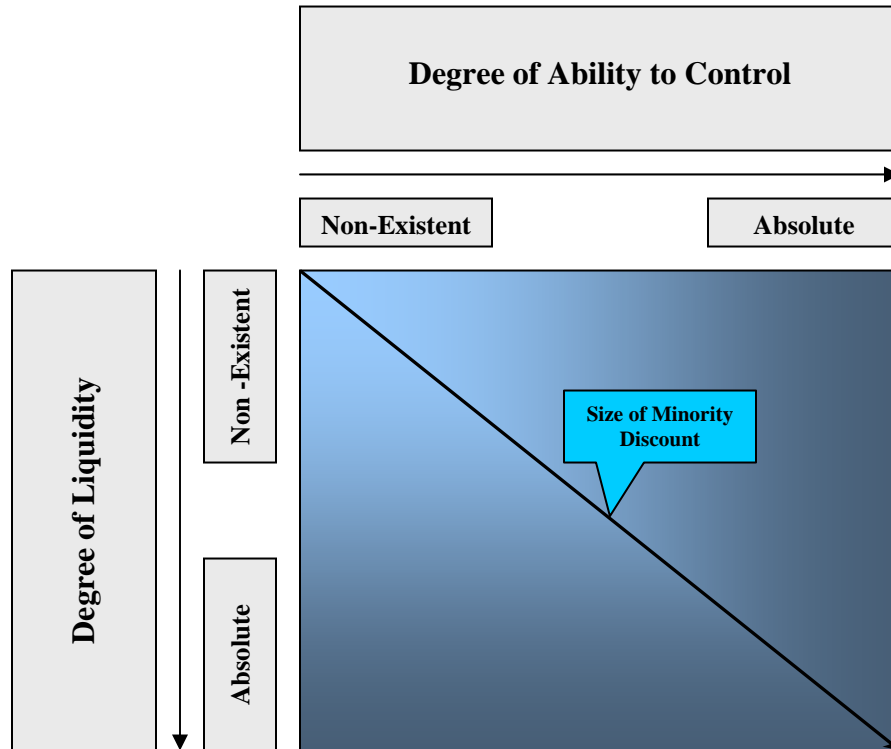
In theory and practice, an individual shareholder who does not have the ability to control the strategy and operations of a business to dictate the timing of the liquidity of the shareholding pursuant to a Shareholders' Agreement or otherwise, may face a discount from pro-rata per share value. In the notional market context, any discount taken from ratable value almost always must be subjectively determined. In the case of an open market price such a discount is established through negotiation even though it may have been explicitly quantified or discussed in negotiation.

Discounts for non-control and illiquidity in the context of individual shareholdings are relative concepts. Their quantification is dependent in the first instance on how en bloc value was determined. The factors that give rise to each of these discounts tend to be co-mingled, such that as a rule they are combined into one 'discount' amount or percentage (a 'minority discount'). Having said that, discounts for non-control and illiquidity are distinct concepts. Control is a function of the relationship between the shareholders of a company, whereas liquidity is a function of external demand for a particular shareholding having regard to all of its attributes, including its degree of control over the business and the en bloc disposition of its outstanding shares.

Discounts for non-control and illiquidity are not 'all or nothing' concepts. Rather, each moves along the following fact and circumstance dictated continuum.



Chart 7 – Minority Discount Continuum



At the absolute:

- control means the ability to do all those things normally associated with ownership. For example, the ownership of 100% of the common shares of a company typically allows the owner a free hand in strategizing and operating it, establishing dividend policy, selling it, or liquidating it (i.e. ‘absolute control’); and
- liquidity means the ability to readily convert an asset into know cash proceeds at any point in time, which may be, and most likely in most cases is, influenced by the ability to control.

At the non-existent:



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PARTNERS LIMITED**

- from a control standpoint, the shareholder with ‘no’ control has virtually no influence on the strategic direction of the company, its operations, dividend payments, and so on, and is severely restricted in his or her ability to readily divest of his or her interest pursuant to the restrictions imposed by the circumstances or the other shareholders; and,
- from a liquidity standpoint the numbers of interest purchasers is expected to be few, or possibly non at all which may be, and likely is in most cases, influenced by an inability to control.

4.6 The Position of CRA

While the relatively few Canadian Court Decisions dealing with minority interest values for income tax purposes limits analysis, those Decisions generally have held that in a notional market context minority shareholdings in privately held companies for income tax purposes have a fair market value somewhat lower than their ratable value.

When determining the value of minority shareholdings for Canadian income tax purposes, the CRA’s attitudes and practice must be considered. The CRA imposes a general requirement of consistency over time in reviewing notional market values of privately held company shares. In most circumstances, share values for income tax purposes are determined to measure capital gains or losses. As a result, values at two different dates commonly are compared to measure the base on which any applicable income tax will be calculated. Unless there have been demonstrable changes between the two measurement dates, the CRA generally will insist that comparable valuation principles be applied, particularly in respect to matters such as group or family control.^{4,5}

⁴ Group control is a term used to describe a circumstance where a group of shareholders, who otherwise deal on an arm’s length basis, collectively own sufficient voting shares in a privately-held company to control it, are presumed to act in concert to exercise control over the economic direction and liquidity of their collective investment. In Canada, the concept of group control principally has been put forward in the context of fair market value determinations required for income tax purposes.

⁵ Family control is a term used to describe a circumstance where family members, who collectively own sufficient voting shares in a company to control it, are presumed to act in concert to exercise control over the economic direction and liquidity of their collective investment. In Canada, the concept of family control principally has been put forward in the context of fair market value determinations required for income tax purposes.



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PARTNERS LIMITED**

Historically, the CRA has combined the concepts of non-control and illiquidity into an all-encompassing 'minority discount'. With respect to the quantum of minority discounts, in the absence of an enforceable Shareholders' Agreement over the past many years the CRA has tended to accept discounts for ratable value as follows:

- where there are two 50% shareholders, discounts in the range of 10% to 20%; and,
- where a shareholding is less than 50% of the outstanding voting shares, discounts in the range of 20% to 40%.

5. ESTATE FREEZE VALUATIONS AND THE PRICE ADJUSTMENT CLAUSE

There are many different ways to implement an estate freeze. That said, the objective of any estate freeze is the same, to defer income tax costs. In its simplest form an estate freeze results in common shares (commonly referred to as 'growth' shares) being exchanged by existing shareholders for shares with a fixed (or 'frozen') value and new 'growth' shares are issued to one or more new shareholders that typically are family members of the next generation. The result of an estate freeze is a deferral of income tax costs in the hands of the new owners of the 'growth' shares.

The exchange of existing 'growth' shares for new fixed value shares is usually consummated vis-à-vis one or more non-arm's length transactions, including those that are subject to the rollover provisions of sections 85 or 86 of the *Canadian Income Tax Act* ('ITA'). Where such non-arm's length transactions take place at an amount that is not fair market value the adverse provisions of sections 15(1), 69, 85 (1)(e.2) or 86(2) of the ITA may apply. Each of these sections, if applicable, may result in double taxation in that the transferor may be required to pay income tax on a capital gain equal to any resultant adjustment to the transferor's proceeds of disposition with no corresponding increase to the adjusted cost base of either the shares taken back by transferor or the newly issued 'growth' shares held by those upon which a 'shareholder benefit' may have been deemed to have been conferred.



CAMPBELL VALUATION
PARTNERS LIMITED

To avoid the risk of double taxation associated with CRA successfully assessing estate freeze transactions at a different fair market value than adopted by the taxpayer, estate lawyers typically incorporate a price adjustment clause in the purchase and sale agreements of non-arm's length transactions. A price adjustment clause enables an adjustment to the transaction price in the event that CRA or other third party (i.e. the Court) concludes that the fair market value of the property transferred is different than the transaction price adopted in the non-arm's length transaction. *Guilder News Co. (1963) Ltd. et al v. MNR* is the precedent case on the issue of the legitimacy of a price adjustment clause. Estate planners and business owners that are in the process of implementing an estate freeze should be aware of and understand the consequences of the *Guilder News* decision.

Revenue Canada (now CRA) assessed the non-arm's length transaction adopted by Guilder News as conferring a shareholder benefit pursuant to the provisions of section 15(1) of the ITA. The taxable benefit assessed upon the shareholder of Guilder News was equal to the excess of Revenue Canada's determination of fair market value over the non-arm's length transaction price adopted to consummate the transaction. Justice C.J. Jaxett refused to invoke this price adjustment clause on the grounds that the parties had not reasonably attempted in good faith to transact at fair market value.

The implication of the *Guilder News* decision is that at law a price adjustment clause may not hold in circumstances where a *reasonable attempt* is not made to determine the fair market value of the property transferred in a non-arm's length transaction. Subsequent to the *Guilder News* decision CRA (formerly Revenue Canada) issued *Interpretation Bulletin IT-169, 'Price Adjustment Clauses'*. IT-169 states that the CRA will recognize a price adjustment clause in circumstances where each of the following conditions is met:

- the purchase and sale agreement in which the price adjustment clause resides represents a *bona fide* intention of the parties to transfer property at fair market value that was determined using a *fair and reasonable method*;
- each of the parties to the agreement notifies CRA indicating that they are prepared to have the price reviewed by CRA and that they will take the steps necessary to settle



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PARTNERS LIMITED

any resulting excess or shortfall and that a copy of the purchase and sale agreement will be filed with the CRA if and when demanded; and,

- the excess or shortfall is actually refunded or paid or satisfied by a debt instrument.

What constitutes a “*bone fide*” intention of the parties to transfer property at fair market value that was determined using a *fair and reasonable method*” is subject to interpretation. That said, an objectively prepared independent valuation typically satisfies this test.

6. VALUE RELATED PROVISIONS IN SHAREHOLDER AGREEMENTS

6.1 Overview

Where a company has two or more shareholders owning common (voting) shares, those persons often enter into an enforceable shareholders’ agreement that set out their collective intent as to their privileges, protections, and obligations as shareholders in the company. A properly structured shareholders’ agreement serves the interest of both minority shareholders and controlling shareholders. A minority shareholder is defined as one that holds 50% or less of a company’s voting shareholders, and therefore cannot unilaterally dictate the affairs of the corporation except to the extent that a shareholders’ agreement provides otherwise. The valuation provisions of a shareholders’ agreement are of critical importance to a company’s stakeholders in that they ultimately dictate the timing of and amount by which inter-shareholder transactions take place. Because a person’s shares of a company often comprise a significant amount of their net worth the valuation terms of a shareholders’ agreement should be carefully considered in any estate plan. In practice, however, shareholders often draft their agreements early in life with a focus on the near-term. Since valuation provisions typically are expected to be triggered in the long-term and usually as a result of an unfortunate event (i.e. upon death, disability, triggering of a shot-gun etc.) they often are inadequately drafted in many respects, including:



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- failing to address possible eventualities that give rise to the need for a valuation (i.e. ‘triggering events’);
- inadequately establishing the process under which value or price is to be determined (i.e. the ‘valuation process’);
- failing to define value terms;
- relying on inappropriate shareholder exit strategies; and,
- failing to protect shareholders where the company’s shares are sold to a third party acquirer.

Inadequate valuation provisions in a shareholders’ agreement can have unintended consequences, which can give rise to costly and uncertain litigation among the parties. Prior to a triggering event occurring, it is never too late for shareholders to revisit the valuation provisions of their shareholders’ agreement. Often, it is not until shareholders near a triggering event (i.e. as they get older) that they begin to fully appreciate the consequences of the valuation provisions in their shareholders agreement.

6.2 Triggering Events

Triggering events are those events that either permit or require the sale of individual shareholdings in various circumstances. It is important that parties to a shareholders’ agreement understand and distinguish the various potential future events that might affect their shareholding interests and possibly the value thereof. Where such eventualities are not addressed or inadequately addressed the greater the risk of an eventual shareholder dispute materializing – see commentary at Section 7. The triggering events that normally should be considered in a shareholders’ agreement include:

- death of a shareholder, including whether life insurance proceeds will be used to finance the acquisition of the deceased’s interest, and how the adequacy of life insurance proceeds is to be established;



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PARTNERS LIMITED**

- permanent disability of a shareholder-employee, including how such disability is to be substantiated, and the treatment of disability premiums. It is also important to establish whether the disabled shareholder is granted the right or the obligation to sell his or her interest, or conversely whether the remaining shareholder(s) have the right to buy the disabled shareholders' interest;
- retirement of a shareholder-employee, including whether retirement is mandatory at a certain age, and if there are penalties for early retirement;
- termination of a shareholders' employment. The valuation provisions pertaining to termination are particularly sensitive given that a shareholder who perceives that he or she has been unfairly treated may claim oppression against the other shareholders of the company. The Courts have a wide range of remedies to grant a shareholder that is successful in a claim of oppression. Most common, however, is a cash award of *fair value* for the shares of the oppressed shareholder where *fair value* typically is taken to mean 'fair market value' without the application of a minority discount – see commentary at Section 5;
- marriage breakdown of a shareholder, which should take into account the provisions in the relevant provincial *Family Law Act*; and,
- insolvency and bankruptcy of a shareholder, where again the valuation provisions must be carefully considered in light of bankruptcy laws that normally require a shareholder to receive 'fair market value' for any shares held in a private company.

When drafting a shareholders' agreement it is not always pleasant to consider mechanisms that occur as a result of a triggering event. It is wise, however, to deal with all possible eventualities while the parties drafting a shareholders' agreement are still '*in agreement*'. Properly structured, a shareholders' agreement can assure a shareholder that there will be market for his or her shares at a price all shareholders perceive as fair. It should also provide continuing shareholders with control over outside parties becoming shareholders against their will.



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PARTNERS LIMITED**

For each triggering event, a shareholders' agreement should set out how the transaction is to be effected (i.e. purchase of shares by the other shareholders, or by the company and subsequently cancelled), the method of determining the transaction price, and terms of payment.

6.3 The Valuation Process

A shareholders' agreement should specify the process upon which value or price is to be determined when a triggering event occurs. The most common, but definitely not the only valuation processes available to shareholders are:

- pre-determined valuation formulas;
- valuation adopted by one independent business valuer;
- valuation by more than one independent business valuer with pre-determined ground rules that establish value or price based on the value conclusions of each business valuer; and,
- arbitration or mediation alone or in combination with the foregoing three valuation processes. That is, the shareholders would have the right to arbitrate or mediate where one or more shareholders disagree with value conclusions generated.

Pre-determined formulas typically are based on a multiple of historic financial results. Although pre-determined formulas reduce subjectivity they often result in inequities for several reasons. In particular, the value of a business' shares or assets is a function of both internal and external factors that change over time and is forward looking (i.e. based on the net present value of estimated future cash flows). A pre-determined formula will not reflect these changes and may not reasonably reflect the business' prospective cash flow generating capability. For example:

- the financial results of owner/manager businesses often reflect bonuses paid to the owner(s)/manager(s) that are motivated by tax planning and not indicative of arm's



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PARTNERS LIMITED**

length equivalent compensation levels. Pre-determined formulas often do not stipulate the appropriate adjustments necessary for owner/manager compensation;

- a multiple of an earnings measure (such as net income, net cash flow, earnings before interest and tax, and so on) for a particular fiscal year can result in significant distortions of determined value if the company's financial performance during that year was not indicative of prospective results because it was abnormally strong or weak;
- a pre-determined multiple may not adequately reflect the value of redundant assets, in particular when their ownership occurs after the pre-determined formula is derived; and,
- using a multiple of average historic earnings (as contrast with one fiscal year) may not adequately reflect important business trends and the business' prospective cash flow generating capability.

An independent valuer can apply judgment that takes into account point-in-time specific valuation issues. Using more than one valuer can provide additional comfort (where the value conclusions of the experts overlap or are close to one another) but is more costly and can be confusing where the value conclusions are significantly different from one another. Where one or more independent valuation experts is called on to determine value either periodically or where a triggering event has occurred, the parties to the shareholders' agreement should be satisfied that the person(s) or firm(s) selected is(are) credible and knowledgeable about the nature of the business and that all relevant valuation factors will be considered. It is not uncommon for a shareholders' agreement to either name a specific valuation firm, contain a list of suitable valuation firms from which to choose, or contain a mechanism by which each shareholder individually lists suitable valuation firms in order of preference with the hopes that one or more valuation firms is on each list. It is not recommended that a shareholders' agreement identify the company's external accounting firm as the valuer due to their real or perceived conflict of interest with one or more of the shareholders of the company.



CAMPBELL VALUATION
PARTNERS LIMITED

Arbitration or mediation clauses typically are included in a shareholders' agreement to as a means of protection against being bound to a value conclusion that one or more shareholders perceives as being significantly misstated.

As a general rule, whatever valuation process is adopted it is recommended that shareholders periodically agree upon the fair market value of specific shareholdings and to stipulate them in writing. This serves to mitigate the risk of facing an uncertain outcome when a triggering event occurs. Further, where shareholders' agree to adopt an 'independent expert' valuation process it may be beneficial to include, and periodically update, an appendix to the shareholders' agreement detailing agreed upon 'principles of valuation'.

6.4 Value Terms

Shareholders' agreements often fail to adequately define value terms, which leaves open the possibility of differences in interpretation when a triggering event occurs. It is recommended that value terms be defined early in a shareholder relationship because at the time of triggering event, each shareholder has a bias towards their own self interest that does not typically exist at the onset of the relationship. A shareholders' agreement normally should address at a minimum the following value terms:

- whether the 'en bloc' equity value⁶ of the company should be determined on an intrinsic (or 'stand-alone') basis, or in the alternative whether 'special interest purchasers'⁷ should be considered. As a practical matter, however, in the absence of open market negotiations, the quantification of post-acquisition synergies often is speculative. Intrinsic value is normally adopted by shareholders for this reason and because typically a triggering event results in one or more 'remaining' shareholders continuing to operate the company on a 'stand-alone' basis;

⁶ En bloc equity value is 'the value of the net assets of or ownership interests of business viewed as a whole'.

⁷ A special interest purchaser is 'a purchaser who can, or believes it can, enjoy post-acquisition economies of scale (or synergies) or strategic advantage by combining the acquired business interest with its own'.



**CAMPBELL VALUATION
PARTNERS LIMITED**

- whether or not a minority discount should apply or in the alternative whether this should be left to the judgment of an independent business valuer;
- where the shares of the departing shareholder(s) are to be acquired by the company, an assumption should be stated with respect to the source of funds. The en bloc equity value of the shares of a company (and consequently the pro-rata or discounted value of a minority shareholding therein) may be affected differently depending on whether the transaction is internally financed or externally financed;
- where the acquisition of a deceased shareholder's interest is to be acquired using life insurance proceeds received by the company, a shareholders' agreement should clarify whether those proceeds are to be accounted for as a component of value. Where life insurance proceeds are excluded the surviving shareholder(s) may realize a benefit that would not have otherwise occurred; and,
- a shareholders' agreement should address the appropriate assumption to be made in respect of contingent liabilities. In an arm's length transaction provisions are typically included in a sale and purchase agreement that deal with the treatment of contingent liabilities. Parties might agree to hold a certain amount of proceeds in escrow to either cover a contingent liability when it materializes or to be released to the vendor when it is known that the liability will not materialize. It is not uncommon for vendors to indemnify purchasers against unknown liabilities the cause of which were present prior to closing (e.g. environmental issues that existed at closing but did not become known until after closing). Shareholders' agreements often do not provide instructions to a valuator as to the appropriate assumption in respect of contingent liabilities in the context of a notional valuation. Such a provision would safeguard against an undesired outcome at the time of a liquidity event occurring.

For each triggering event, the shareholders' agreement should set out the terms of payment for the acquired shares. The generally accepted definition of fair market value inherently assumes cash equivalent payment. Where payment is made over time, and market rates of interest are not paid on the outstanding balance, such factors normally should be considered in the agreed upon payment terms.



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PARTNERS LIMITED

6.5 Shareholder Exit Strategies

Unless stipulated otherwise in a shareholders' agreement or some other agreement among shareholders, the value of a minority interest in a privately held company frequently is worth less than its pro-rata portion of the en bloc fair market value of the company. Further, many third party acquirers are not interested in acquiring an interest in a privately-held company unless they have control (i.e. a majority ownership of the voting shares). Consequently, in the absence of an 'en bloc' sale of the shares of a privately held company to a third party acquirer, a minority shareholder seeking to divest of his or her interest normally has no choice but to transact with other shareholders. At the same time majority shareholders typically want control over who can acquire an equity interest in the business. In circumstances where a specified triggering event does not apply, a shareholders' agreement typically include reciprocal buy-sell or 'shotgun' clauses to protect the liquidity of a shareholder's interests. Pursuant to a shot-gun clause, a shareholder can offer to sell his or her shares to another shareholder at price and on terms specified in the offer. The shareholder receiving the offer must either:

- accept the offer, and acquire the shares of the offering shareholder at the price per share and terms specified in the offer; or,
- reject the offer, which requires the shareholder receiving the offer to sell his or her shares to the offering shareholder at the price per share and terms specified in the offer.

Whichever course of action is adopted by the shareholder receiving the offer, it results in a binding agreement of purchase and sale between the shareholders.

Before implementing a shot-gun clause in a shareholders' agreement, shareholders should consider their relative negotiating strengths. One shareholder may have access to greater financial resources or one shareholder may be more actively involved in the managing of the business and as a result is significantly more knowledgeable of the business. In some cases, particularly in small business, one shareholder may enjoy 'personal goodwill',



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PARTNERS LIMITED**

being the benefit that accrues to the business by virtue of the reputation, business contacts, and so on, of a particular shareholder. Personal goodwill is not commercially transferable and as a result the business may be worth much more to the shareholder with the personal goodwill than the other shareholder without it. It is these types of inequities that may render a traditional shot-gun clause inappropriate.

To avoid the possible inequities of a traditional shot-gun clause while still protecting a shareholders ability to divest of their shareholding, and the interests of those shareholders wishing to remain with the company, shareholders' agreements often include right of first refusal provisions. Right of first refusals typically are structured in one of the following two ways:

- as a 'hard' right of first refusal, whereby the shareholder wishing to sell solicits third party offers, and presents the best offer to the other shareholder(s) in the company. The other shareholder(s) are then given the opportunity to purchase the selling shareholder's interest based on the price and the terms of that offer. If the other shareholder(s) elect(s) not to purchase the shares within an agreed period of time, the selling shareholder can then his or her interest to the party making the offer on those same terms; or,
- as a 'soft' right of first refusal, whereby the shareholder wishing to sell his or her interest establishes a price and terms of sale, which is presented to the shareholder(s) holding the right of first refusal. If the other shareholder(s) elect(s) not to acquire the shares within an agreed time period, the selling shares is free to sell his or her interest in the open market at a price and on terms that are no less favourable than what was offered to the other shareholder(s).

The hard right of first refusal typically is preferable from the point of view of the person holding the refusal right. Third party purchasers rarely spend a significant amount of time assessing a potential share acquisition in the face of an overriding right of first refusal. The soft right of first refusal typically is better from the vendor's perspective. Although it forces the prospective vendor to be disciplined when establishing the initial price and terms offered to the shareholder holding the first refusal right, in the event the



**CAMPBELL VALUATION
PARTNERS LIMITED**

offer is not accepted, the vendor is able to deal with third party purchasers unencumbered by the first refusal right.

In addition to the foregoing exit strategy options, shareholders may not want to subject themselves to the future uncertainties of a shot-gun clause or a right of first refusal. Such shareholders may opt to rely on a hard 'put' or 'call' right in their shareholders' agreement. Such rights entitle each shareholder or a specified shareholder to sell (i.e. 'put') his or her shares to the other shareholder(s) or purchase (i.e. 'call') the shares of the other shareholder(s) at either a specified price or at fair market value to be determined an independent valuer, an agreed upon valuation formula or other valuation process – see Section 6.3.

6.6 Example of Principles of Valuation Incorporated in a Shareholders' Agreement

Attached as Exhibit A is an example of a set of 'principles of valuation' that may be implemented upon a liquidity event arising pursuant to the terms of a shareholders' agreement. It must be noted that Exhibit A is only an example and may not be applicable or appropriate in a fact-specific situation. It is intended only to illustrate that there are many valuation terms and concepts that should be considered by shareholders' when executing a shareholders' agreement. Use of Exhibit A is prohibited without the express written consent of CVPL and CVPL accepts no responsibility or liability for its use whatsoever.

7. INTER-SHAREHOLDER TRANSACTIONS OF PRIVATE COMPANY SHARES

7.1 Overview

Inter-shareholder transactions, whether between family shareholders or shareholders at arm's length, arise in a variety of situations and often require the preparation of an independent share valuation. Such transactions often arise in circumstances where the



**CAMPBELL VALUATION
PARTNERS LIMITED**

valuation provisions of a shareholders' agreement are inadequate – see commentary at Section 7. In these circumstances a business valuer may be engaged:

- by one or more (but not all) of the transacting parties, in which case a valuation report generated may be used as a tool in settlement discussion and, if necessary, in a litigation process;
- collectively by all transacting parties pursuant to a Court order, in which case the value conclusions set out in a valuation report typically are binding; or,
- collectively by all transacting parties on a volunteer basis (i.e. not pursuant to a Court order), in which case the value conclusions set out in a valuation report can either be binding, binding subject to arbitration, or non-binding.

7.2 Triggering Events

Triggering events are those events that give rise to an inter-shareholder transaction, some examples of which include:

- disagreement among shareholders;
- permanent disability of a shareholder;
- retirement of a shareholder;
- termination of a shareholder's employment;
- marriage breakdown of shareholder;
- shareholder insolvency or bankruptcy;
- dissent and/or oppression actions commenced by one or more shareholder(s);



CAMPBELL VALUATION
PARTNERS LIMITED

- death of a shareholder; and,
- so on.

7.3 Selecting a Business Valuator

The selection of valuer is a critical step in determining value to effect an inter-shareholder transaction. In selecting a valuer it is important that the valuer:

- be independent and be perceived as such by all transacting parties. Even where the parties are in dispute, the independence of a value is of paramount importance. Lack of independence (or perceived independence) enhances the likelihood that opposing parties will neither consider nor properly weigh the valuation advice provided;
- possess effective verbal and communication skills; and,
- is engaged as early as possible in the dispute process. It is not uncommon that where transacting shareholders attempt to settle their situation in the absence of independent valuation advice early in the process, the parties form unrealistic expectations and become entrenched in unrealistic positions. This lends to a more acrimonious situation and enhances the likelihood of litigation, which at the onset of most inter-shareholder transactions is an event that all parties do not wish to experience.

Where the parties have either voluntarily decided or have been order by the Court to engage a valuer to set the price of a transaction, it is important that all parties are given equal input into and perceive the 'valuer selection process' to be fair.

7.4 Important Value Concepts

Prior to commencing the valuation process the valuer should be clearly informed by the transacting parties as to the appropriate definition of value and the important value concepts to be applied when reaching a value conclusion. Without this information the



CAMPBELL VALUATION
PARTNERS LIMITED

valuer's conclusion may not meet the needs and objectives of the transacting parties, and both inefficiencies in the valuation process and the potential for exacerbation of a dispute is more likely to occur. At least the following important things should be agreed (or determined) at the onset of the valuation process:

- the appropriate valuation date;
- basis of 'en bloc' value – intrinsic value or open market price;
- pro-rata value or minority discount; and,

Where these concepts are not agreed by the transacting party they may agree to:

- have the valuer determine value under different scenarios (e.g. with and without the application of a minority discount or at more than one valuation date) for the purpose of subsequent negotiation, arbitration or litigation in respect of the various scenarios after the valuation is completed;
- arbitrate, mediate, or use other means to settle each of the foregoing things prior to having the valuer determine value; or,
- instruct the valuer to determine the foregoing things at his or her discretion. In such a circumstance a valuer may require independent legal advice to assist in such a determination.

7.5 Existence of Shareholders' Agreement

Transacting parties should be informed of the options available to them and the consequences they face with respect to the valuation concepts set out at Section 7.4. Ideally, the parties will have negotiated and executed a shareholders' agreement that deals with the aforementioned issues prior to a valuation being required. In the event an enforceable shareholders' agreement does not exist, it generally is more efficient for the parties to negotiate and agree (or failing agreement to resolve through mediation,



CAMPBELL VALUATION
PARTNERS LIMITED

arbitration or otherwise) the issues set out at Section 7.4 at the onset of the valuation process as opposed to a later stage when the valuer has expended a considerable amount of time.

7.6 Valuation Procedures

In our experience, the following things enhance the possibility of an efficiently carried out successful inter-shareholder transaction where the parties have elected to or have been ordered by the Court to engage one valuer:

- to avoid any misunderstanding that may arise during the valuation process it is important that all agreed 'important valuation concepts' and 'valuation procedures' be clearly set out in an engagement letter authorized and signed by each of the transacting parties;
- where possible, specific representatives of the company being valued (if possible, being or at least including, persons independent of the transacting parties) should be designated to handle all questions and information requests put forth by the valuer;
- each of the disputing parties either or through designated representatives should be given equal opportunity to provide information that each believes to be important to the valuation;
- each of the disputing parties should separately be presented with a draft valuation report setting out the valuation approach adopted and the reasons for the conclusions reached. If agreed by the disputing parties in advance, each disputing party can be given the opportunity to comment in writing on the contents of the draft valuation report with said comments provided to each of the other parties for 'reply comments'. All comments and 'reply' comments may then result in amendments to the draft valuation report;
- each of the transacting parties (or designated representatives thereof) should sign a letter of representation with respect to the draft report confirming in writing:

December 6, 2005



**CAMPBELL VALUATION
PARTNERS LIMITED**

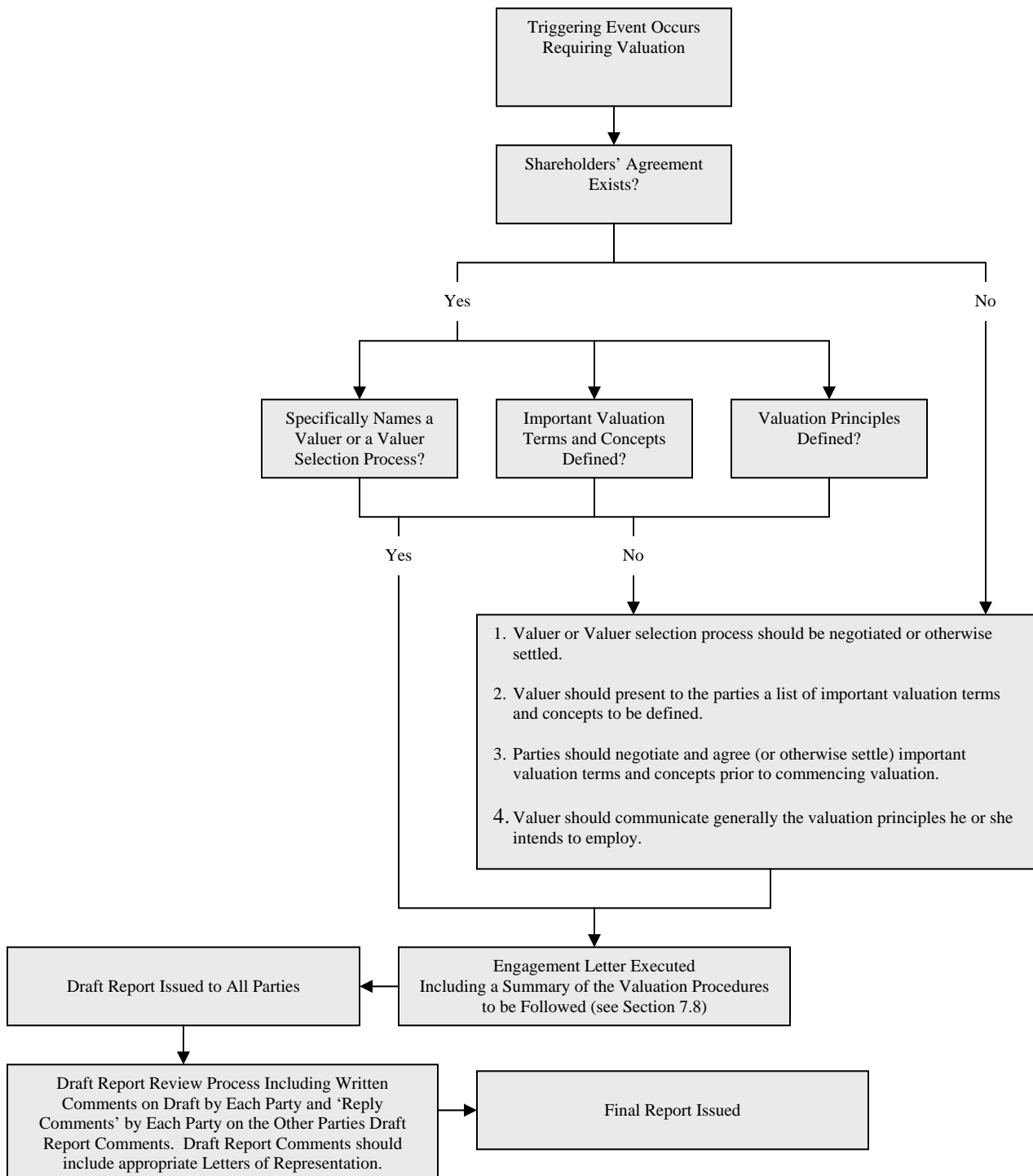
- factual representations that they have made,
 - that they understand the valuation methodology(ies) utilized, and
 - that other than their comments and 'reply' comments they have no information or knowledge of any facts or information not specifically noted in the draft valuation report which would reasonably be expected to affect the conclusions expressed therein; and,
- finally, a final valuation report should be issued to the transacting parties.

7.7 Valuation Process Decision Tree

The following chart illustrates in a decision tree form the foregoing concepts and procedures.



Chart 8 – Inter-shareholder Transaction Decision Tree





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PARTNERS LIMITED**

7.8 Typical Valuation Procedures

In summary, the valuation process we typically employ in inter-shareholder transaction matters includes the following steps:

- a detailed review of the historic and prospective operating results of each company that is the subject of valuation;
- interviews are conducted with executives of the company(ies) being valued and depending on the circumstances parties external to the company(ies) that are knowledgeable of the industry in which the company(ies) operate;
- a tour of the operations of the company(ies) being valued;
- depending on the circumstances, the engagement of independent real estate or equipment appraisers or other experts as required; and,
- other procedures as deemed necessary in a given fact specific situation.



CAMPBELL VALUATION
PARTNERS LIMITED

APPENDIX A
EXAMPLE OF 'PRINCIPLES OF VALUATION' AND DEFINITIONS RELATED
THERE TO

Definitions

Adjusted Net Book Value Methodology means a valuation methodology whereby the net book value of the assets and liabilities of a Holding Company as at the Valuation Date are adjusted to be reflected at Fair Market Value such that the Equity Value of the Holding Company is equal to the amount by which the Fair Market Value of its tangible assets (adjusted for income tax considerations where appropriate), exceeds the Fair Market Value of its liabilities;

Arm's Length Equivalent Amount means an amount that reasonably and prudently would be paid to a party unrelated to the payer for the same services provided to the payer by a party related to the payer;

Capitalized After-Tax Discretionary Cash Flow Methodology means a valuation methodology whereby Enterprise Value is determined by capitalizing a range of estimated prospective maintainable after-tax Discretionary Cash Flow of an Operating Business using a range of Capitalization Rates that reflect the risk inherent in that range of prospective maintainable after-tax Discretionary Cash Flow;

CDA means capital dividend account as that term is defined in the *Income Tax Act* of Canada;

Capitalization Rate means a rate of return used to capitalize to present value a range of maintainable after-tax Discretionary Cash Flow;

Clearing Dividends means a dividend amount required to fully clear an Operating Business' or a Holding Company's CDA and RDTOH account balance existing at the Valuation Date;

Current Assets means those assets reflected as current assets on a financial statement fairly presented in accordance with Generally Accepted Accounting Principles;

Current Liabilities means those liabilities reflected as current liabilities on a financial statement fairly presented in accordance with Generally Accepted Accounting Principles;

Depreciated Replacement Value means a term used by equipment appraisers to describe the amount determined by estimating the replacement cost (new) of Fixed Assets



CAMPBELL VALUATION
PARTNERS LIMITED

less an amount for depreciation and obsolescence to equate the replacement cost (new) to the depreciated Fixed Assets being appraised;

Discretionary Cash Flow means the cash flow of an Operating Business that can be:

- (i) withdrawn by the owners (through dividends, remuneration or other distributions) without impairing the prospective operating results of the Operating Business subject to valuation,
- (ii) reinvested in the Operating Business subject to valuation for the purpose of expanding or enhancing the profitability of that Operating Business,
- (iii) used to satisfy a debt obligation of the Operating Business subject to valuation,
- (iv) retained in the Operating Business as a Redundant Asset, or
- (v) a combination of the foregoing;

Discounted After-Tax Discretionary Cash Flow Methodology means a valuation methodology whereby Enterprise Value is determined by discounting to present value the forecast after-tax Discretionary Cash Flow of an Operating Business using a range of Discount Rates that reflects the risk inherent in that forecast after-tax Discretionary Cash Flow;

Discount Rate means a rate of return used to discount to present value forecast after-tax Discretionary Cash Flow;

EBITDA means earnings before interest, taxes, depreciation and amortization;

Enterprise Value means the total value of an Operating Business or a Holding Company including both its debt and equity components. For greater clarity Enterprise Value is equal to Equity Value plus Seasonally Adjusted Short Term Indebtedness and Long-Term Debt;

Equity Value means the value to the shareholders of an Operating Business or a Holding Company. For greater clarity, Equity Value is equal to the Fair Market Value of the Shares, which is the same as Enterprise Value less Seasonally Adjusted Short Term Indebtedness and Long-Term Debt;

Fair Market Value means the highest price available in an open and unrestricted market between informed and prudent parties, under no compulsion to act and acting at arm's length, expressed in terms of cash and otherwise determined in accordance with the principles of valuation set out in this Shareholders' Agreement;



CAMPBELL VALUATION
PARTNERS LIMITED

Fixed Assets means all depreciable property that are not Real Property (i.e. excludes buildings) such as computers, furniture, fixtures, machinery and equipment, leasehold improvements etc.

Generally Accepted Accounting Principles means those accounting principles prescribed in accordance with laws of Canada;

Growth Capital Investment means a capital outlay incurred to increase the level of operation of an Operating Business relative to its existing level of operations;

Hindsight Information means information known only after the Valuation Date;

Hidden Tax Costs means the income tax cost that would arise on the notional sale of each asset owned by a Holding Company at Fair Market Value determined as at the Valuation Date in accordance with the principles of valuation set out in this Shareholders' Agreement;

Holding Company means a company with no active business operations, owning passive investments in assets such as real property, shares in publicly-held companies, and shares in privately-held operating companies. The earnings generated by a Holding Company normally are of less significance from a value standpoint than is the appreciating value of the underlying investments themselves;

Intrinsic Value Basis means without consideration of a premium that a 'special purchaser' might be willing to pay pursuant to perceived post-acquisition net economic value added synergies or strategic advantage that may accrue in varying degrees to external 'special purchasers';

Liquidation Value means the net amount of after-tax cash flow (including all costs and expenses arising as a result of liquidation), if any, available to the shareholders of an Operating Business or a Holding Company following a Voluntary Liquidation, a reorganization of a business pursuant either to a proposal to creditors, or a forced liquidation of a business pursuant to a receivership or other proceeding under the Bankruptcy Act;

Long Term Debt means any financial debt other than both Short Term Indebtedness and any Current Liability included in Net Trade Working Capital;

Negative Redundancy means the equity amount required to be injected into a given Operating Business in order to 'normalize' its balance sheet, such that following said equity injection the business owns an appropriate amount debt relative to its revised equity balance;



CAMPBELL VALUATION
PARTNERS LIMITED

Net Book Value means with respect to:

- individual assets and liabilities, the capital cost, or otherwise determined book value, of an asset or liability less accumulated depreciation or amortization as it appears on the financial statements of a business fairly presented in accordance with Generally Accepted Accounting Principles; and,
- a business viewed as a whole, the difference between total assets (net of depreciation and amortization), and total liabilities of the business as they appear on that business' financial statements fairly presented in accordance with Generally Accepted Accounting Principles;

Net Trade Working Capital means the amount by which Current Assets specifically related to the ongoing principle operating activities of an Operating Business (e.g. trade accounts receivable, inventories, taxes recoverable etc.) exceed Current Liabilities that have arisen from the Operating Business' ongoing principle operating activities (e.g. accounts payable, accrued liabilities, taxes payable etc.) Net Trade Working Capital excludes Short-Term Indebtedness and is different from 'working capital' that includes all Current Assets and Current Liabilities;

Normalized EBITDA is the EBITDA of each Operating Business adjusted to exclude unusual and non-recurring revenues and expenses and to reflect an arm's length equivalent revenue and cost structure;

Operating Business means an active operating business that is not a Holding Company;

Purchased Shares means the shares that will be purchased by the Purchaser as a result of a liquidity event occurring in accordance with the terms of this Shareholders' Agreement;

Purchaser means the Shareholder(s) that will purchase the Purchased Shares as a result of a liquidity event in accordance with the terms of this Shareholders' Agreement;

Redundant Asset means an asset that is not required to generate the prospective after-tax Discretionary Cash Flow of the Operating Business subject to valuation;

Real Property means an ownership interest in real estate, which is an identified parcel or tract of land, including buildings and other improvements, if any;

RDTOH means refundable dividend tax on hand as that term is defined in the *Income Tax Act* of Canada;



CAMPBELL VALUATION
PARTNERS LIMITED

Short Term Indebtedness means financial debt, net of cash on hand, incurred for the purpose of financing the ongoing working capital requirements of an Operating Business. Short Term Indebtedness excludes those Current Liabilities included in Net Trade Working Capital;

Seasonally Adjusted Short Term Indebtedness means the average month end Short Term Indebtedness balance required to sustain the working capital requirements of an Operating Business over a typical twelve month season;

Shares means the issued and outstanding shares of the Holding Company;

Shareholder means any shareholder of the Holding Company;

Sustaining Capital Reinvestment means the capital outlay required each year to maintain operations at existing levels;

Test Methodology means a secondary valuation methodology used to test Enterprise Value determinations based on the application of either a Discounted After-Tax Valuation Methodology or a Capitalized After-tax Valuation Methodology;

Valuation Date means the day prior to the day on which a liquidity event requiring a Fair Market Value Determination occurs in accordance with the terms of this Shareholders' Agreement;

Vendor means the Shareholder or his or her legal personal representative(s) selling the Purchased Shares pursuant to a liquidity event in accordance with the terms of this Shareholders' Agreement;

Voluntary Liquidation means the sale of the assets and wind-up of the operations of an Operating Business where a residual value normally is expected to be realized by the owner of the operations; and,

Weighted Average Cost of Capital ('WACC') means a rate of return determined as the weighted average of the after-tax cost of debt and levered equity. WACC can be used as either a Discount Rate or a Capitalization Rate, inclusive or exclusive of inflation in either instance.

Principles of Valuation - General

Fair Market Value of the Shares shall be determined:

- (i) as at the Valuation Date;

December 6, 2005



CAMPBELL VALUATION
PARTNERS LIMITED

- (ii) on an Intrinsic Value Basis;
- (iii) without taking into account in any manner the number of Purchased Shares relative to the total number of outstanding shares of the Holding Company or the status of the Vendor and Purchaser. For greater clarity, Fair Market Value of the Purchased Shares shall be determined without a discount for non-control, illiquidity, or otherwise (i.e. a minority discount);
- (iv) without the inclusion of any life insurance proceeds received or receivable by the Holding Company on account of the death of any Shareholder whose death has given rise to the need for the particular determination of Fair Market Value;
- (v) without regard to the occurrence of the absence (by virtue of death, retirement or other event) of any Shareholder or the imminent possibility thereof;
- (vi) on the assumption that a notional transaction will be financed by external sources;
- (vii) based on only those facts known and the financial outlook of each Operating Business as at the Valuation Date. For greater clarity, Hindsight Information shall not be reflected in the determination of Fair Market Value;
- (viii) based on financial statements of each Holding Company and Operating Business prepared in accordance with Generally Accepted Accounting Principles; and,
- (ix) based on financial forecasts of each Operating Business prepared in accordance with Generally Accepted Accounting Principles.

Principles of Valuation – Specific to each Holding Company

Fair Market Value of the Shares of each Holding Company shall be determined by adopting an Adjusted Net Book Value Methodology whereby:

- (i) the Fair Market Value of Current Assets and Current Liabilities (including Short Term Indebtedness) of each Holding Company is assumed to equal Net Book Value as at the Valuation Date;
- (ii) the Fair Market Value of Long Term Debt of each Holding Company is assumed to equal Net Book Value as at the Valuation Date adjusted to reflect interest rates prevailing at the Valuation Date for debt instruments comparable to the Long Term Debt of each Holding Company;

December 6, 2005



**CAMPBELL VALUATION
PARTNERS LIMITED**

- (iii) the Fair Market Value of each investment in an Operating Business is equal to Fair Market Value determined in accordance with the Principles of Valuation Specific to each Operating Business as set out in this Shareholders' Agreement;
- (iv) the Fair Market Value of Real Property is equal to the Fair Market Value of each identified Real Property asset owned at the Valuation Date as determined by an accredited real estate appraiser;
- (v) the Fair Market Value of Fixed Assets is equal to the Depreciated Replacement Value of each identified Fixed Asset owned at the Valuation Date as determined by an accredited equipment appraiser;
- (vi) assuming there is cash or financing available to a Holding Company to clear any RDTOH and CDA account balances that exist at the Valuation Date, an adjustment to the sum of the foregoing Fair Market Value amounts shall be made such that the Vendor is put in the same after-tax economic position that he or she would have been in had they received their portion of Clearing Dividends in lieu of proceeds of disposition on the sale of the Purchased Shares;
- (x) a reasonable portion of Hidden Tax Costs is deducted from the foregoing Fair Market Value amounts having consideration for the following things:
 - (a) income tax planning available to the Purchaser in respect of Sections 86 and 87 or any other section of the *Income Tax Act* as at the Valuation Date and any risks related thereto,
 - (b) income tax planning available to a notional arm's length purchaser of the Shares of a Holding Company in respect of Sections 86 and 87 or any other section of the *Income Tax Act* as at the Valuation Date and any risks related thereto,
 - (c) the likelihood of either the Purchaser, or a notional external purchaser of the Shares of a Holding Company divesting of a particular asset owned by that Holding Company in the near-term subsequent to the Valuation Date, and
 - (d) the liquidity of the particular asset in question.

The Equity Values that result from the foregoing for each Holding Company shall be allocated amongst the various classes of Shares of each Holding Company having consideration for the specific attributes of those Shares.



CAMPBELL VALUATION
PARTNERS LIMITED

Principles of Valuation – Specific to each Operating Business

Fair Market Value of the Shares of each Operating Business shall be determined by adopting as a primary valuation methodology either a Discounted After-tax Discretionary Cash Flow Methodology or a Capitalized After-tax Discretionary Cash Flow Methodology (collectively referred to herein as “**Going Concern Cash Flow Methodologies**”) except in circumstances where the Liquidation Value of an Operating Business is greater than its Equity Value determined based on the application of either of a Going Concern Cash Flow Methodology, in which case Liquidation Value shall be adopted.

With respect to the application of a Going Concern Cash Flow Valuation Methodology:

- (i) the after-tax Discretionary Cash Flow adopted will reflect a reasonable assessment of the prospective after-tax Discretionary Cash Flow generating ability of each Operating Business as at the Valuation Date;
- (ii) the prospective after-tax Discretionary Cash Flow of each Operating Business shall be determined as Normalized EBITDA:
 - (a) minus income taxes thereon. In this regard the income tax rate adopted should reflect the weighted average combined federal and provincial corporate income tax rate applicable to the taxable income earned by the Operating Business subject to valuation and proportionate to the provinces in which that Operating Business earns taxable income. The income tax rate adopted should not reflect the “small business deduction” income tax credit,
 - (b) plus income tax credits other than the “small business deduction” available to the Operating Business (i.e. income tax loss carry-forward amounts that either exist at the Valuation Date or are forecast to materialize in the prospective after-tax Discretionary Cash Flow adopted),
 - (c) plus or minus prospective changes in Net Trade Working Capital, as appropriate,
 - (d) minus Sustaining Capital Reinvestment amounts net of related tax shield, as appropriate, and
 - (e) minus Growth Capital Investment amounts net of related tax shield, as appropriate;



**CAMPBELL VALUATION
PARTNERS LIMITED**

- (iii) the Discount Rate or Capitalization Rate adopted (as appropriate) shall be expressed as a Weighted Average Cost of Capital calculated as $K_u \times \{1 - [T \times D/(D + E)]\}$ where:
- “ K_u ” is an unlevered rate of return on equity available in the open market at the Valuation Date and which reflects the risk inherent in achieving the prospective after-tax Discretionary Cash Flow adopted,
 - “ T ” is the marginal combined federal and provincial corporate income tax rate applicable to taxable income earned by the Operating Business subject to valuation that either prevailed at the Valuation Date or as legislated to prevail subsequent to the Valuation Date as the case may be. In this regard, the combined federal and provincial income tax rate adopted should be a weighted average provincial tax rate proportionate to the provinces in which the Operating Business earns taxable income, and
 - “ $D/(D+E)$ ” is the debt:Enterprise Value ratio that appropriately reflects an efficient amount of debt that could be raised by an Operating Business subject to valuation that does not put that Operating Business at undue financial risk;
- (iv) Equity Value (i.e. the Fair Market Value of Shares) of each Operating Business shall equal the present value of after-tax Discretionary Cash Flow:
- (a) plus the addition of the Fair Market Value of each Redundant Asset owned by the Operating Business subject to valuation where the Fair Market Value of Redundant Assets is determined net of all estimated disposition and income tax costs,
 - (b) less the Fair Market Value of any identified Negative Redundancies inherent in the Operating Business subject to valuation as at the Valuation Date,
 - (c) assuming there is cash or financing available to the Operating Business to clear any RDTOH and CDA account balances that exist at the Valuation Date, plus an amount that will put the Vendor in the same after-tax economic position that he or she would have been in had they received their portion of Clearing Dividends in lieu of proceeds of disposition on the sale of the Purchased Shares;
 - (d) less an amount equal to the Seasonally Adjusted Short Term Indebtedness of the Operating Business subject to valuation, and



**CAMPBELL VALUATION
PARTNERS LIMITED**

- (e) less an amount equal to the Long Term Debt outstanding as at the Valuation Date for the Operating Business subject to valuation;
- (v) Fair Market Value determinations resulting from the application of either a Going Concern Cash Flow Methodology should be tested for reasonability vis-à-vis one or more than one of the following Test Methodologies, as appropriate:
 - (a) comparable transaction multiples. This Test Methodology involves an analysis of transaction multiples derived from the publicly stated price paid for an asset or company considered to be sufficiently similar (in terms of size, nature of revenues, asset type, asset mix, and geographic location) to the asset or company, which is the subject of valuation,
 - (b) comparable public company multiples. This Test Methodology involves an analysis of public company multiples derived from the publicly stated share price of companies considered to be sufficiently similar (in terms of size, nature of revenues, asset type, asset mix, and geographic location) to the asset or company, which is the subject of valuation,
 - (c) the value relationships (i.e. multiples of trailing EBITDA, Equity Value per unit of sales etc.) inherent in transactions involving either the shares of or a business within one or more of the Operating Companies or Holding Companies. This Test Methodology involves a comparison of the value relationships inherent in the sale price of the shares of or a business within one or more of the Operating Companies or Holding Companies to the value relationships inherent in the value conclusions reached for the like shareholding or business based on the application of a Going Concern Cash Flow Methodology, or
 - (d) another Test Methodology(ies) or a combination of the foregoing as may be appropriate at the Valuation Date.

When determining the Liquidation Value of an Operating Business:

- (i) the Fair Market Value of Current Assets, Current Liabilities (including Short Term Indebtedness), and Long Term Debt shall be assumed to equal Net Book Value as at the Valuation Date;
- (ii) the Fair Market Value of Real Property shall be assumed to equal the Fair Market Value of each identified Real Property asset owned at the Valuation Date as determined by an accredited real estate appraiser;



**CAMPBELL VALUATION
PARTNERS LIMITED**

- (vii) the Fair Market Value of Fixed Assets is equal to the Liquidation Value of each identified Fixed Asset owned at the Valuation Date as determined by an accredited equipment appraiser;
- (viii) all disposition costs, income tax costs and other costs arising upon liquidation should be deducted from the foregoing Fair Market Value amounts; and,
- (ix) subject to adequate cash being available after considering the foregoing items, an adjustment to the sum of the foregoing Fair Market Value amounts shall be made to reflect the incremental after-tax cash flow that would accrue to the shareholders of the Operating Business if a Clearing Dividend were paid in respect of any RDTOH and CDA account balances existing at the Valuation Date.

The Equity Values that result from the foregoing for each Operating Business shall be allocated amongst the various classes of Shares of each Holding Company having consideration for the specific attributes of those Shares.