ATLANTIC INSTITUTE FOR MARKET STUDIES

Policy Paper

A Valuation and Analysis of Atlantic Canadian Liquor Monopolies

By Alex Whalen and Ian Madsen

AIMS Available Online Version Includes

APPENDIX A - Details and Assumptions about Valuation

APPENDIX B - Valuation

Halifax, Nova Scotia,

January 2018

The Atlantic Institute for Market Studies (AIMS)

AIMS is a Canadian non-profit, non-partisan think tank that provides a distinctive Atlantic Canadian perspective on economic, political, and social issues. The Institute sets the benchmark on public policy by drawing together the most innovative thinking available from some of the world's foremost experts and applying that thinking to the challenges facing Canadians.

AIMS was incorporated as a non-profit corporation under Part II of the *Canada Corporations Act* and was granted charitable registration by Revenue Canada as of 3 October 1994. It received US charitable recognition under 501(c)(3), effective the same date.

287 Lacewood Drive, Suite 204,
Halifax, Nova Scotia, Canada B3M 3Y7

Telephone: (902) 429-1143

aims@AIMS.ca   facebook.com/AtlanticInstituteCA   @aims_ca

www.AIMS.ca   LinkedIn /company/atlantic-institute-for-market-studies

---

A Valuation and Analysis of Atlantic Canadian Liquor Monopolies Appendix A and B

By Alex Whalen and Ian Madsen

Content

Halifax, Nova Scotia,

January 2018

Appendix A: Details and assumptions about valuation

Taxation

As Crown corporations owned by provincial governments, the provincial liquor store chains do not have to pay federal corporate income tax. They are not obliged to pay provincial corporate income tax, either, although their respective governments could require them to do so. The federal corporate income tax is 15 per cent, so that is a significant amount of profit that provincial governments could lose in the future, unless selling off the stores and, perhaps, enacting other market-liberalizing measures, increases total sales volumes, and thus total profits too.

Future Growth

While liquor is a very mature, established industry, that does not mean it has no growth potential. It is certainly evolving, as new products and new product categories keep appearing. However, health concerns, a very slow increase in consumers' disposable income, low population growth, and the inability of retailers or manufacturers to increase prices significantly in a near-zero inflation environment weigh heavily on any growth projection that might be greater than the estimated long-term growth potential for the economy. In the case of the Atlantic Provinces, which are facing population declines, and low or minimal real economic growth for the foreseeable future, it would be overly optimistic to employ any growth rate that exceeds that of the regional economy.

Due to its unknown effects, the possibility of increased interprovincial trade in alcoholic beverages brought about by a court decision in New Brunswick was not included in the analysis in this study. However, it could have a depressing effect on the substantial profit margins in the stores.

There are three possible avenues of extra growth for liquor stores: if tobacco becomes further restricted and eventually becomes sold only in designated controlled venues such as liquor stores; if marijuana and associated products, and perhaps, later, other controlled substances become sold only in the highly controlled and regulated structure of licensed liquor stores; delivery to customers.

These first two possibilities, while they may seem a little far-fetched at present, have some plausibility, as tobacco is now highly restricted, with major warning labels and no advertising permitted on the packages, and marijuana and hashish are slated to be legalized by the federal government within its current mandate; i.e., by mid-2018 (they have promised this, but it may slip by). The new vaping product, particularly nicotine-based e-cigarette versions, could become more highly restricted and conceivably part of this coterie of regulated, controlled products sold only in licensed stores.

It is because of those two possibilities, and the continual introduction of new products, that this study does not regard the alternative scenario of actual liquor store sales decline as plausible, and, instead, will make the assumption that liquor store sales (not all of which may, in the future, be dominated by alcohol-based products) will rise in line with the growth of the regional economy, however subdued that may be. Another foundation for liquor sales is that they are a part of Western culture and socializing.

More restrictive drinking and driving laws have led to a decline in liquor sales in some bars and restaurants, but, as the financial statements of the Atlantic provinces liquor stores show, they are still growing, although slowly. Drinking alcoholic beverages has a long history, dating back thousands of years, and is not done purely for intoxication purposes. Hence, the assumption is made that there will be no radical reduction in the proclivity to drink in the general population, including in the Atlantic Provinces.

Gambling, or “Gaming”

It is difficult to disentangle the gambling division from the liquor stores’ results. Gambling has been a growth area, although it has likely saturated its potential market in the Atlantic Provinces and elsewhere. Should the liquor stores be divested by the provincial governments, it is possible, even likely, that the gambling division would not be included in the divestiture. The gross margin (sales minus direct costs such as labour, lottery terminals and other devices, electric power, rent) directly attributable to the gambling revenues would have to be excluded from the valuation to ensure a proper estimate of the stand-alone liquor divisions.

Comparator Companies

Unfortunately, and a little strangely, there are few publicly listed liquor store chains. There are only two in Canada, both based in Alberta. None could be found in the United States. This is a small sample from which to make inferences about a potential valuation of provincial liquor store chains. So, other retailers in Canada, and manufacturers of alcoholic beverages were used. There are also problems with using these two classes of companies. This could lead to an attractive investment opportunity for ordinary investors and institutional ones as well, should one or more of the liquor store chains go public, leading to a higher than normal valuation versus other retailers, or even other liquor retailers.

Retailing of other products is different from retailing liquor. In the latter sector, there is a steady demand that is resistant to recession, and relatively resilient to faddishness or merchandising and managerial missteps in liquor retailing, whereas retailing of other products is much riskier. For example, there is a high mortality rate among clothing, furniture, and even food retailers.

However, food retailing has some of the same attributes: the sale of consumer staples that are recession resistant, and slowly increasing over time. Pharmacy and convenience store chains also have similar stability. Beer, wine, and other alcoholic beverage-producing companies are in the same business as liquor store chains, but in a different level of the vertical supply chain. They are in a very competitive commercial space and suffer a high mortality rate.

However, niche or craft breweries and boutique wineries have been a high-growth sector in Canada and around the world in the past several years, so they have higher growth rates than liquor stores and the whole liquor industry in general. They could then be expected to have higher valuations than liquor stores or retailers in general.

Ultimately, the judgment was made that the diversity of the companies selected for market valuation comparisons with the provincial liquor store chains diversified the different valuation factors into an acceptable set of average valuation metrics that were still superior to using market valuation metrics from the stock market as a whole.

Some companies did not have all the valuation metrics. This means that the market valuations for the liquor stores using one metric, such as market value to operating cash flow, may use an average figure derived from a different set of companies than another metric, such as revenue to EBITDA. Once all the valuation metrics' averages are blended together, the judgment was made that these omissions and differences roughly balanced each other and evened out the final valuation. However, there is enough variation between all these diverse averages that a range of values is given for the market valuation of the liquor store chains.

Discounted Free Cash Flow Valuation

The trickiest aspects of a discounted cash flow valuation of a private company, or even a public one, are deciding on an appropriate risk-adjusted rate of return to discount future free cash flows to the present; and estimating a realistic and sustainable terminal growth rate for the entity.

Fortunately, liquor store chains are in a mature, stable, non-volatile business with little likelihood of bankruptcy and a future that looks much like the recent past: slow, gradual growth.

Hence, a range of low required or expected returns was used for the discount rate and a limited range of low growth rates was employed. Since there is still a considerable amount of variability in possible results, a range of possible valuation was given for this method, too.

Figure 4

Market Value Valuation of Atlantic Provincial Liquor Store Chains

(See individual market model valuations for details.)

Untaxed	NB	NL	NS	PEI
Average of best metrics averages, removing highs and lows	$1,971,437,867	$1,723,595,774	$2,994,924,423	$259,881,684
	Total: $6,949,839,748			
Median of best metrics averages, including extreme values	$2,059,184,535	$1,701,715,949	$2,149,850,910	$226,288,265
	Total: $6,137,039,660			
Final estimated market value of equity	$1,436,929,351	$1,701,715,949	$2,149,850,910	$204,129,863
	Total: $5,492,626,073 (Most conservative value)			
Fully Taxed	NB	NL	NS	PEI
Average of best metrics averages, removing highs and lows	$1,436,929,351	$1,723,595,774	$2,994,924,423	$259,881,684
	Total: $6,415,331,233			
Median of best metrics averages, including extreme values	$1,509,096,735	$1,438,121,195	$2,149,850,910	$226,288,265
	Total: $5,323,357,106			
Final estimated market value of equity	$1,436,929,351	$1,089,473,453	$1,939,920,862	$201,372,232
	Total: $4,667,695,899			

Appendix B: Valuation

Market-based valuation of Atlantic provinces liquor store chains

The best probable estimate of the total market capitalization, that is, the total value of the companies were they to be traded on a public stock exchange:

The calculations used to arrive at this range of figures were performed using comparison companies, the closest peers being two Canadian liquor store chains. However, seven other Canadian retailers and three Canadian wine- or beer-producing companies were also used. One important metric (price to book value) could not be used for two of the four provincial liquor store chains – New Brunswick's and PEI's – due to low or zero attributed equity in them.

Figure 5

Intrinsic, Discounted Free Cash Flow (DFCF) Valuation of Atlantic Provincial Liquor Store Chains

(See individual Liquor Control Board models for details.)

Untaxed	NB	NL	NS	PEI
Value of Co., Low, Untaxed	$1,669,858,514	$1,786,282,710	$2,733,622,046	$260,737,890
	Total: $6,450,501,160			
Value of Co., High, Untaxed	$2,0336,447,007	$2,594,507,128	$3,824,852,823	$364,821,485
	Total: $9,120,628,443			
Average Value, Untaxed	$2,003,152,761	$2,190,394,919	$3,279,237,435	$312,779,687
	Total: $7,785,564,801			
Fully Taxed	NB	NL	NS	PEI
Value of Co., Low, Taxed	$1,150,201,680	$1,151,424,658	$1,922,023,650	$179,099,409
	Total: $4,402,749,397			
Value of Co., High, Taxed	$1,609,349,086	$1,672,400,156	$2,689,273,594	$250,593,853
	Total: $6,221,616,688			
Average Value, Taxed	$1,379,775,383	$1,411,912,407	$2,305,648,622	$214,846,631
	Total: $5,312,183,043			

Note: The discount rate range (seven to 11 per cent) may seem high in current circumstances, but is commensurate with that which is demanded for private equity, which is the status of these unlisted liquor store chains. The growth rates (0.25 per cent to 2.25 per cent) are rather low, and lower than in recent years, as there is considerable uncertainty regarding the health and growth of the Atlantic Provinces' economies.

Final Caution: Neither of the valuation ranges above, neither the market value nor the intrinsic value, constitutes a private market value that a corporate acquisitor may pay, such acquisitor having the benefit of being able to attempt to optimize the value of the taken-over company, with synergies, cost-cutting, asset disposal, optimization, and perhaps the use of previous years' tax-shielding losses (however, there are no such losses for these companies).

The financial analysis of a privately controlled entity, whether owned by a government body or agency or controlled by individuals, a family, or other private group, is more challenging than a financial analysis conducted on a publicly traded commercial enterprise.

Metrics used in valuing a publicly traded company may not be applicable, or some data may not be available, making such measures absent in the analysis.

This study makes no effort to assess or adjust the financial data for any public policy or other aspect of the strategy or operation of this entity, as it is difficult to separate the effects of any non-commercial actions from those that a similar commercial entity would do. However, these non-taxable entities had estimates for taxation applied against their results to ensure proper comparison with their peers and as fully commercial entities, as they would be if they were divested.

The analysis incorporates some assumptions and projections. All obvious ones are elucidated, although a few may have been inadvertently omitted. Comments are inserted in appendices, which show details of the calculations and how and why they were done the way they were. These notes include how and why any adjustments to accounting and other items were made.

The estimates and the final estimated valuation of the enterprise that is the subject of this analysis are just that: estimates only and not to be taken to be definitive, authoritative, or unassailable. They are targets of legitimate, alternative valuation by other analysts using other techniques or assumptions, or both.

Since the valuation analysis is not definitive, the possible values of the corporations, whether using market comparators or intrinsic valuation methods, are also given as ranges and not just as single numbers.

It is useful to remember that the market valuation of a company that is listed on a public stock exchange can vary widely, even wildly, from day to day, week to week, month to month, year to year, or even within one trading day. Since a public marketdetermined share price is not an eternal verity, the possible value of companies in this study is not set in stone.

This study, in neither of the analyses above, makes any attempt to estimate or include any sort of pension, other value impairment, derivative, or other liabilities or contingent liabilities that have not already been fully discounted and included in the main income, financial position, cash flow statements, or any other estimate of liabilities or assets that could augment or detract from the valuations that were calculated. Where pension or other non-cash losses or other similar impairments were used to lower final net income in the companies' financial statements, they were, in some instances in this study's analysis, either ignored or added back, as necessary, and usually indicated when this was done.

ATLANTIC INSTITUTE FOR MARKET STUDIES

Making a Donation

AIMS is a registered charity that operates with the financial support of foundations, corporations and individuals and offers tax receipts for donations. AIMS does not receive government funding or contract itself for specific research projects. These policies enhance the Institute's ability to think freely, hold decision-makers to account for their choices, and maintain its professional integrity and intellectual independence.

Cost of Research: Each research project has its own parameters with respect to the amount and quality of the information available, the level of expertise required by the researcher and the amount of time that it takes to complete the paper. The total cost tends to range between $10,000 - $20,000+ which includes the author's fee, oversight and guidance by our Director of Research, proofreading, time, peer review, formatting, communications, radio ads, and media relations.

AIMS would like to invite you to join our group of valued supporters by filling in the form below. AIMS has been an influential voice in Canada for over 20 years and those who support our mission and believe in moving it forward are integral to AIMS's continued success.

Name: ____________________

Organization: ____________________

Address: ____________________

Telephone: ____________________

Email: ____________________

Payment Method: Visa ☐ Mastercard ☐ Cheque ☐

$50 ☐ $75 ☐ $100 ☐ Other ____________________

Card Number: ____________________ Expiry Date: ____________________

Card Holder: ____________________ Signature: ____________________

Please mail this form to:

287 Lacewood Drive,
Suite 204, Halifax, NS
B3M 3Y7

Or you may email it to aims@aims.ca

If you wish to donate using our online portal, go to the Contribute to Atlantic Prosperity page on our website: aims.ca/donate