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Marmar Penner Inc. Newsletter

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GOODWILL IN PUBLIC COMPANY TRANSACTIONS: IS IT COUNTER TO INDUSTRY RULES-OF-THUMB?

Most business valuations consider the net income earned by the business since that is the benefit to the investor. Despite that, many businesses also trade based on rules-of-thumb tied to revenue, or other factors. For example, pharmacies have been known to sell at prices based on a multiple of annual prescription drug sales or the number of prescriptions filled annually. Another example: The client lists of certain investment advisors (“IAs”) have been known to sell for about one year’s gross revenue or up to 1% of the client assets being managed. Most of the live transactions in these industries are unreported because they are privately arranged between an individual buyer and seller. However, two recent transactions between pairs of public companies shed some light on the existence of transferable goodwill in these industries.

In September 2011, National Bank agreed to buy the investment advisory business operated by HSBC Bank. HSBC had \$14.2 billion of client assets under management (“AUM”) by 120 IAs located in 27 offices across

Canada. Most of the business was centred in Ontario and British Columbia. National Bank paid \$206 million in cash plus an additional amount, which was set aside to ensure maximum retention of HSBC's IAs.

According to a recent study by PriceMetrix, a software firm that collects data in the investment advisory business, the average client pays an IA between 0.73% and 1.06% of their AUM as an annual fee for financial management and trading. Applying this to the \$14.2 billion of AUM that was acquired in the HSBC transaction, one might expect these books of account to generate between \$104 million and \$150 million in annual gross revenue, given the one-year-revenue rule-of-thumb. Based on Price Metrix's data, National Bank appears to have overpaid. Using the 1% of client assets rule-of-thumb ($1\% \times \$14.2 \text{ billion} = \142 million) also suggests a price that was too high. Does this imply that the industry rules-of-thumb are too light? The answer is "No", because National Bank was centred in Quebec and was seeking to expand beyond that province. It had earlier bought Manitoba-based Wellington West and was now seeking to expand in Ontario and B.C. Not surprisingly, buying a complete organization for a price higher than the rules-of-thumb is less expensive than trying to establish a network of offices in a new territory and then attempting to lure IAs to your new unestablished locations. After all, the cost to lure each individual IA is still that rule-of-thumb price. One can understand why there were multiple synergies available to National Bank in the HSBC transaction, which justifies (at least for them) the higher price that they paid. National Bank was indeed a "special purchaser".

In another recent market transaction, Loblaws paid \$35 million to acquire the prescription files of customers held by 95 Zellers stores with in-house pharmacies. Zellers, as readers may be aware, sold most of its store leases to Target Corp., which will be soon converting them to Target stores. However, the major renovations to each store will require that

stores close for up to nine months. Such a delay will likely lead to the loss of many of these customers, so the files were auctioned to the highest bidder. According to Credit Suisse analyst David Hartley, Loblaws paid less than one-third of the market value in a normal scenario. How was Loblaws able to get such a good deal from Zellers? Was nobody else bidding? According to another industry expert, K.J. Harrison & Partners, which specializes in advising pharmacies, Shoppers Drug Mart and the Katz Group are both knowledgeable buyers and would have been in the hunt. So, with all these special purchasers, how was Loblaws able to get such a cheap price? The answer lies in that most pharmacy sales involve the sale of the *location together with* the prescription files. In this case, just the files were sold. Loblaws will have to work to retain the uprooted customers who will now have to relocate to a new pharmacy. Goodwill of location is definitely a factor in the pharmacy business. This transaction demonstrates that the value of the prescription files is worth significantly less without the location to go with it. Conversely, most of the goodwill in the investment advisory business belongs to the IA personally as clients tend to follow IAs who move from one firm to another. Location is not nearly as important in the IA business, if at all.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.