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FSAT NEWS

FINANCIAL SERVICES ADVISORY TEAM FALL/WINTER 2022

Welcome to our 28th issue of FSAT News, a newsletter published by DJB's Financial Services Advisory Team (FSAT) to better inform and help you manage your business's potential.

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Loss of Earning Capacity

When a person has been injured, they can often recover damages from the person responsible for causing their injuries. One head of damages to be considered is the past and future loss of employment (or self-employment) income that the person has, or will, suffer due to their injuries.

We generally try to approach these calculations by determining what the person's income would have been, if not for their injuries, and compare that to what their income will now be (if any), given their injuries. For example, if it is assumed that the person, who was working full-time, will now be able to work only 15 to 20 hours per week (or perhaps 2 to 3 shifts per week) because of their injuries, we may calculate the person's future loss to be one-half (or other appropriate percentage) of their previous full-time earnings. It is generally preferably to tie these assumptions, as closely as possible, to medical evidence and/or actual post-accident performance.

However, sometimes the extent of the person's injuries, and how it will affect their future earning potential, is not yet known. The person may have currently returned to full-time employment, but, due to their injuries there may be concern that the person

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will not be able to continue in that full-time employment in the future, that they may be out of the workforce from time to time, or that they may have lost opportunities to pursue certain work. This is often referred to as a loss of competitive advantage, or loss of earning capacity.

In this regard we note that, based on Statistics Canada data, a partially disabled worker is generally:

- More likely to be unemployed at any point in time;
- Less likely to participate in the work force;
- Likely to earn less than people without disabilities who have similar qualifications;
- More likely to work on a part time basis, due to their disability; and
- Likely to face an increased risk of being forced to leave the workforce early.

Advancing a claim for a loss of earning capacity is a legal issue, however, we note that there are many cases supporting the calculation of such loss. For example, Belton v. Spencer, 2021 ONSC 2029 (CanLII) dated March 23, 2021 states:

- *"In Canada, an award for future loss of income compensates the plaintiff for his or her loss of earning capacity – in other words, the loss of an asset, the capacity to earn."*
- *"Whereas compensation for past loss of earning capacity is based on what the plaintiff would have, not could have, earned but for the injuries he sustained, a plaintiff who seeks compensation for future loss of earning capacity need not prove that it will be lost or diminished on a balance of probabilities.*

  The plaintiff need only establish that his loss was a real and substantial possibility because of the injuries he sustained."
- *"The plaintiff is entitled to compensation for loss of earning capacity to recognize the likelihood that there may indeed be positions in the future which the plaintiff might otherwise have had an opportunity to obtain but which will not be feasible for him in light of the continuing symptoms from his injuries."*

In cases where the extent of the effect of the person's injuries on their future earning potential is not yet known, we often refer to statistical data regarding the 'wage gap' between people with disability and those without.

Over the years, Statistics Canada has conducted various surveys on disability and activity limitations, the most recent being the 2001 and 2006 Participation and Activity Limitation Surveys (PALS), and the 2012 and 2017 Canadian Surveys on Disability (CSD).

According to studies done using this data, the wage deficit for a male with a 'mild' disability is about 8% to 16% of that of a male without a disability. That is, on average, over the working life of the individual, a male with a mild disability will earn about 84% to 92% of a male without a disability. The wage gap for a female with a mild disability is between 9% and 21% over their working life. Similar data is also available for people with a 'moderate', 'severe', or 'very severe' disability.

To estimate a person's loss of future employment income, we can apply these percentages against the average earnings for their anticipated occupation. For example, if a person without a disability would be expected to earn $50,000 per year in a specific occupation, the loss for a male with a mild disability working in that occupation could be estimated to be between $4,000 and $8,000 (8% to 16% of $50,000) per year.

We note that there are cases that specifically support the use of PALS/CSD data to calculate a loss of earning capacity (although the calculations can be further adjusted based on specific circumstances). Other cases support use of a percentage, but do not specifically refer to PALS/CSD. A review of such cases indicates that it is important to try to tie the loss to the specific circumstances of the individual, including medical evidence available, as noted earlier.

Of course, each situation should be considered based on the specific background and circumstances in that case. Ultimately, calculating an economic loss is a complicated process with each case presenting its own set of unique issues. Our Financial Services Advisory Team (FSAT) has significant experience preparing these calculations. If you have any questions or require assistance with a calculation, please contact a member of our team.

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Considerations When Preparing Guideline Public Company Multiples for a Private Business

Among the approaches or methodologies employed by business valuators to determine the value of a business or equity interest is the market approach. The market approach determines the value of a business or equity interest using one or more methodologies that compare the subject business to similar assets, businesses, business ownership interests, and securities that have been sold or publicly traded. The advantages of using the market approach eliminates some subjective estimates and uses data that is readily available and verifiable. Two commonly applied methods under the market approach are the guideline public company method and the precedent transaction method. In this article, we will focus on the guideline public company method.

The guideline public company methodology is a useful tool in determining the value of a business or equity interest by comparing the subject company to similar companies that are publicly traded. This allows a private business to better understand the price it might receive if it was to trade publicly, based on public companies within a similar industry and similarly sized operations.

There are three steps to prepare a guideline public company comparison:

1. Identifying a list of comparable publicly traded companies and calculating applicable valuation multiples. A valuation multiple is applied to a financial measure such as normalized earnings before interest, taxes, depreciation, and amortization (EBITDA) to develop the value of a business;
2. Adjusting the guideline public company multiples based on the relative size and risk of the comparable public companies in relation to the subject company; and
3. Applying the selected multiples, after any adjustments, to the subject company/interest in order to determine its value.

Identifying comparable public companies and calculating valuation multiples

When identifying comparable public companies, it is important to consider the industry, operation size, location, risk, and diversity of revenue streams of the subject company. For each variable, consider the impact of relevant differences between the selected public comparable companies and the subject company. For example, classifying a restaurant into a full-service restaurant industry versus the fast-food limited service industry could result in different market multiples. Similarly, diversified companies are expected to have different market multiples compared to companies that engage in a specific line of business.

A common misconception is selecting more public companies, will result in a better analysis when the public companies may not be truly comparable to the subject company. Ideally, an average of a number or group of comparable public companies should be used for an accurate analysis.

Once a set of public comparable companies have been identified, valuation multiples are calculated using either the Enterprise Value or Equity Value. Both can be applied to earnings before interest and taxes

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(EBIT), EBITDA, revenue, or even non-financial measures. When calculating the valuation multiples, review the public company's financial reports for one-time adjustments that may affect EBITDA or the selected measure. The most common valuation multiples use the Enterprise Value, being the "debt-free" approach. The Equity Value may be more relevant and reliable for equity valuations. See our Spring/Summer 2022 issue of the FSAT News for an in-depth discussion on the differences between Enterprise Value and Equity Value.

Adjusting guideline public company multiples for comparability to private companies

Professional judgment is required to determine the potential discounts that is applicable to the subject company. For example, an inherent minority discount applicable to public traded companies may offset a liquidity discount that is applicable to smaller private companies. The following are common discounts to public company valuation multiples when valuing smaller private companies:

Liquidity discount: The amount by which the en bloc value of a business or ratable value of an interest therein is reduced in recognition of the expectation that the business or equity interest cannot be readily converted to cash.

Minority discount: The reduction from the pro rata portion of the en bloc value of the assets or ownership interests of a business as a whole to reflect the disadvantages of owning a minority shareholding.

Size discount: Large, diversified, and attractive businesses may have little or no discount, whereas smaller companies may have considerable discounts.

Applying selected valuation multiples

Finally, prior to applying the selected Enterprise or Equity Value multiples to the subject company, ensure the earnings of the subject company are "normalized" so they are representative of future maintainable earnings and are similar to the earning measure of the comparable public companies.

The market approach is often used as a secondary methodology or to assess the reasonability of a valuation conclusion. However, it can also be an informative first step if you are considering selling your business or adding a shareholder. To ensure you consider accurate guideline public comparable companies multiples for your business, one of our valuation specialists may be able to assist.

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FSAT SERVICES

- Assistance with Business, Acquisitions & Divestitures, Including Due Diligence & Quality of Earnings Reports
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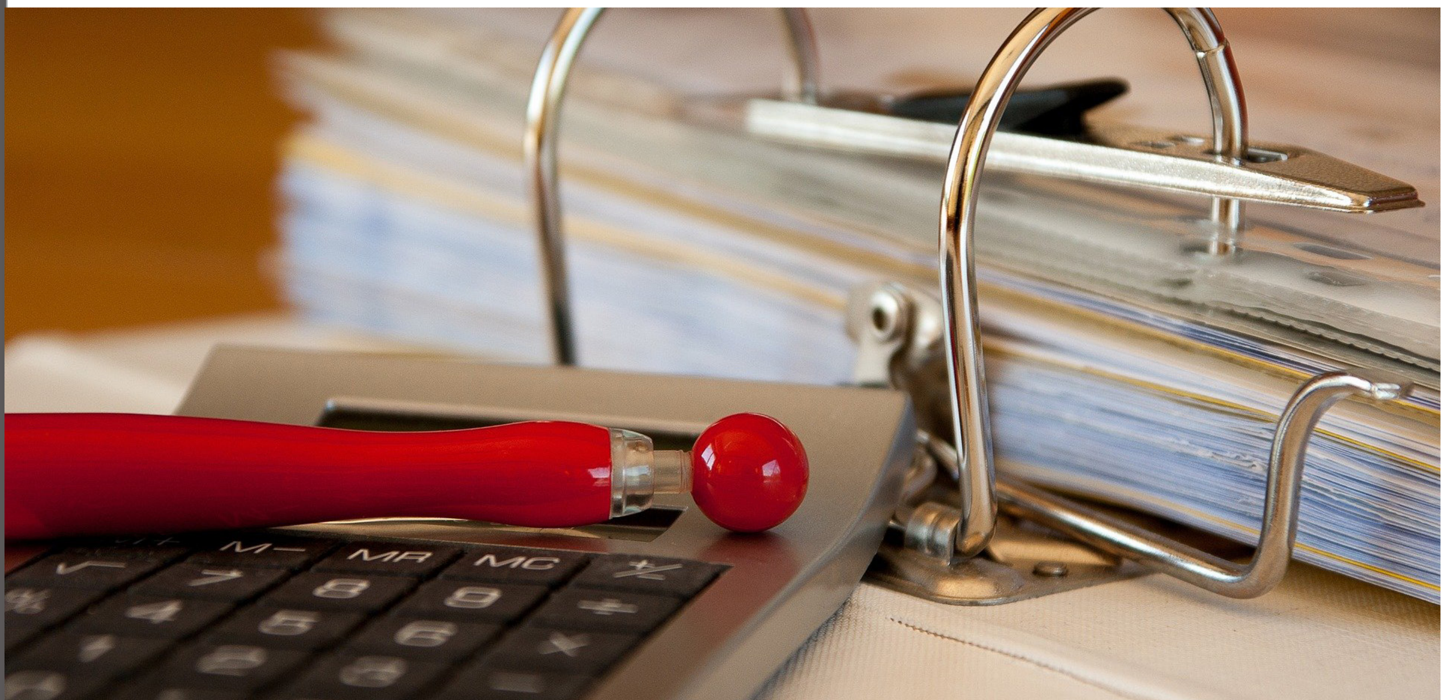
- Matrimonial Disputes
- Shareholder Agreements & Dispute Resolution
- Value of Future Care Cost Analysis
- Wrongful Dismissal Claims

Discount Rate Increases to 0.5% for Trials in 2023



Each year the Ministry of the Attorney General of Ontario publishes the discount rates to be used for the calculation of awards for future pecuniary damages in Ontario under rule 53.09 of the Rules of Civil Procedure. The rates for the first 15 years are based on calculations set out in the Rules of Civil Procedure, with the annual rate thereafter fixed at 2.5%. The discount rate is intended to reflect the difference between estimated investment and price inflation rates.

For the past 3 years the discount rate to be used to calculate future economic losses for amounts that would increase with inflation, were set at 0% for the first 15 years, and 2.5% thereafter.

For trials scheduled to commence on, or after January 1, 2023, the rates have been increased to 0.5% for the first 15 years, and 2.5% thereafter.

Although not a significant change, the effect of this change will be to reduce our present value calculations by about 3.5% over a 15 year period, and by about 5% for a 20 year period.

For trial scheduled to commence on or after January 1, 2023, the rates are as follows.

- For amounts expected to increase with inflation (e.g. salary), the discount rates to be used are 0.5% for the first 15 years and 2.5% thereafter.
- For amounts that are static (that don't increase with inflation), such as Income Replacement Benefits (IRBs) or many Long-Term Disability benefits, a higher discount rate would be warranted. Based on the Attorney General published inflation rates, the discount rates for such amounts will be 2.8% for the first 15 years, and 2.9% thereafter, for trials beginning in 2023. These are up from 1.8% for 2022. As this discount rate has increased, the present value amount will be lower under the new rates.

Our Financial Services team has significant experience preparing these present value calculations. If you have any questions or require assistance with a calculation, please contact a member of our team.

Rule 53.09 Rates

	2023	2022
First 15 years	0.5%	0%
Thereafter	2.5%	2.5%

Working Capital in Business Transactions

Defining Working Capital

"Working capital" is the capital of a business which is used to fund day-to-day operations and meet short-term obligations. In its most basic form, working capital is calculated as a business' current assets, less its current liabilities.

However, in open market transactions and notional business valuations certain current assets and liabilities are often excluded when assessing the "operating" or net trade working capital of a business, such as cash, shareholder/related party loans, and other non-operational amounts. Cash is generally excluded from net trade working capital of privately held businesses unless the cash is used directly in the operations of the business, such as cash kept in cash registers in a retail business. This is because in most cases, the cash held in a business accumulates as a result of operations (i.e., through net income earned), and that cash is available to be either reinvested in the business or to be withdrawn by the owners, and is therefore not necessary in order to maintain the existing operations. In simple terms, net trade working capital is related to the operating activities of a business (excluding cash) such as accounts receivable, inventory, prepaid expenses, accounts payables, and accrued liabilities.

Calculating Working Capital

Determining which line items should be included in working capital may involve some judgment and is not always simple because the makeup of working capital can vary widely across different industries and even from business to business. This is why it is important to consider the specific nature of the operations of a business that impact how it employs working capital, as well as broader working capital issues that are common in the industry. Additionally, each component of working capital may need to be examined further to ensure all balances within the account are up-to-date, are operational and belong in working capital, and that the value reflected in the financial statements does not over or under-represent the asset or liability.

Finally, the accounting standards used in the source financial statements should also be considered when calculating working capital, as balances on the balance sheet may be calculated differently depending on the accounting standards applied (i.e., GAAP, ASPE, IFRS).

Normalized Working Capital

In cases when the value of a business is determined based on its ability to generate future cash flows (i.e., using an income/earnings based methodology as opposed to an asset based methodology), the working capital that is required to operate the business is included in this value, and is not added to the value of the business. This is because the businesses requires the working capital to fund its continued operations and generate the level of income that this value is based. The amount of net trade working capital required to maintain ongoing operations is commonly referred to as the "normalized" net trade working capital amount.

Working Capital in a Business Sale

When a business is sold, it is common for the letter of intent between the buyer and seller to include general terms stating that the business will be sold with a sufficient level of working capital for the new owner to maintain operations. As the transaction advances, a specific amount of "target working capital" is usually agreed upon by both parties with corresponding definition on how the target working capital is to be calculated. This represents the amount that the buyer and seller agree is required to maintain operations, and that is expected to be left in the business at the time of closing. This target amount is based on an analysis of the company's historical financial results, industry norms, ratio analysis, and benchmarks, and

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is ultimately determined through negotiations between the buyer and seller.

Working capital in a business at any one point in time is not always representative of the ongoing amount required. In some businesses and industries, the working capital required changes dramatically due to timing, such as large projects completed and invoiced, from month to month or year to year, such as businesses that experience seasonality or are in cyclical industries. For these types of businesses, it may be necessary to examine the average working capital requirement across different periods. Working capital balances may also be higher or lower than the required amount simply due to management's own preferences. For these reasons, it is important to determine working capital requirements for a business on a normalized basis, which includes adjustments for seasonality or irregular changes that are not related to normal operations.

Implications on Price

When the amount of working capital left in the business on the day the sale of the business closes is different from the previously agreed upon target working capital amount, there is usually an adjustment made to the sale price to reflect this difference. In transactions where the actual working capital is less than the target, this negatively impacts the seller because the sale price is usually reduced by this amount. When the actual working capital is greater than the target, an increase to the sale price may be warranted. In a notional valuation context, a similar adjustment should also be considered if the working capital of the subject business is higher than or below what would be considered "normal" on the valuation date with a corresponding adjustment to the valuation conclusion of the shares.

The process for negotiating working capital in a business sale usually follows these broad steps:

- A letter of intent is developed, outlining the broad terms agreed to by the buyer and seller. This usually includes an agreement that there will be a "normal" level of working capital in the business.
- The buyer will analyze financial information about the business, which is supplied to them in order to better understand the working capital requirement of the business.
- During the due diligence phase, both parties continue to analyze information about the business to determine any potential adjustments to working capital.
- Through negotiations, both parties will eventually come to an agreement on the "target working capital".
- A purchase agreement is drafted, and will further define how working capital is calculated and the target amount agreed to.
- The purchase agreement is finalized, and additional clauses may be added outlining a post-closing dispute resolution process (including working capital disputes).
- Post-closing, the buyer will determine the actual working capital level that was in the business at close and further discussions may take place between the buyer and seller to determine any post-closing adjustments.
- If necessary, the dispute resolution process is initiated as outlined in the purchase agreement to remedy any disputes between the buyer and seller.

At DJB, our team of specialists have the professional experience to assist business owners and prospective buyers throughout the transaction process. Our trusted professionals can assist in many aspects of business sales and purchases, including assessing the complex issues involved in determining the value of a business and analyzing its working capital requirements.

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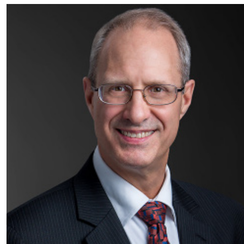

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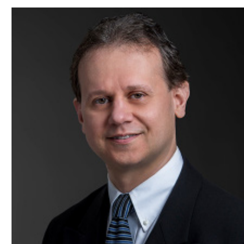

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