

Wealth and Value Creation In Canada— WHAT A DIFFERENCE A YEAR MAKES

Almost Two-Thirds of All Firms Did Not Provide Adequate Returns to Their Shareholders

BY VIJAY JOG AND JOHN HITSMAN¹

Last year at this time, the disparity between the market's valuation and the value fundamentals wasn't on anyone's radar screen — especially in the Technology and Communication sectors, where Nortel's astounding market capitalization came to dominate the TSE 300.² The technology sector-driven bull market pushed valuations to the breaking point as the TSE 300 broke through 11,000 on August 15, 2000. The market seemed to ignore fundamentals or history and stocks were priced on unrealistically high expectations and lofty acquisition premiums.

Today, the TSE 300 is hovering at around 7,500 and there is little or no expectation that it will recover to its 2000 levels in the near future. This volatility of the stock

market and wide variations between market values and underlying value fundamentals require investors to review and reflect on the relative value and wealth creation by Canadian firms. The wealth creation reflects the stock market-based performance whereas the positive value creation performance reflects the ability of corporate management to earn a return on capital that exceeds cost of capital.

In this paper, we document both the wealth and the value creation performance of 468 publicly traded Canadian companies listed continuously on the Toronto Stock Exchange over the four-year period from 1997 to 2000. We also focus on the “new” versus “old” economy stocks using a four-year

exhibit 1 TOP 10 WEALTH CREATORS GROUPED BY SIZE OF 2000 YEAR-END ASSETS

> \$200 MILLION			< \$200 MILLION		
Rank	Company	AER	Company	AER	AER
1	BONAVISTA PETROLEUM LTD.	149%	AASTRA TECHNOLOGIES INC.	171%	171%
2	B C E EMERGIS INC.	131%	GLOBAL THERMOELECTRIC INC.	148%	148%
3	BALLARD POWER SYSTEMS INC.	85%	KNOWLEDGE HOUSE INC.	133%	133%
4	PATHEON INC.	81%	NAPIER ENVIRONMENTAL TECHNOLO.	93%	93%
5	C-MAC INDUSTRIES INC.	78%	DYNASTY COMPONENTS INC.	68%	68%
6	MOSAIC GROUP INC.	71%	PURCELL ENERGY LTD.	57%	57%
7	SHAW COMMUNICATIONS INC.	61%	CANADIAN HYDRO DEVELOPERS INC.	53%	53%
8	HOME CAPITAL GROUP INC.	60%	CROSSOFF INCORPORATED	52%	52%
9	BIOVAIL CORPORATION	52%	TRICAN WELL SERVICE LTD.	49%	49%
10	COGECO CABLE INC.	48%	SOUTHWARD ENERGY LTD.	45%	45%

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exhibit 2

CONSISTENT WEALTH CREATORS

Firms in top 20% of their Respective Industry

1997-2000		1993-2000	
Company	# Years	Company	# Years
BONAVISTA PETROLEUM LTD.	4	BALLARD POWER SYSTEMS INC.	5
AASTRA TECHNOLOGIES INC.	3	CANADIAN HYDRO DEVELOPERS INC.	5
B C E EMERGIS INC.	3	A G F MANAGEMENT LIMITED	4
BALLARD POWER SYSTEMS INC.	3	ABER DIAMOND CORPORATION	4
BRACKNELL CORPORATION	3	B C E EMERGIS INC.	4
CANADIAN HYDRO DEVELOPERS INC.	3	BIOSCRYPT INC.	4
FOUR SEASONS HOTELS INC	3	BONAVISTA PETROLEUM LTD.	4
FRANCO-NEVADA MINING CORP.	3	CANADIAN WESTERN BANK	4
HURRICANE HYDROCARBONS LTD.	3	CANWEST GLOBAL COMMUNICATIONS	4
TONKO DEVELOPMENT CORP.	3		

running time period, thereby dampening some of the short-term volatility of the stock markets.

WEALTH CREATION —

We document the wealth creation results using the Annual Economic Return (AER) measure, where a positive AER value (indicating positive wealth creation) indicates that the stock market returns exceeded the shareholders' expected return for the given level of risk associated with the stock. Conversely, negative AER indicates that actual returns were less than what shareholders expected. We estimate the expected return of shareholders using the single factor

model with Bayesian adjustment using the standard Vasicek method.³

Irrespective of the two bull years on the TSE, based on a four-year average AER, our results show that only 34% of the 468 companies included in this year's study created shareholder wealth. Exhibit I shows the top 10 wealth creators broken into large and small firms by size of assets.

Among the small firms, telephone equipment manufacturer Astra Technologies leads the pack of wealth creators and Bonavista leads in the large firm grouping.⁴ Exhibit 2 shows the list of perennial wealth creators in Canada over an eight-year period. Prominent in the list is Ballard Power Systems whose wealth creation performance has been stellar in spite of the fact that it has rarely created economic value.

Exhibit 3 explores the results for the best, the worst, and the average four-year wealth creation results for each of 25 broad industry groupings. Eight of the 25 groups showed an average positive wealth creation performance. Not surprisingly, the Technology, and Oil and Gas sectors show the

exhibit 3

MINIMUM, MAXIMUM AND AVERAGE AER BY INDUSTRY

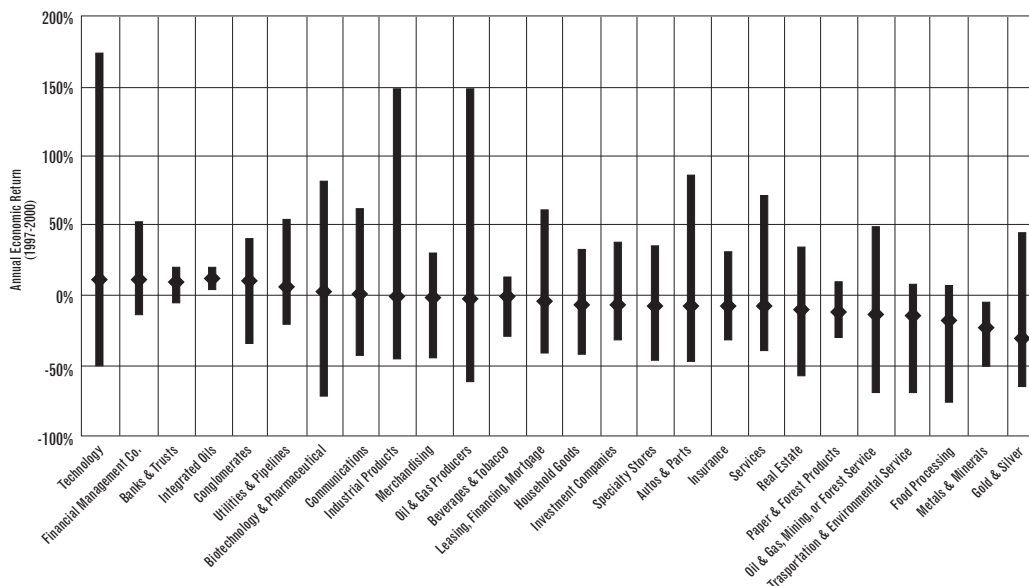


exhibit 4

Firms in Top 20% of Industry

CONSISTENT VALUE CREATORS

1997-2000		1993-2000	
Company	Years	Company	Years
AKITA DRILLING LTD.	4	CALDWELL PARTNERS INT'L INC.	8
BRAMPTON BRICK LIMITED	4	FRANCO-NEVADA MINING CORP.	8
CALDWELL PARTNERS INT'L INC.	4	ROTHMANS INC.	8
CAMCO INC.	4	SCEPTRE INVESTMENT COUNSEL LTD	8
COGNOS INC.	4	AKITA DRILLING LTD.	7
DUPONT CANADA INC.	4	COGNOS INC.	7
ENGHOUSE SYSTEMS LIMITED	4	DUPONT CANADA INC.	7
FRANCO-NEVADA MINING CORP.	4	GENNUM CORPORATION	6
GENNUM CORPORATION	4	LEON'S FURNITURE LTD.	6
GORAN CAPITAL INC.	4	M D S INC.	6
LEON'S FURNITURE LIMITED	4	SINO-FOREST CORPORATION	6
M D S INC.	4	SNC-LAVALIN GROUP INC.	6
METRO INC.	4	TRANSAT A.T. INC.	6
PASON SYSTEMS INC.	4	UNICORP INC.	6
ROTHMANS INC.	4	UNI-SELECT INC.	6
SCEPTRE INVESTMENT COUNSEL LTD	4		
SINO-FOREST CORPORATION	4		
TRANSAT A.T. INC.	4		
UNICORP INC.	4		
WESCAST INDUSTRIES INC.	4		
WHEATON RIVER MINERALS LTD.	4		

widest intra-industry differences in individual company performance; the lowest difference being found in the Bank and Trust sector (10 firms). On average, the Gold and Silver sector continues to be the worst-performing sector and not a single firm in Metals and Minerals generated higher-than-expected wealth for shareholders over the period. Another important conclusion from this exhibit is that, irrespective of the industry sector, there is a wide variation between the best and the worst wealth creators.

VALUE CREATION —

“Over Half of the Most Prominent Publicly Traded Firms in Canada Destroyed Value”

The wealth creation rankings above were based solely on a firm's stock market price and dividend performance adjusted for the expected rate of return. These rankings do not necessarily reflect the ability of current management to create value for shareholders since some of that performance may, at times, be driven by the market's future expectations. The alternative method is to evaluate performance based on whether or not management was able to generate a return on invested capital exceeding the firm's cost of the capital. Thus, firms providing operating returns greater than their cost of capital can be viewed as showing positive Economic Value

Creation (EVC). Over the four years of study, 212 (45%) of the 468 firms were able to create positive economic value while almost 55% of the publicly traded firms in Canada destroyed value. The highest ranked company in this year's study is Enghouse Systems Limited, whose management returned 103.9% on capital over and above its cost.

There is significant evidence of value creation dominance of some companies in their respective industries over time. Over the eight annual rankings ending in 2000, no less than 15 of the firms have been in the top 20% of their

industry for at least six out of the eight years (Exhibit 4). Some companies, such as Caldwell Partners, Franco Nevada, Rothmans and Sceptre Investment Counsel, have led their sectors in all eight periods. Clearly, there are management teams that have found value-creating management systems and strategies within their own sectors.

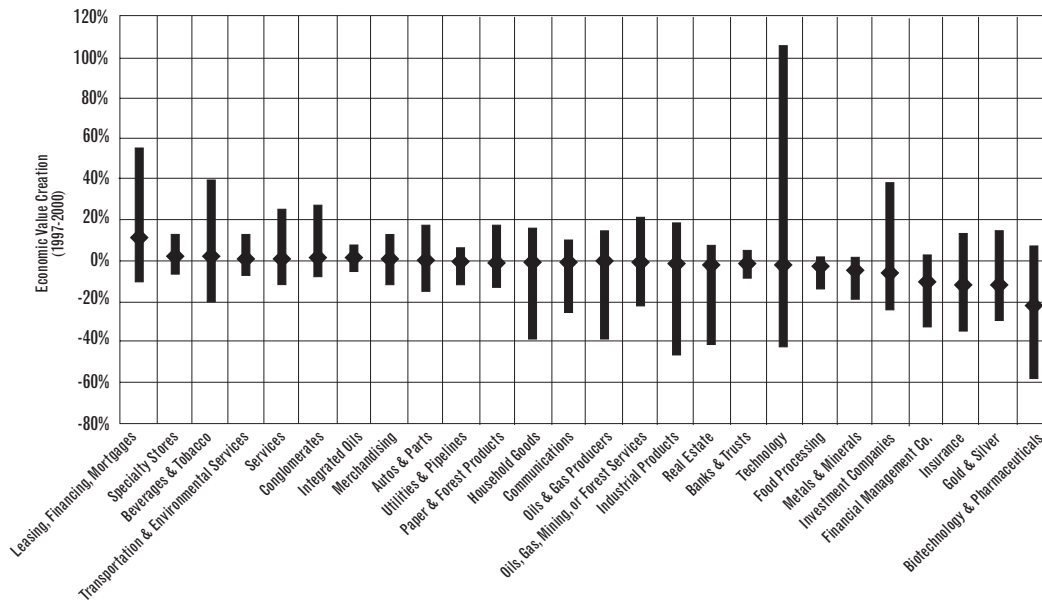
Wide variations in value creation ability exist within individual industries. Exhibit 5 shows that, on average, the highest-performing industry was Leasing, Financing, and Mortgages with a four-year return of 12% over and above the cost of capital. On average, the worst-performing sector was Biotechnology and Pharmaceuticals at -23%. A close look reveals that in two industries, there was not a single company that was able to create value over the four years. We contend that these results should be used by the boards of directors and institutional shareholders to evaluate the relative (within their industry) capabilities of management, and to influence their compensation arrangements accordingly.

VALUE VERSUS GROWTH

The changing nature of the market valuation in relation to value fundamentals can be seen in Exhibit 6. It shows the percent contribution of the firms with negative NOPAT (net operating profit after tax) in each of the last five years,

exhibit 5

MINIMUM, MAXIMUM AND AVERAGE EVC BY INDUSTRY



their share of the total market capitalization; and the subsequent yearly change in their market valuation. We can see that the number of firms with negative NOPAT (firms with operating losses) has increased consistently over the years and, at the same time, the market has continued to put a higher relative market valuation as seen by their increasing share of total market capitalization. There was definitely a change in market valuations in year 2000 but not sufficient to counterbalance these relatively high valuations. These results indicate that the valuations at the year-end 2000 were still much higher compared to the underlying performance of these firms. The declines seen in year 2001 may simply represent the continued and, probably, inevitable correction in market valuations to reflect the underlying fundamentals.

NEW VERSUS OLD ECONOMY

Given the current state of the economy and the turmoil of the last two years, specifically in the valuation of technology stocks, a look at our results with respect to the 'new economy' is in order. Exhibit 7 shows the changing nature of the Canadian capital markets. Here, we identify the top 10 firms with the largest changes in market value over each of the last four years in three broad groupings: Technology, Resource and Other. As can be seen, eight of 10 firms with the largest changes in market value in 1996 were from the Resource sector, whereas Technology contributed only one. Interestingly, from 1996 to 1999 the Resource and Technology sectors

were moving in opposite directions, culminating in the 1999 technology bull market where seven of 10 top percentage gainers were Technology firms. In 2000, we see a slowdown in the Technology train coupled with a resurgence of Resource stocks. Moreover, the percentage of operating profit after tax of Technology firms remained at approximately seven percent of the total. Their share of market capitalization rose from nine percent in 1996-97 to over 30 percent in 1998-2000, showing a very wide disparity between stock prices and value fundamentals.

CONCLUSION

Canadian equity markets have seen a drastic shift in direction over the last few years. In 2000, the TSE 300, propelled by Nortel Networks, reached levels higher than the Dow Jones Industrial Average, an occurrence that will perhaps never be repeated. Our results indicate that this was a result of valuations that significantly deviated from the underlying value-fundamentals. As of the 2000 year-end, relative market valuations still remained high, a fact since recognized through the decline in valuations in the last eight months. Were it not for the high prices of energy stocks, the overall wealth creation performance would have been even worse.

Our results also indicate that we have some consistent value creators in Canada whose valuations could be higher than they have been. It is also clear that a large number of companies and their management have been unable to create shareholder value again on a consistent basis, but that they are being given

exhibit 6 FIRMS WITH NOPAT < 0 1996-2000

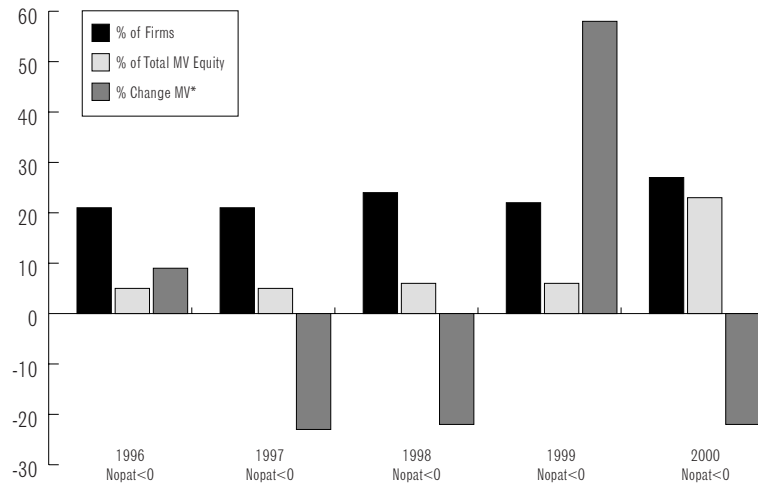
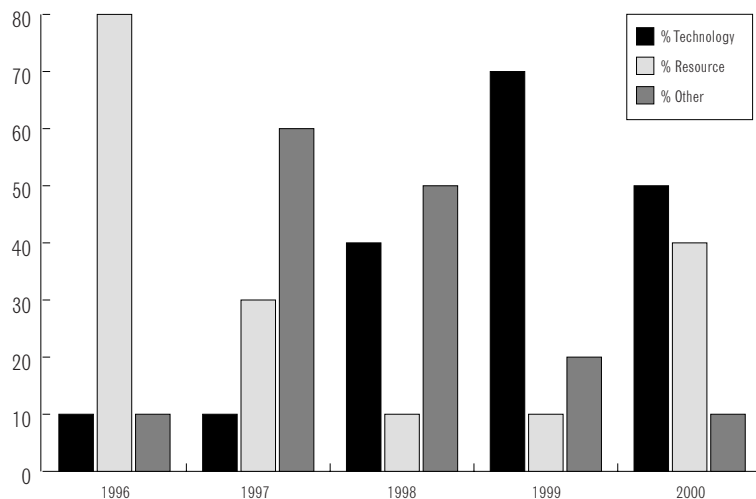


exhibit 7 TOP TEN DELTA MV% Technology Sector vs. Resource Sector 1996-2000



the benefit of the doubt by seemingly forgiving Canadian capital markets. These consistent value-destroying companies exist in every sector, thus one cannot use sectoral conditions as the reason for their mediocre performance. What continues to be a mystery is the fact that a large number of Canadian firms continue to destroy shareholder value even with an undervalued Canadian dollar and still remain immune to pressures from their boards of directors. Moreover, we believe that the weak performance results of the majority of Canadian companies in our sample is evidence of questionable executive com-

cost of capital-negative value creation performance. Its entire stock market performance has been based on expectations about its future. As of August 2001, Ballard's stock has declined to \$35 compared to a 52-week high of \$179, indicating a severe correction in investors' expectation about its future.

pensation systems and the fact that a weak corporate governance environment persists.

Based on these results, it is obvious that Canadian investors may continue to shift even more of their assets south of the border and would continue to ask for less restrictive foreign investment limits on retirement assets. In the absence of radical changes to the corporate governance regimes of consistent value-destroying firms, U.S.-led acquisitions can only grow. ♦

1. Authors are grateful for research assistance provided by Sharon Wang, comments by Kobana Abukari, and data provided by StockGuide.

2. Nortel Networks peaked in July at \$124 with some analysts predicting the stock to reach \$200 within the next twelve months.

3. Please refer to "Keeping Score", Canadian Investment Review, Summer 1996, pp. 19-31, "Updating the Corporate Scorecard", Canadian Investment Review, Winter 1996/97, pp. 19-24, "Wealth and Value Creation in Canada, Canadian Investment Review, Fall 1997, pp. 24-28 and Fall 1998", pp. 24-27. These papers also define and describe the details of the methodology and conceptual issues.

4. Our results are based on year-end 2000 prices. Our analysis of Ballard over the last twelve years indicates that Ballard has never generated operating returns over the