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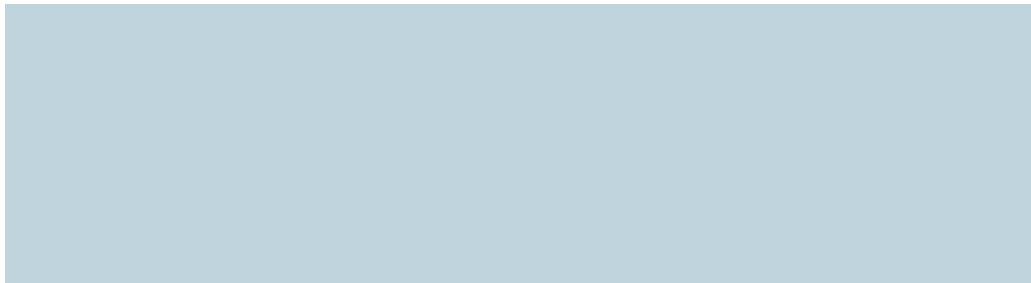
PERSPECTIVES



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The hollowing out of Corporate Canada

Myth or reality?

By Ken Smith – July 2006

In the wake of recent foreign takeovers, there has been conflicting commentary on the “hollowing out” of the Canadian economy. On the one hand, with each falling icon – Hbc, Dofasco, Fairmont, Domtar, etc. – the press of the day has reported on the increasing foreign control of our economy and the failure of Canadian companies to take their place on the global stage.

On the other hand, those watching the direct investment statistics see a different story. On the basis of direct foreign investment into and out of Canada, Canada is a net buyer – our companies are investing more abroad than foreign companies are investing here. As *The Economist* reported in its February issue, referencing Statistics Canada data, “Canadians are relaxed... these icons were not considered sacred... Canadians are on a global shopping spree of their own”.

However, Canadians should not be “relaxed” by the direct investment statistics. Canada as a net buyer as measured by direct foreign investment sets the bar too low. We could be “winning” on this measure by acquiring many minor positions in international companies whilst foreign companies acquire controlling interests in all our national leaders.

Nor, at the other extreme, should we expect all of our corporate leaders to come out on top as their respective industries restructure in a global economy. This would be an unrealistic expectation for a small economy such as ours.

So how should we measure Canada's performance in global industry restructuring? How are we doing in the long game? Finally, how concerned should we be about the recent spike in foreign takeovers?

Three yardsticks need to be applied to understand our performance:

1. international acquisition spending relative to the size of our economy (i.e., acquisitions, not just investments, but recognising that we can't expect to spend as much as countries many times our size);
2. international acquisitions by Canadian companies relative to foreign acquisitions of Canadian companies (i.e., are we gaining or losing our share of corporate leaders as industries restructure);
3. relative value creation (i.e., are we creating or destroying shareholder value in the process).

On the first measure, Canada has been punching well above its weight on the global stage. In the past 5 years, Canada spent the equivalent of 3% of GDP on foreign acquisitions, whereas the US spent only 1%. Countries of the EU have, of course, been active within the EU, but have also spent only 1% of the EU GDP outside of the EU. 49% of Canada's total M&A budget is spent outside of Canada, compared with only 20% of the US budget and 22% of the EU M&A budget spent outside of the US and EU respectively.

On the second measure, Canada had been performing well until the last year or so. Over the last 5 years, Canadian companies acquired international ones at a faster pace than foreigners acquired Canadian firms. In fact, Canada posted a \$6.4 B surplus in M&A spending over that period. Note that this is net of a 2005 spending deficit – Canada had a spending surplus of \$34B in the 4 years prior to 2005 and a spending deficit of \$28B in 2005 (more on this later). Even including 2005, this is a significant surplus, especially in comparison with the United States which posted a surplus of only \$5.2B over the same period despite being 10 times our size with significantly higher M&A activity. The EU realised a net M&A

spending deficit over the same period, with ownership of a total of \$111.8 B in assets leaving Europe since 2001.

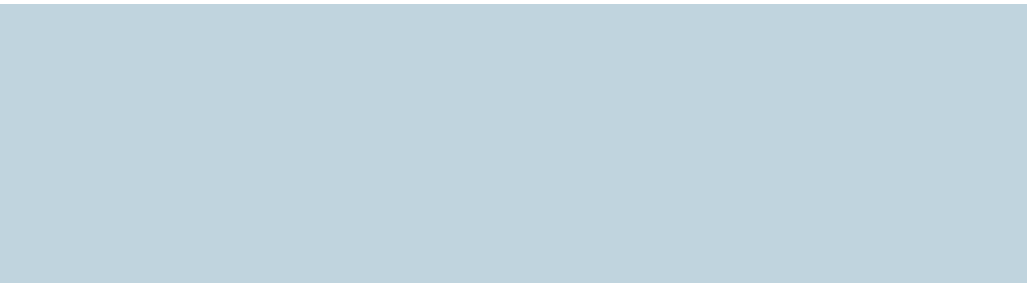
On the third measure, value creation, the news should encourage Canadian CEOs and their boards to do more. Canadian companies are in general better acquirers, as measured by long term shareholder value created, with success rates of 50 to 60% over the past 15 years, consistently higher than the US and Europe across all large deals foreign and domestic. When acquiring in the US, contrary to popular wisdom, Canadian companies do as well or better. Canada's few large acquisitions overseas have not done as well, with 40 to 45% success rates. However, this is far superior to US performance overseas, but inferior to European acquisitions in North America.

The most recent deficit in international acquisitions, last year and so far this year, could be the result of recent changes in conditions, for both outbound and inbound acquisitions. For example, a lot of Canadian capital has been pouring into the oil sands, leaving less available for foreign acquisitions. The world is also discovering Canada as an investment opportunity. We offer a robust economy, a currency outperforming the US Dollar, a leader in a range of global commodities; "sticky" oil reserves now the envy of the world, and a gateway to the US market. It should be no surprise that more foreign companies want a piece.

This investment in Canada is certainly not all of the "hollowing out" variety either. The foreign investment in the tar sands is symbiotic to the development of the associated Canadian companies and service industries. There are also many examples of foreign takeovers that leave Canadian headquarters intact and strengthen the companies acquired, such as the recent takeover of Hbc and the announced plans for the new Domtar. In fact, while close to 25% of the 100 largest companies operating in Canada are foreign owned, two thirds of these are essentially headquartered in Canada, i.e., have Canadian operations and headquarters jobs proportional to the size of the Canadian company. E.g., the Canadian operations of Hbc, ING, Imperial Oil, McKesson and IBM Canada are hardly "branch plants". These companies offer the quality and quantity of jobs, investment and spin off benefits of comparable Canadian controlled companies, (in contrast to some of the large US retailers and consumer goods companies that don't even bother to report separately on Canadian operations).

However, this recent spike in acquisitions of Canadian companies raises the bar for Canadian corporate acquisitions abroad, and Canadian leaders need to step up their game. The boards of some Canadian companies may be conservative to a fault – Canadian companies have generally outperformed others in creating shareholder value in international acquisitions. Therefore, a stance too risk averse when an industry is restructuring may fail shareholders in the long run, as well as fail Canada if the Canadian headquarters is lost in the process. Canadian companies have created international leaders such as Alcan, Manulife, RIM, CN, Weston's, Quebecor, Thomson, Bata and Bombardier, and we can create more by taking a more aggressive stance in domestic and international acquisitions as our industries restructure on a global basis.

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