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PUBLIC CHOICE ALTERNATIVES

Extreme Dearth of Cash Flow

A VALUATION OF EXPORT DEVELOPMENT CANADA

BY IAN MADSEN

FRONTIER CENTRE FOR PUBLIC POLICY
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EXECUTIVE SUMMARY

Export Development Canada, ‘EDC’, is a major force in the Canadian export financing and insurance or guarantee market, and a large one in terms of capital employed—and consequent risk to the taxpayer. It could be worth as much as $30B were it divested; or, it could be worthless if unable to fully realize its illiquid assets in the form of cash. As a business, making the very optimistic assumption that it can turn its stated ‘comprehensive income’ into free cash flow, its value, on a fully taxed basis (as a Crown corporation, it pays no tax, now), is estimated between $24B—$27B. Using comparable Canadian financial firms, the range is $10B—$11B. It could be worth the highest figure, if re-jigged and optimized.

INTRODUCTION

Export Development Canada, 'EDC', a Crown corporation owned entirely by the federal government of Canada, loans or insures and guarantees export financing loans to Canadian-domiciled or -controlled corporations. It also finances or guarantees investment by foreign firms into Canada, although that is not apparently a priority, and, more controversially at times, investment by Canadian-headquartered firms into foreign countries.

About one third of EDC's financial exposure is to aerospace and ground transportation. As Bombardier, which has received abundant favourable treatment from the federal and Quebec governments over the years, is the biggest Canadian manufacturer in these sectors, it begs the question if EDC is overexposed to this one company, and vulnerable to problems this client might experience.

The biggest single foreign nation that EDC helps Canadian firms do business in is the United States. This likely makes some sense, as nearly 80 percent of Canadian exports go to that country, and we have a free trade agreement with it. However, as there are long-established commercial, customs, legal, regulatory, investment, financial, and other protocol arrangements with the US, it is a bit puzzling that additional aid is needed by Canadian firms in accessing this nearby market.

EXPORT DEVELOPMENT CANADA, A HISTORY

Export Development Canada (EDC) was created in 1944 as Canada's export credit agency, and established as a Crown corporation on October 1, 1969 as Export Development Canada under the *Export Development Act.*[1] EDC operates as Canada's export credit agency and is a self-financing Crown corporation that operates at arm's length from the Government.[2]

EDC's mission is to support Canadian direct investment overseas and investments into Canada;[3] much of their support is done through partnerships with other financial institutions and through help from the Government of Canada.[4]

Many of the members of the the EDC's board of directors are from the private sector and were appointed by the Government of Canada. As with any board of directors, their responsibility is to supervise the direction and management of EDC and oversee the strategic direction of the EDC.[5]

The Government of Canada is the sole shareholder of EDC, but since 2009, EDC has been running under broadened powers to increase access to credit for Canadian businesses and companies by participating in domestic financing and insurance transactions with financial institutions from the private-sector.[6]

Today EDC has nineteen international representations including Mexico, Colombia, Peru, Chile, Brazil, Germany, Turkey, UK, Russia, Indonesia, India and China to name a few. However, most of its loan portfolio is in the United States. Headquartered in Ottawa, EDC has eighteen offices across Canada that are intended to help businesses grow and consider investing internationally.

As of 2016, EDC facilitated more than $1.3T in exports and foreign investment by Canadian companies[7] and helped more than 7,150 Canadian companies do business in over 200 markets in 2016.[8] EDC's customers' export sales and investments totalled $99B.[9] From the $99B in customer export sales and investments, approximately $63.9B contributed to Canada's GDP.[10]

VALUATION FACTORS

For the purpose of this study and the examination of the divestiture of EDC, a very optimistic perspective was taken. As a crown corporation, EDC remains a growing concern due to its inability to fully convert net income into free cash flow[11] or even operating cash flow,[12] both are key factors in corporate survival and growth. Over the past five years, EDC has not generated *free* cash flow and has had negative *operating* cash flow much larger than its reported comprehensive income. Generally, a well-run corporation over time has its moving multi-year average of annual net income approximately equal to the average of its free cash flow. This has not been the case with EDC for the past five years and perhaps even longer.

Most companies flounder when they show substantial positive net income due to tallying up revenue financed by either short-term or long-term debt or by shareholder capital, in the form of common equity injections. EDC is in this situation. EDC has not demonstrated that it is able to convert profits into ready cash to pay bills, service debt, or for other purposes, yet, its capital base has increased. This is only possible because it has the full backing of the federal government guaranteeing its obligations.

INTRINSIC, DISCOUNTED FREE CASH FLOW VALUE OF EDC

As noted above, EDC is unable to generate free cash flow and it has been substantially negative for years and shows no signs of changing in the future. Therefore, the intrinsic value of EDC is negative. However, using an optimistic perspective that EDC or if divested under new management were able to convert its entire net income into future free cash flows, the corporation's full taxed value could range from $14.7B to $58.8B, with a *median* value of $23.5B and a *mean* value of $26.8B.

It needs to be reiterated that this treatment of EDC's future financial results is very optimistic. In addition, it is important to consider that if EDC is unable to convert all of its reported 'comprehensive income' into actual cash, its value as a cash-generating business would be correspondingly much less. For example, if only half of its comprehensive income is able to be converted into free cash flow, its intrinsic value would be half the estimated value stated above. It is advisable to use the lowest most conservative value, $14.7B, as the uppermost bound of value that could be realized for EDC unless its cash conversion capability is radically improved.

Table 1

Intrinsic Value, Using Discounted Free Cash Flow

Valuation Matrix - Presented Value of Discounted Free Cash Flow = Estimated Next Year Free Cash Flow (Required Rate of Return = Growth Rate)

Projected Free Cash Flow for 2017 ($M): $ 1.18

Matrix Values ($M) g==v; r==>	4.00%	5.00%	6.00%	7.00%	8.00%	9.00%	10.00%
0.00%	$ 29.4	$ 23.5	$ 19.6	$ 16.8	$ 14.7	$ 13.0	$ 11.8
1.00%	$ 39.2	**$ 29.4**	**$ 23.5**	**$ 19.6**	**$ 16.8**	**$ 14.7**	$ 13.0
2.00%	$ 58.8	**$ 39.2**	**$ 29.4**	**$ 23.5**	**$ 19.6**	**$ 16.8**	$ 14.7
3.00%	$ 117.7	**$ 58.8**	**$ 39.2**	**$ 29.4**	**$ 23.5**	**$ 19.6**	$ 16.8
4.00%	--	$ 117.7	$ 58.8	$ 39.2	$ 29.4	$ 23.5	$ 19.6
5.00%	-$ 117.7	--	$ 117.7	$ 58.8	$ 39.2	$ 29.4	$ 23.5

Mean (Average)	**Median**	**Minimum**	**Maximum**
$ 26.9	**$ 23.5**	**$ 14.7**	**$ 58.8**

MARKET VALUE COMPARISON

VALUATION OF EDC

There are several viable financial corporations that can be used for comparison for valuing EDC. Currently, there are seven independent publicly listed insurance finance companies in Canada, twelve diversified financial firms, and the six large chartered banks all which could be used for comparison valuation purposes.

Initially, this valuation used several standard market valuation metrics, including Trailing Price-to-Earnings ratio and Forward Price-to-Earnings ratios (P/E); Price-to-Sales (P/S) ratio; Price-to-Book Value (P/BV); Enterprise Value-to-Revenue (EV/Rev), Enterprise Value-to- Earnings Before Interest, Depreciation and Amortization (EV/EBITDA), and Price-to-Operating and Price-to-Free Cash Flow (P/CF, P/FCF). However, some metrics had to be discarded due to insufficient information on either the comparator companies or EDC, or the inapplicability of the ratio to either the comparators or EDC, or negative or otherwise anomalous results. Four ratios were ultimately used: trailing P/E (price-to-earnings), forward P/E, P/S (price-to-sales) and P/BV (Price-to-Book Value). The corporation's estimated full taxed value could range from $6.1B to $16.3B, with a median value of $10B and a mean value of $10.6B.

Table 2

Market Comparison Based Valuation of EDC

Valuation metrics as applied to EDC (Market value of common equity)		Forward Trailing P/E Market Value to Net Icome	P/E (Market Value to Est. Net Icome)	Price to Sales	Price to Book
Average Seven Canadian Insurance Holding Co.	As Is (Fully Taxed)	$ 8.2	$ 8.3	$ 8.8	$ 15.6
Average Twelve Canadian Private Equity or Diversified Finance Companies	As Is (Fully Taxed)	$ 14.1	$ 9.5	$ 6.1	$ 112.2
Average Six Large Canadian Chartered Banks	As Is (Fully Taxed)	$ 10.0	$ 9.1	$ 6.3	$ 18.3
Average of Canadian Insurance and Diversified Finance Companies Averages	As Is (Fully Taxed)	$ 11.5	$ 9.2	$ 5.9	$ 14.7
Average of All the Above	As Is (Fully Taxed)	$ 10.8	$ 9.2	$ 6.1	$ 16.3

CONCLUSION

The decision on whether or not to keep or sell off all, most, or part of a Crown corporation is up to the citizens and taxpayers of the province, or, in this case, of all of Canada, usually via their elected representatives in the House of Commons.

When it comes to EDC, while it appears to fill a valuable role, it is clear that other institutions or companies would be able to serve in its place facilitating international trade and investment with Canadian companies. Canadian taxpayers should have cause for concern since EDC appears to be chronically unable to convert reported profits into actual cash and is papering over this deficiency by increasing its debt.

Whether or not EDC is divested, it will ultimately be the federal government and in turn the taxpayers who are on the hook for the insolvency of EDC. It is only logical that EDC take steps to make its assets more liquid and to ensure that it is able to convert revenues into actual cash.

The venture capital, 'VC', or private equity, 'PE', aspect of the company's operations cannot be the only reason that revenues and assets are not being turned into cash. Even in those realms, there are established ways of making such investment liquid, such as selling stakes to outside investors, selling entire client companies, receiving debt proceeds by securing loans from outside entities against the assets of the VC or PE clients. In some cases, initial public offerings in these companies can be issued, so EDC can raise necessary cash by selling to the public on a stock exchange. There may be already some, perhaps even many, of these liquidity events as they are called, but they are not translating into adequate turnover of receivables to generate cash.

When it comes to its letters of credit and other sorts of export financing, it becomes clear that a client is in good standing; i.e., that it is not only paying back EDC, but is receiving regular, dependable payments for its sales in foreign countries, it should be possible to offload the client, and the debt, to other financial entities at home or abroad. Perhaps this is already going on, but not with the speed it needs to for EDC to realize better cash flow.

EDC has a useful role in Canadian foreign investment and export sales. However, its current mode of operations puts all of Canada at risk in the event of a major disruption to foreign trade or investment, such as large regional wars, protectionism, financial volatility, or an outright severe recession.

It is far better that private investors take on such a risk. The government should initiate a plan to make EDC a more normal, commercial, cash profit-generating financial firm, and then optimize its operations further to make it appealing to either individuals in the public via an initial public offering, sale to institutional investors, shrewd corporate acquirers, or some combination of those. One possibility is that a consortium of large chartered banks or other Canadian financial firms invest in EDC for foreign exposure and market, product and geographic diversification that they might find attractive.

Whatever course is taken, EDC is not truly as profitable as it initially appears, and is a risk that may not be palatable in the future, however worthy its economic, political, or social mission may be purported to be. EDC could not really afford the $500M dividend paid to Ottawa in 2016.

APPENDIX 1:

RATIONALE FOR DIVESTITURE OR PRIVATIZATION

While it is up to the people through their elected representatives to decide if a Crown corporation or other government agency or entity should be sold or otherwise privatized and the proceeds used for the benefit of all citizens and taxpayers, there are some established reasons to embark on such a path, some or all of which are cited for divestiture of such enterprises but may not be applicable in any single, specific case.

1. The government has no mandate to own or run a commercial enterprise. The provision of citizens' safety, security and justice is the government's primary role, and its involvement in the economy should generally not extend beyond this.

2. Regulation can usually accomplish any public policy reason for direct involvement in an industry. If regulation is not easily feasible, then a direct contract or subsidy to any affected individuals, entity or entities may be more efficient or effective and less economically disruptive or costly.

3. If a government-controlled or sponsored enterprise has a monopoly position, near-monopoly, or effective monopoly in a line or lines of business or businesses, then opportunities are lost in one or more commercial or potentially commercial sectors for entrepreneurs and investors to try to create and grow businesses to enrich and sustain themselves, employees, suppliers, and others.

4. A monopoly, near-monopoly, or effective monopoly market position by a government-owned or sponsored entity could result in far higher prices for customers, the general public, or a section of the public, than would be the case in a fully competitive marketplace for the industry involved.

5. A government-owned or -sponsored enterprise may compete directly against private sector firms, which are owned by or employ citizens, or against individual citizens, all of whom the government is supposed to serve, not disadvantage.

6. The government-owned or -sponsored enterprise may compete unfairly against its private sector rivals in that it had or has access to lower-cost government-sourced and -guaranteed capital (debt). It may have a much larger debt component in its capital versus that which would be tolerated in the private sector. Thus, it may not have to meet high standards for profit and cost control, allowing it to offer lower than true free market-based competitive pricing.

7. Government-owned firms may not need to pay provincial or federal income taxes. This can allow such firms to supply goods or services more cheaply than the private sector companies they are competing with.

8. Government-owned or -sponsored enterprises may not have any kind of profit orientation or target, may be used as public policy vehicles and may be given preference in their activities or even in their transgressions, such as labour or environmental abuses.

9. Government-owned or -sponsored enterprises, by virtue of being public sector vehicles overseen by bureaucrats and politicians, may be places where favoured individuals find employment, particularly at management levels.

10. Since profit is a secondary goal of a government-owned or -sponsored enterprise, it is difficult to evaluate the effectiveness, efficiency or productivity of the enterprise or its employees. Consequently, these employees and assets may not be very productive or effective.

11. Government-owned or -sponsored enterprises are often creations of certain time-fixed circumstances and outlive whatever use or public policy role their creators may have conceived. Often, advances in technology; the modernization of transport, telecommunication or information technology; the evolution of the economy and available products and services and the increasing standard of living make these enterprises potentially obsolete. In the private sector, firms and individuals must adapt and evolve, or decline.

12. Government-owned or -sponsored enterprises perpetuate their possibly obsolete existences by virtue of the constituencies that build up around them: employees, managers, directors and bureaucrats, customers, suppliers and associated advocates or consultants. They can lobby to keep the enterprise going, despite dysfunction or losses. They are far more motivated to do so than are the taxpayers, whose average cost is much less per person and may be indirect, hidden or difficult to calculate.

13. Because they are not profit-oriented, government-owned or -sponsored enterprises are usually less efficient, and thus they lower the overall efficiency of the entire economy. This can make a whole nation less competitive than its global rivals are, whether nations or individual companies. The effects are worse the greater the government involvement in the economy. When taken to its most extreme, as happened in 20th-century communist nations, the countries were unable to compete against capitalist companies, despite their immense direct and indirect subsidies, government support and the lack of profit requirement.

14. Funds tied up in the capital of government-owned or -sponsored enterprises could be used to reduce government debt or lower taxes on individuals or corporations, which they could then spend or invest as they freely choose, and thus they could inject money back into the economy in more-lucrative and -constructive ways.

15. Governments, generally, have a poor record of picking winners, or creating or owning enterprises that have market-competitive profitability, or attractive returns on assets, equity, or even returns that exceed governments' own cost of debt service. If, rarely, they actually do, it generally turns out that they have been provided unusually good market, operational, regulatory, or other conditions not available to other, investor-owned firms.

16. The greater the number and size of government owned or government sponsored enterprises in an economy, the greater the size and power of the government, which is usually the largest single entity in society, increasing the dangers of abuse of power, including injuring individual citizens, companies, or groups. Effective capacity of opposition or recourse against this power diminishes as the portion of the economy the government occupies increases.

ENDNOTES

1. https://www.edc.ca/EN/About-Us/Disclosure/Pages/infosource-welcome.aspx.
2. *Ibid.*
3. https://www.edc.ca/EN/About-Us/Pages/default.aspx.
4. https://www.edc.ca/EN/About-Us/Disclosure/Pages/infosource-welcome.aspx.
5. *Ibid.*
6. http://www1.edc.ca/publications/2015/2014ar/en/13-2-7-1.shtml.
7. https://www.edc.ca/EN/About-Us/Pages/default.aspx.
8. *Ibid.*
9. *Ibid.*
10. https://www.edc.ca/EN/About-Us/Corporate-Reports/Documents/annual-report-e-2016.pdf.
11. Free cash flow is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. Free cash flow represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base.
12. Operating cash flow is the amount of cash a company generates from the revenues it brings in, excluding costs associated with long-term investment on capital items.

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