VALUATION SERIES

No. 7 / OCTOBER 2018

PUBLIC CHOICE ALTERNATIVES

Impossible to Soar With a Pension Deadweight

A VALUATION OF CANADA POST CORPORATION

BY IAN MADSEN

FRONTIER CENTRE FOR PUBLIC POLICY

Ideas that change your world / www.fcpp.org

IAN MADSEN

Ian Madsen, B.A. (Alberta), M.B.A. (Toronto), CFA, is a Senior Policy Analyst at the Frontier Centre for Public Policy. He has extensive experience in portfolio and financial analyses, managing investment portfolios, and managing investment research operations (including overseas). He lives in Surrey, B.C.

FRONTIER CENTRE
FOR PUBLIC POLICY

203-2727 Portage Avenue, Winnipeg, Manitoba Canada R3J 0R2
Tel: 204-957-1567
Email: newideas@fcpp.org

The Frontier Centre for Public Policy is an independent, non-profit organization that undertakes research and education in support of economic growth and social outcomes that will enhance the quality of life in our communities. Through a variety of publications and public forums, Frontier explores policy innovations required to make the prairie region a winner in the open economy. It also provides new insights into solving important issues facing our cities, towns and provinces. These include improving the performance of public expenditures in important areas such as local government, education, health and social policy. The author(s) of this study have worked independently and the opinions expressed are therefore their own, and do not necessarily reflect the opinions of the board of the Frontier Centre for Public Policy.

Valuation Series No. 7 • Date of First Issue: October 2018.

ISSN 1491-78

Ideas that change your world / www.fcpp.org

PUBLIC CHOICE ALTERNATIVES:

Impossible to Soar With a Pension Deadweight

A VALUATION OF CANADA POST CORPORATION

BY IAN MADSEN

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Canada Post Corporation (CPC) is a large nationwide provider of mail and parcel delivery services. It could be worth as much as $30B were it divested; or it could be worthless if unable to fully realize its illiquid assets into cash. Using comparable Canadian financial firms, the range is $10 – 11B. As a private business its valuation maybe substantially higher if it can turn its stated 'comprehensive income' into free cash flow. Its value on a fully taxable basis may be worth as much as $24 – 27B, if CPC would be organizationally optimized and re-jigged for cash generation.

INTRODUCTION

Canada Post Corporation, 'CPC', a Crown corporation owned entirely by the federal government of Canada, delivers regular mail such as cards, letters, magazines, bills and invoices; direct promotional and advertising material; and parcels and packages. It has a monopoly on delivery of traditional mail to residential, office, and other mailboxes. For several years now, it has been fully taxable, paying corporate income tax to the Federal and Ontario governments.

The company has made big strides since veering toward bankruptcy decades ago. E-commerce has given CPC a new lease on life. Package and parcel delivery are now growing briskly, even as ordinary traditional 'snail mail' continues to decline. Direct marketing mail continues to be an essential source of revenue.

For the purpose of a market valuation, several European postal services that have been sold off to investors or corporate acquirers were reviewed; Royal Mail is used in the market value comparison portion of this study.

Canada Post Corporation, A History

Canada Post Corporation (CPC) began as a predecessor company in the form of a government agency in 1763[1] as a weekly mail service in pre-independence Canada. From a few thousand addresses it is required to deliver to, CPC now serves 16.2M.[2] While the number of addresses goes up by hundreds of thousands every year, the number of pieces of letter mail per address declines, putting pressure on costs, particularly labour The labour unrest of the 1970's has largely ended, but left an unwelcome legacy.

In earlier years, the company accumulated a large, unfunded pension and other employee benefits liability which it continues to try to whittle down. This huge debt, actuarially estimated at $6.3B at the fiscal year end[3], December 31st, 2017, is a major weight on the company, and responsible for it having no book value or equity at this time. Whether or not CPC is divested or not, the federal government, and Canadian taxpayers, will have to reckon with it.

1. Canada Post Corporation. "2017 Annual Report". https://www.canadapost.ca/assets/pdf/aboutus/financialreports/2017_ar_overview_en.pdf, p 6.
2. *Ibid,* p 9.
3. *Ibid.,* p 63.

VALUATION FACTORS

The valuation of CPC is superficially straightforward. For several years, now, it has been paying federal and provincial income tax at roughly the statutory rates. It has not had any wild gyrations in revenues or costs in the past, and does not appear likely to have any in the near future, being a mature and relatively predictable and solid business.

However, the unfunded pension and other employee benefits liability cannot be ignored, and is incorporated in the valuation. Two versions of each valuation were performed: the first examining the company 'as is', the second making the assumption that this liability was removed and the special contribution by CPC to shrink the liability was also eliminated.

Version I Canada Post Corporation 'As is', i.e., with full Unfunded Pension and Other Employee Benefits Liability and Related Annual Special Cash Contribution to Reduce It.

INTRINSIC, DISCOUNTED FREE CASH FLOW VALUE OF CPC - VERSION I

Using the present value of projected future free cash flows, **the corporation's full taxed value** could range from $14.8B to $59.2B, with a median value of $14.8B and a mean value of $19.0B.

As the company is low growth, and has a huge unfunded liability, the lowest value is the most realistic and conservative.

Table 1

Intrinsic Value, Using Discounted Free Cash Flow Method

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 2018 ($B): $ 0.59

Matrix Values ($M) g==v; r==>	4.00%	5.00%	6.00%	7.00%	8.00%	9.00%	10.00%
0.00%	$ 14.79	$ 11.83	$ 9.86	$ 8.45	$ 7.39	$ 6.57	$ 5.92
1.00%	$ 19.72	$ 14.79	$ 11.83	$ 9.86	$ 8.45	$ 7.39	$ 6.57
2.00%	$ 29.58	**$ 19.72**	**$ 14.79**	**$ 11.83**	**$ 9.86**	**$ 8.45**	$ 7.39
3.00%	$ 59.15	**$ 29.58**	**$ 19.72**	**$ 14.79**	**$ 11.83**	**$ 9.86**	$ 8.45
4.00%	--	**$ 59.13**	**$ 29.58**	**$ 19.72**	**$ 14.79**	**$ 11.83**	$ 9.86
5.00%	-$ 59.15	--	$ 59.13	$ 29.58	$ 19.72	$ 14.79	$ 11.83
6.00%	-$ 29.58	-$ 59.15	$ --	$ 59.13	$ 29.58	$ 19.72	$ 14.79
7.00%	-$ 19.72	-$ 29.58	-$ 59.15	$ --	$ 59.13	$ 29.58	$ 19.72

	Minimum	Maximum	Median	Mean (Average)
Final Total(s)	**$ 8.45**	**$ 59.15**	**$ 14.79**	**$ 19.03**

MARKET VALUE COMPARISON VALUATION OF CPC - VERSION I

There are several viable comparison firms available for valuing CPC. There are three delivery companies listed in the United States, including Royal Mail of the United Kingdom. There are also three cargo and expeditor firms listed in Canada, and another six in the United States.

Several standard market valuation metrics were initially used, 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 Free Cash Flow (P/CF, P/FCF) (please consult the accompanying valuation spreadsheet file in Excel for details). The corporation's estimated full taxed value could range from $1.44B to $12.6B, with a median value of $3.99B and a mean value of $5.79B.

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. Five ratios were ultimately used: trailing P/E (price-to-earnings), forward P/E, P/S (price to sales), P/BV (Price to Book Value), and Price to Operating Cash Flow (P/CF). The results are in Table 2.

Table 2

Valuation of CPC Using Comparable Companies' Financial Ratios

Valuation metrics (five viable of an initial eight) applied to Canada Post; i.e., market value of common equity (Figures $B)	Forward Trailing P/E Market Value to Net Icome	Forward P/E (Market Value to Est. Net Icome)	Price to Sales	Enterprise Value/Revenue (subtracting net debt)	Price to Operating Cash Flow
Average Three US-listed Mail or Parcel Delivery Firms	$ 2.41	$ 1.36	$ 8.25	$ 3.36	$ 22.32
Average Three Canadian Expeditor or Cargo Delivery Firms	$ 3.29	$ 1.52	$ 10.78	$ 10.08	$ 7.17
Average Six US Expeditor or Cargo Delivery Firms	$ 2.78	$ 1.45	$ 7.57	$ 1.26	$ 9.58
Average of All the Above	$ 2.82	$ 1.44	$ 8.54	$ 3.99	$ 12.16
Comparable Companies Using Five Viable Financial Valuation Ratios:	Mean	Median	Minimum	Maximum	
Final Estimated Market Values	$ 5.79	$ 3.99	$ 1.44	$ 12.16	

INTRINSIC, DISCOUNTED FREE CASH FLOW VALUE OF CPC - VERSION II

Version II. Elimination of the Unfunded Pension and Other Employment Benefits Liability and annual payment to reduce it.

Using the present value of projected future free cash flows, the corporation's full taxed value could range from $8.58B to $60.1B, with a median value of $15.0B and a mean value of $19.32B. As the firm's future has a number of question marks, the lowest value is most realistic and conservative.

Interestingly, the effects on free cash flow are not substantial, so the final result shows little benefit to elimination of the unfunded liability of $6.3B and the annual cash drain to reduce it. However, this is a theoretical calculation of the value of the firm, and is limited by its nature.

Table 3

Intrinsic Value, Using Discounted Free Cash Flow Method

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 2018 ($B): $ 0.60

Matrix Values ($M) g==v; r==>	4.00%	5.00%	6.00%	7.00%	8.00%	9.00%	10.00%
0.00%	$ 15.01	$ 12.01	$ 10.01	$ 8.58	$ 7.51	$ 6.67	$ 6.01
1.00%	$ 20.02	$ 15.01	$ 12.01	$ 10.01	$ 8.58	$ 7.51	$ 6.67
2.00%	$ 30.03	**$ 20.02**	**$ 15.01**	**$ 12.01**	**$ 10.01**	**$ 8.58**	$ 7.51
3.00%	$ 60.06	**$ 30.03**	**$ 20.02**	**$ 15.01**	**$ 12.01**	**$ 10.01**	$ 8.58
4.00%	**--**	**$ 60.06**	**$ 30.03**	**$ 20.02**	**$ 15.01**	**$ 12.01**	$ 10.01
5.00%	-$ 60.06	--	$ 60.06	$ 30.03	$ 20.02	$ 15.01	$ 12.01
6.00%	-$ 30.03	-$ 60.06	$ --	$ 60.06	$ 30.03	$ 20.02	$ 15.01
7.00%	-$ 20.02	-$ 30.03	-$ 60.06	$ --	$ 60.06	$ 30.03	$ 20.02

Final Total(s)	**Minimum**	**Maximum**	**Median**	**Mean (Average)**
	$ 8.58	**$ 60.06**	**$ 15.01**	**$ 19.32**
Estimated Values in Version I; i.e., with current Unfunded Pension and other Benefits Liability	**$ 8.45**	**$ 59.15**	**$ 14.79**	**$ 19.03**
Difference; i.e., increase in Market Value from removing $ 6.29B in Unfunded Pension and other Benefits Liability	**$ 0.13**	**$ 0.91**	**$ 0.23**	**$ 0.29**
Net Benefit from Removal of Unfunded Pension and other Benefits Liability	**-$ 6.17**	**-$ 5.39**	**-$ 6.07**	**-$ 6.01**

MARKET VALUE COMPARISON VALUATION OF CPC - VERSION II

Elimination of the unfunded liability and the related annual cash contribution had a much more substantial effect on the estimated market value of Canada Post. It also made two more financial ratios viable for use in the valuation. Only Price to Free Cash Flow (P/FCF) could not be used. While the net benefit of eliminating the unfunded liability still appears to be negative, in real life its elimination could be quite positive. When a major financial, environmental, tax, or legal contingency hovers over a company or asset, it greatly reduces the number of parties interested in bidding on it, lengthens the time to when a deal could be closed, complicates the negotiations, as well as, of course, reducing the potential price the company or asset could realize without such a burden, and may even require an expensive indemnification of such a contingency for closure.

So, it is likely best for the federal government to assume the burden of CPC's unfunded liability before the sale of the company to realize the highest possible price to an acquirer, group of acquirers, or the general public in an initial public offering prior to listing on a stock exchange. This could be very politically difficult, but would make the launch of Canada Post into the private sector a successful one. It could be a hard sell if all or most of the liability remains on the company's books. As it is, as the owner of Canada Post at present, the federal government is ultimately responsible for this liability now; there should be no illusions about that.

Table 4

Market Value of Canada Post Using Twelve Comparable Companies' Metrics

Value metrics (Seven viable of an initial eight) applied to Canada Post; i.e., market value of common equity. Figures in $B.	Trailing P/E Market Value to Net Icome	Forward P/E (Market Value to Est. Net Icome)	Price to Sales	Price to Book Value	Enterprise Value/ Revenue (minus debt)	Enterprise Value/EBITDA (minus debt)	Price to Operating Cash Flow
Average Three US-Listed Mail or Parcel Delivery Firms	$ 2.41	$ 2.52	$ 8.25	$ 14.44	$ 9.66	$ 5.03	$ 22.32
Average Three Canadian Expeditor or Cargo Delivery Firms	$ 3.29	$ 2.82	$ 10.78	$ 2.24	$ 16.38	$ 4.91	$ 7.17
Average Six US-Expeditor or Cargo Delivery Firms	$ 2.78	$ 2.70	$ 7.57	$ 25.34	$ 7.56	$ 4.98	$ 9.59
Average of All Above	$ 2.82	$ 2.68	$ 8.54	$ 21.27	$ 10.29	$ 4.97	$ 12.16

Comparable Companies, Using Seven Viable Financial Valuation Ratios	Mean	Median	Minimum	Maximum
Final Estimated Market Values	$ 8.96	$ 8.54	$ 2.68	$ 21.27
Estimated Values in Version I; i.e., with current Unfunded Pension and other benefits burden	$ 6.79	$ 3.99	$ 1.44	$ 12.16
Difference; i.e., increase in market value from removing $ 6.30B in Unfunded Pension and other Benefits liability	$ 3.17	$ 4.55	$ 1.24	$ 9.11
Net Benefit from removal of Unfunded Pension and other Benefits liability	-$ 3.13	-$ 1.75	-$ 5.06	$ 2.81

CONCLUSION AND RECOMMENDATIONS

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.

Canada Post has had an impressive turnaround and is now a very propitious candidate for divestiture. It no longer has an essential service role, as nearly all important communications are now conducted electronically. It has only a notional difference in orientation and operation from delivery companies such as Federal Express and United Parcel Service.

As discussed earlier, the main problem in selling off the company, whether to a corporate acquirer, a consortium of institutional investors, private equity funds, or to individual investors via an initial public offering (IPO) on a stock exchange, is the massive unfunded pension and other unfunded benefit liability. While $6.3B is a big chunk of debt to swallow, the federal government should seriously consider taking it on to ensure that it can maximize the total proceeds of any divestiture of Canada Post.

As with any enterprise, there is a risk of serious operating losses and financial loss. These types of risks, and the risk of complete obsolescence, decline, and bankruptcy are best taken on by private investors who are prepared to assume such risks and are motivated to minimize or eliminate them. Risk of total loss for Canada Post is not out of the question, and it seems to make little sense for Canadian taxpayers to retain such a risk.

Since there is no compelling reason to retain Canada Post, it is recommended to be sold, with the proceeds used against any liability associated with the company that remains with the federal government, and the remainder to be used to offset the abundant federal budget deficits that are projected to last several years into the future.

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.

FRONTIER CENTRE
FOR PUBLIC POLICY