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PUBLIC CHOICE ALTERNATIVES

Hard Habits to Break

A VALUATION OF MANITOBA LIQUOR & LOTTERIES

BY IAN MADSEN

FRONTIER CENTRE FOR PUBLIC POLICY

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

Using an **intrinsic value method,** and discounting to the present, ML&L's projected future free cash flows, as the company is today, but taxed at statutory rates, the range of estimates is $12.13B to $84.91B, with a tighter range of a median (midpoint of the array of estimated values) of $21.23B to a mean (simple average of the array of estimated values) of $27.32B. Making allowances of bad debt of as much as 5 percent of outstanding loans, that is, by $1.55B, does not lower the estimated value of the company appreciably. Discounting for a bad-but-not-Great Depression-level of bad debt experience of 5 percent of the total loan portfolio, the range becomes a median of $20.20B to a mean of $25.99B. This version used adjustments to the free cash flow calculation which may not be fully reliable.

Under the **market-based valuation system,** the current, 'as is'—but now fully taxed-value ranges from $51B to $359B, with a median of $95B and a mean (average) of $136B. Only five valuation metrics were usable, and the averages were inflated by some anomalous comparison companies' metrics applied against financial numbers from FCC that could be more optimistic than warranted.

Again, making allowances of bad debt of as much as 5 percent of outstanding loans, that is, by $1.55B, does not lower the estimated value of the company appreciably. The minimum value is $49.53B, the maximum is an extremely unlikely $357.46B, and the tighter range goes from a median of $93.05B to a mean of a very doubtful $134.93B.

Intensive examination of the assets of ML&L, evaluation of its business practises and assets, and scrutiny of its accounting would be necessary for a much more precise valuation range for the company and that is beyond the scope of this study.

INTRODUCTION

Manitoba Liquor & Lotteries, A History

The earliest manifestation of ML&L was in 1878, when it allowed one drinking establishment per three hundred people. In 1916, all alcoholic beverages were outlawed, aside for medicinal purposes. Prohibition ended five years later. The Manitoba Liquor Control Commission was born in 1923 and held a monopoly on all alcoholic beverage sales and permits. It also kept track of every consumer's purchases by name, and limits on them were set, which continued until 1968. In 1928 beer parlours were allowed to be opened. By the 1960's most restrictions were lifted, but self-serve liquor stores did not open until 1970. Private wine stores were not permitted until 1994. In 2012 the first grocery store liquor outlets were permitted.[1]

The first casino opened under provincial authority in 1984, as did the Manitoba Lotteries Foundation. In 1991 video lottery terminals were introduced. VLT's and casinos expanded over the next several years. In 2014 all lottery and casino operations were amalgamated with liquor distribution and retail sales into what is now ML&L.[2]

1. *Winnipeg Free Press,* January 19th, 2013, "A brief history of booze in Manitoba", by Bartley Kives. See https://www.winnipegfreepress.com/opinion/fyi/Manitoba-liquor-regulation-over-the-past-143-years-187589291.html.

2 Manitoba Liquor & Lotteries website, Our History. See https://www.mbll.ca/content/history#35.

INTRINSIC VALUE: VALUATION OF ML&L AS A BUSINESS, USING DISCOUNTED FREE CASH FLOW

The intrinsic value model uses a perpetuity with a constant growth rate and constant cost of capital. This is appropriate for a stable company in a slow-growth, mature sector. For the intrinsic value of ML&L, projecting future cash flow growth, and bringing it to a net present value, a relatively conservative approach was taken which could undervalue the company (see Table 1). The company's free cash flow growth rate range was a restrained 2 to 4 percent, and the required rate of return or cost of capital range was from 5 to 9 percent. Projecting higher growth in the future could be reasonable, however alcoholic beverage production is a very mature industry, although gambling and cannabis are higher growth, but more uncertain.

ML&L's cost of capital, given low expectations and high current valuations in the stock market, could well be lower than the range used (and thus raise its estimated value), although there is also a chance that interest rates and the rate of return investors demand on equity (share) investment could increase.

The statutory tax rate used in calculations may be lower in the future, as there is continued global pressure to lower corporate tax rates, exemplified by the recent drop in US corporation income tax rates. The range of estimates is $5.9B to $41.0B, with a tighter range of a median (mid-point of the range of the array of estimates) of $10.25B to a mean (simple average of the array of estimates) of $13.2B.

Table 1

Intrinsic Value, Using Present Value of Discounted Future Cash Flows

Present Value of Discounted Free Cash Flow = Estimated Next Year Free Cash Flow (Required Rate of Return ['r'] = Growth Rate ['g'])

Projected Fully Taxed Free Cash Flow Estimate for FY2018 ($B): $ 0.41

Matrix Values ($B) g==v; r==>	4.00%	5.00%	6.00%	7.00%	8.00%	9.00%	10.00%
0.00%	$ 10.25	$ 8.20	$ 6.84	$ 5.86	$ 5.13	$ 4.56	$ 4.10
1.00%	$ 13.67	$ 10.25	$ 8.20	$ 6.84	$ 5.86	$ 5.13	$ 4.56
2.00%	$ 20.51	$ 13.67	$ 10.25	$ 8.20	$ 6.84	$ 5.86	$ 5.13
3.00%	$ 41.01	$ 20.51	$ 13.67	$ 10.25	$ 8.20	$ 6.84	$ 5.86
4.00%	--	$ 41.01	$ 20.51	$ 13.67	$ 10.25	$ 8.20	$ 6.84
5.00%	–$ 41.01	--	$ 41.01	$ 20.51	$ 13.67	$ 10.25	$ 8.20
6.00%	–$ 20.51	–$ 41.01	$ --	$ 41.01	$ 20.51	$ 13.67	$ 10.25
7.00%	–$ 13.67	–$ 20.51	–$ 41.01	$ --	$ 41.01	$ 20.51	$ 13.67

	Minimum	Maximum	Median	Mean (Average)
Total Market Value ($B)	$ 5.86	$ 41.01	$ 10.25	$ 13.20

Source: Author's calculations based on a model using summary versions in annual reports from the company.

MARKET-BASED VALUE: VALUATION OF ML&L USING STOCK MARKET AND FINANCIAL METRICS

As noted in the Executive Summary, the 'as is' current value of the company, but also being taxable, which it, as a Crown, is not currently, but as it would be should it be sold off, ranges from $1.5B to $97.2B, with a mean (simple average of the array of estimates) of $11.2B and a median (mid-point of the range of the array of estimates) of $20.2B. Only seven of the eight available valuation metrics were usable: Trailing and Forward Price to Earnings Ratio (P/E); Price to Sales (P/S), Enterprise Value/Revenue (EV/Rev), Enterprise Value to Earnings before Interest, Depreciation and Amortization (EV/EBITDA); and Price to Operating Cash Flow (P/CF). Please see the details of the model results in Table 2.

Table 2

Market Valuation Using Financial Metrics from Comparable Companies

Valuation metrics applied to ML&L; Figures in $B.	Trailing P/E (Market Value to Net Income)	Forward P/E (Market Value to Estimated Net Income)	Price to Sales	Enterprise Value/Revenue (subtracting net debt)	Enterprise Value/EBITDA (subtracting net debt)	Price to Operating Cash Flow
Average Two Canada Liquor Retail Companies		$ 35.40	$ 0.58	$ 0.26	$ 43.48	$ 12.59
Average Eight Canadian Specialty Retail Companies	$ 10.53	$ 8.36	$ 1.31	$ 1.21	$ 16.28	$ 110.50
Average Four Canadian Liquor Manufacturers or Gaming Companies	$ 14.49	$ 11.98	$ 3.18	$ 3.02	$ 22.11	$ 10.26
Average of All Above, Evenly Weighted by Company	$ 11.25	$ 11.28	$ 1.68	$ 1.54	$ 21.14	$ 74.87

Market Value Using Comparable Companies and Seven Viable Valuation Ratios:

	Minimum	Maximum	Median	Mean (Average)
Total Market Value ($B)	$ 1.54	$ 74.87	$ 20.29	$ 11.26

Source: Source: Capital IQ via Yahoo!Finance; additional material from BMO Investorline; valuation model formulas.
Note: Blank cells indicate either small sample, or negative, or very extreme result(s).

CONCLUSION

This study used detailed financial statements, but the trends in net income, capital expenditures and other adjustments on free cash flow made some estimates of future net income and free cash flow not fully reliable. A more thorough appraisal of assets, operations, business strategy, and rigorous examination of accounts prior to a proposed floating of ML&L shares on a stock market or before the company would be sold to private investors could and should determine a very different value for the company.

As far as is known, the proceeds of such a sale would go to the provincial government of Manitoba. Proceeds of at least $12B, and perhaps much more than that, could help lower, if only temporarily, the trajectory of escalating provincial debt. It is certain that there will always be retail liquor stores owned and operated by private investors. This is no longer a crucial sector, if it ever was, that has any obvious need to have a large government presence.

APPENDIX I:

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 case.

1. The government has no mandate to own or run a commercial enterprise. Libertarians, 'Classical Liberals' and free-market conservatives believe that 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. In some cases, government-owned entities are monopolies or effective monopolies, and use their market-dominating power to charge higher prices than would be the case in a fully competitive sector with several viable companies in intense rivalry to offer customers the best product or service at the best price.

12. 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.

13. 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.

14. 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.

15. 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 ways.

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 proportion of the economy the government occupies increases.

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