VALUATION SERIES

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PUBLIC CHOICE ALTERNATIVES

A Glimmer of Profits on the Rock

A VALUATION OF NEWFOUNDLAND AND LABRADOR LIQUOR CORPORATION

BY IAN MADSEN

FRONTIER CENTRE FOR PUBLIC POLICY

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EXECUTIVE SUMMARY

Newfoundland and Labrador Liquor Corporation, or NLC, is the monopoly Crown corporation which controls and retails all beverage alcohol in that province, aside from restaurants and bars, to which it wholesales. Using an **intrinsic value method,** and discounting to the present, NLC's projected future free cash flows, as the company is today, but taxed at statutory rates, the range of estimates is $1.8B to $12.8B, with a tighter range of a median (midpoint of the array of values) of $3.8B to a mean (simple average of the values) of $4.9B.

Under the **market-based valuation system,** the current, 'as is' – but now fully taxed-value. The range of estimates is $1.8B to $12.8B, with a tighter range of a median (midpoint of the array of values) of $3.2B to a mean (simple average) of $4.1B. Seven of eight available valuation metrics were usable. It needs to be emphasized that these values are all on the optimistic side, as the company has monopolistically high profit margins which may not be allowed to continue were the company to be divested.

INTRODUCTION

Newfoundland and Labrador Liquor Corporation, A History

Newfoundland and Labrador Liquor Corporation, or NLC, is the province's monopoly Crown corporation liquor, beer and wine retailer. It has 25 Liquor Stores and 4 satellite store locations. It also supplies 146 Liquor Express locations and 1,400 licensees.[1]

NLC has a division, Rock Spirits, which is a blending and bottling plant that employs over 45 people. It has developed various products, including the legendary 'Screech', and brands and sells them in the province, elsewhere in Canada, and in the United States. It also contract bottles for other companies.[2]

In 1915, the colonial legislature prohibited the sale of alcohol. Prohibition was formally ended in 1921, and restricted retail sales became legal. The antecedent to NLC, the Board of Liquor Control was established in 1924.[3] NLC as it is known today was founded in 1954, and took its present corporate form in 1973.[4] NLC will be the purveyor of cannabis products for the province.

1. See http://www.nlliquor.com/corporate/about-nlc/~/media/Files/PDF/Corporate/AnnualReports/NLC%20Annual%20Report%202018.ashx, p 6.

2. See http://www.nlliquor.com/corporate/about-nlc/~/media/Files/PDF/Corporate/AnnualReports/NLC%20Annual%20Report%202018.ashx, p 7.

3. See https://journals.lib.unb.ca/index.php/nflds/article/view/21238/24544, para. 1.

4. See https://www.google.com/search?ei=95sdXLj3DeTS0gKjwrYo&q=newfoundland+liquor+corporation+founding&oq=newfoundland+liquor+corporation+founding&gs_l=psy-ab.3.33i160.8034.12799.13421.0.0..0.146.1535.17j3.0.1.gws-wiz.0j0i71j0i22i30j33i21.socos4twtSY.

INTRINSIC VALUE, VALUATION OF NLC 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 crudely but generally appropriate for a stable company in a slow-growth, mature sector. For the intrinsic value of NLC, 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).

Each constituent (eg., revenue, cost of goods sold, interest expense, depreciation and amortization, administrative and sales expense) determining the final free cash flow was projected independently. The company's free cash flow growth rate range was held to a restrained 2 to 4 percent, and the required rate of return or cost of capital range was from 5 to 8 percent. Projecting higher growth in the future could be reasonable, however alcoholic beverage production and sales is a very mature industry, although gambling and cannabis are higher growth, but more uncertain. NLC'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 $1.8B to $12.8B, with a tighter range of a median (midpoint of the array of values) of $3.2B to a mean (simple average) of $4.1B. However, these calculations are based on the current high gross margins enabled by the company's monopoly status and interprovincial trade barriers, which may not be extended indefinitely, particularly if the company were to be divested and cease being a cash cow.

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 ($M): $ 128.18

Matrix Values ($M) g==v; r==>	4.00%	5.00%	6.00%	7.00%	8.00%	9.00%	10.00%
0.00%	$ 3,204	$ 2,564	$ 2,136	$ 1,831	$ 1,602	$ 1,424	$ 1,282
1.00%	$ 4,273	$ 3,204	$ 2,564	$ 2,136	$ 1,831	$ 1,602	$ 1,424
2.00%	$ 6,409	**$** 4,273	**$** 3,204	**$** 2,564	**$** 2,136	**$** 1,831	$ 1,602
3.00%	$ 12,818	**$** 6,409	**$** 4,273	**$** 3,204	**$** 2,564	**$** 2,136	$ 1,831
4.00%	--	**$** 12,818	**$** 6,409	**$** 4,273	**$** 3,204	**$** 2,564	$ 2,136
5.00%	–$ 12,818	--	$ 12,818	$ 6,409	$ 4,273	$ 3,204	$ 2,564
6.00%	–$ 6,409	–$ 12,818	$ --	$ 12,818	$ 6,409	$ 4,273	$ 3,204
7.00%	–$ 4,273	–$ 6,409	–$ 12,818	$ --	$ 12,818	$ 6,409	$ 4,273

	Minimum	Maximum	Median	Mean (Average)
Total Market Value ($M)	$ 1,831	$ 12,818	$ 3,204	$ 4,124

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

Note: The discount rate, or required rate of return, 'r', is the cost of capital for the investor. The growth rate is ina range that is commensurate with a slower growth, mature business.

MARKET-BASED VALUE: VALUATION OF NLC USING STOCK MARKET AND FINANCIAL METRICS

As noted in the Executive Summary, the 'as is' current value of the company, but rendered fully taxable, which it, as a Crown, is not currently, but as it would be, should it be sold off, ranges from $192M to $4.25B, with a mean (simple average) of $1.63B and a median (midpoint of the array of values) of $1.61B. That the median and mean are very close does not mean that there is any great precision or authoritativeness of the determination of these estimates. Seven of eight possible valuation metrics (Trailing and Forward Price to Earnings, 'P/E'; Price to Sales, 'P/S'; Price to Book Value, 'P/BV'; Enterprise Value to Revenue, 'EV/Rev'; Enterprise Value to Earnings Before Interest, Taxes and Depreciation and Amortization, 'EV/EBITDA'; and Price to Free Cash Flow, 'P/FCF') were usable. To repeat, the value that could be realized from divestment of NLC could be considerably less than these projections, which are based on the current high gross margins enabled by the company's monopoly status and interprovincial trade barriers, which may not be extended indefinitely. Please see the details of the models' results in Table 2.

Table 2

Market Valuation Using Financial Metrics from Comparable Companies

Valuation metrics applied to NLC; Figures in $M.	Trailing P/E (Market Value to Estimated Net Income)	Forward P/E (Market Value to Estimated Net Income)	Price to Sales	Price to Book Value	Enterprise Value/Revenue (subtracting net debt)	Enterprise Value/EBITDA (subtracting net debt)	Price to Free Cash Flow
Average Two Canadian Liquor Retail Cos.	$	$ 7,066	$ 106	$ 594	$ 130	$ 8,667	
Average Eight Canadian Specialty Retail Cos.	$ 2,232	$ 1,669	$ 258	$ 112	$ 316	$ 3,294	$ 2,329
Average Four Canadian Liquor Manufacturers or Gaming Companies	$ 2,385	$ 2,251	$ 332	$ 192	$ 383	$ 4,254	$ 394
Average of All Above, Evenly Weighted by Company	$ 2,385	$ 2,251	$ 332	$ 192	$ 383	$ 4,254	$ 1,610

Market Value Using Comparable Companies and Seven Viable Valuation Ratios

	Minimum	Maximum	Median	Mean (Average)
Total Market Value ($M)	$ 192	$ 1,818	$ 1,629	$ 1,610

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

CONCLUSION

This study used detailed historical financial statements, but the trends in net income, costs and capital expenditures may not be fully and reliably extrapolated. A more thorough appraisal prior to a proposed floating of NLC 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 Newfoundland and Labrador. However, as it is likely that the statutory monopoly NLC currently enjoys would be ended, its future value may be less than forecast.

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.