Canadian-owned firms are profoundly influenced by the Canadian capital markets' narrow definition of **'risky behaviour,'** and the unfortunate result is a dearth of globally-competitive Canadian companies.

Underestimating the Risk of the {Status Quo}

By Roger Martin

History shows that the general view held by the Canadian capital markets is that it is risky for Canadian firms to take steps to grow aggressively abroad, which implies that it is safer for these firms to stay in Canada. I would argue that exactly the opposite is true, and that capital markets participants – institutional and retail investors, equity analysts, investment managers, and rating agencies – need to develop a more productive understanding of risk in order for Canada to prosper in a globalizing world.

For most Canadian firms, sitting at home in Canada and taking only minimal steps towards internationalization is one of the riskiest things they can do, and it will result in their eventual demise. While going abroad is also risky, it must be compared rigorously to the risk of staying at home to put the relative risks in productive context. I do not believe that the Canadian capital markets community makes this critical comparison, and as a result, it inadvertently discourages Canadian firms from going abroad and becoming genuinely global. The end result is starkly evident if we look at the statistics: Canada produces far-too-few globally competitive companies for its own long-term health.

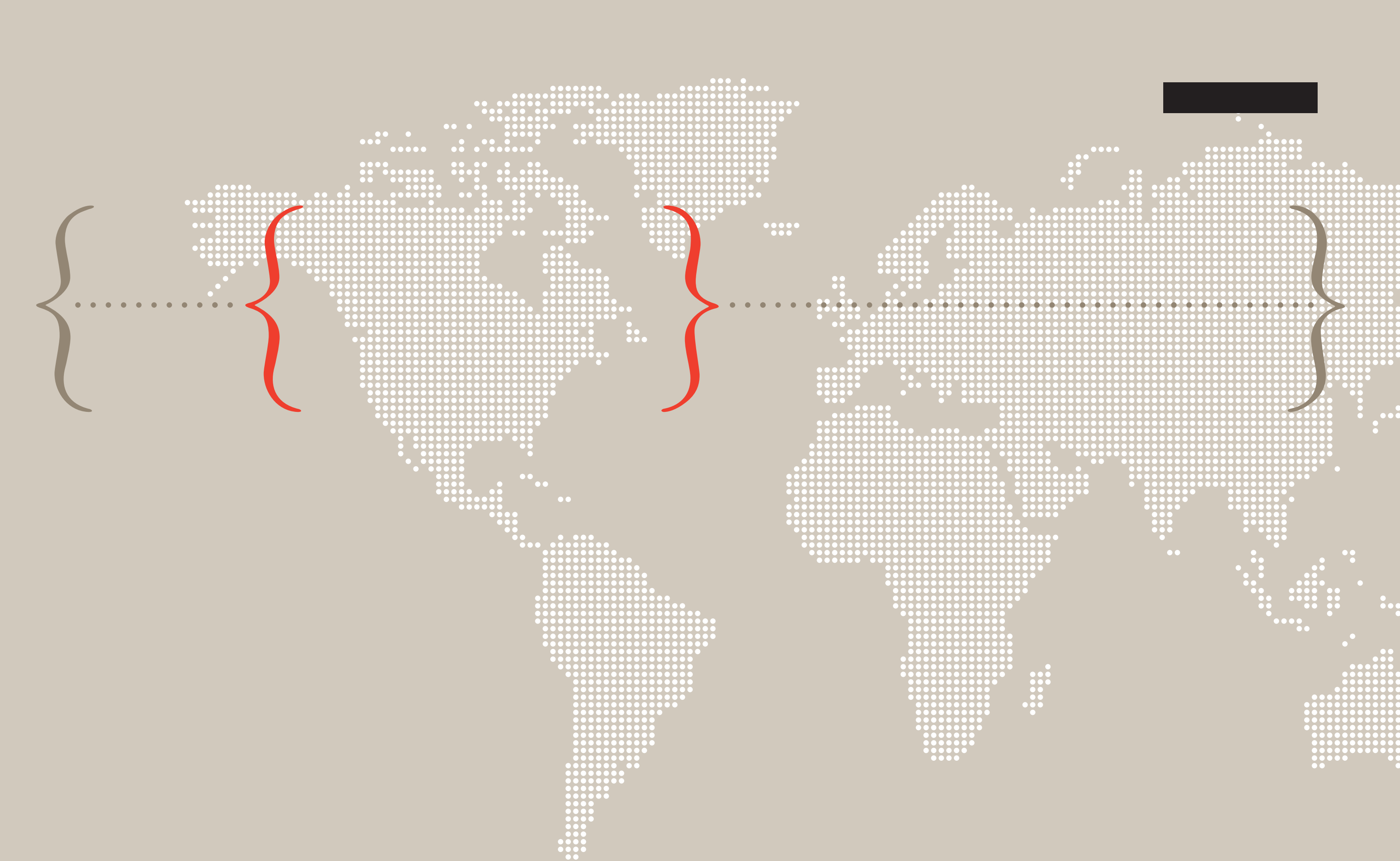
Exhibit A: Thomson and West Publishing

Thomson Corporation is one of 72 Canadian companies that has achieved status as one of the top five in global sales in its industry worldwide. In fact, Thomson makes this list easily: by the measures of most observers, it is #1 in the world in information services provision across sectors such as finance, science, health care, legal and regulatory.

As a member of the Thomson board, I can disclose that not a board meeting goes by where my fellow board members and I don't thank our lucky stars for the fortitude of the leadership in place at Thomson in 1996. That was the year that Thomson spent what was viewed as a whopping US$3.4 billion to buy privately-owned **West Publishing**, then the leading information services provider in the legal and regulatory space. Today, the legal and regulatory business is the most profitable business in the entire Thomson portfolio, the one that contributes the most to its market capitalization, and the one that has propelled the company from a significant player in the information services business to the biggest, and what many consider the best, in the world.

So the decision to buy West Publishing must have been a no-brainer, right?

Wrong. At the time, Thomson faced withering criticism for the purchase, which was considered 'too risky' on a variety of dimensions. The price was considered "a stunner" (*The Globe and Mail*, February 27, 1996) and the win in the bidding war for West "a pricey victory" (*The Financial Post*, February 27, 1996). In the words of one reporter: "it reaffirms that Thomson will pay just about anything for an information business" (*Media Daily*, February 26, 1996.)



Given the reaction it received, it's not surprising that the company's stock price fell on the announcement, and two rating agencies immediately downgraded Thomson. If the company had held a referendum among outside shareholders on whether to follow through with the deal or cancel it, I suspect it would have been voted down. Fortunately for those shareholders, Thomson was led by the late-great **Ken Thomson**, whose managerial hallmark was long-term vision, and the transaction was completed over the howls of protest from the Canadian capital markets.

Eleven years later, it would be inconceivable for Thomson to consider parting with the West franchise, even at a huge multiple of the "pricey" and "stunning" purchase price. Thomson's market capitalization of $11.6 billion the day after the announcement has almost tripled to $31.7 billion in the intervening period, and a meaningful chunk of that increase is attributable to leveraging the West franchise.

Unfortunately, this is anything but an isolated case for Canadian firms taking steps toward global competitiveness. Similar examples abound. When **Toronto Dominion Bank** bought **Waterhouse** in 1996 to become a top three player in discount brokerage, TD was seen as risking its strong and successful Canadian discount brokerage business with a reckless acquisition. Likewise, when **Nortel** bought **Bay Networks** in 1998 to participate in the emerging data transmission/router business, it was considered a risky 'bet-the-company' move; and when smaller **Premdor** bought the larger **Masonite International** business from **International Paper** in 2000 to leapfrog into global leadership in the door manufacturing business, it was frowned upon by the capital markets. The same held true for **Weston Food's** purchase of **Best Foods** bakery business in 2001 and **Couche-Tard's** transformational purchase of **Circle K** in 2003. Even **Dominic D'Alessandro's** master stroke purchase of **John Hancock** by **Manulife** in 2003 – which has resulted in Canada owning one of the top five life insurers in the world – was the subject of much criticism.

Even internal developments to build global capability have been viewed askance. When **Bombardier** made the decision to develop the Regional Jet in 1992 – a decision that propelled the company into the global elite of aerospace firms – the dominant capital market view was that this was riskier than sticking to the production of Dash turboprops.

Of course, all of the moves described here were risky in a variety of ways. Big acquisitions and new product introductions are, by definition, risky. And there are plenty of stories of Canadian companies going 'a bridge too far' with big foreign acquisitions. Interestingly, a majority are in a single sector: retail. But that is a subject for another day.

The question is this: why have the Canadian capital markets frowned so unanimously on the above-mentioned deals, each of

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which was critical to the emergence of a Canadian firm as a global player?

It is not necessarily because the Canadian capital markets *over*-estimate the risk of new ventures. Rather, I believe that they *under*estimate the risk of the status quo. Through careful analysis, they estimate the acquisition/new venture's integration risks, the risks of not understanding the new market, the risk of increased leverage, and so on. Inevitably, their net assessment is that the new initiative in question represents little more than risk on top of risk.

In the West acquisition by Thomson, observers were quick to enumerate the associated risks: there was the risk of the value of West's product falling due to the potential emergence of free Internet access to court records; the risk of handling the increased debt load; the risk of the transaction being challenged and disallowed by U.S. antitrust regulators; and the risk produced by the cultural differences between Thomson and West. The problem is that such assessments only address one side of the coin.

In general, the risk associated with a new investment is considered a net incremental addition to the basic risk level of the company, and the incremental addition of risk is considered a net negative. Hence the immediate drop in stock price for most of the above examples at the time of the announcement. The implicit assumption is that the risk of doing nothing – of continuing the status quo – is low and stable. The logic seems to be that, "since we are already doing what we are doing, it can't be terribly risky." This, unfortunately, is a very flawed assumption.

In the case of Thomson, the risk of not making the West acquisition was that of being left behind in the global race to become a scale player in the information services business. While it is conceivable that Thomson could have kept up with global rivals such as **McGraw Hill**, **Reed Elsevier** and **Wolters Kluwer** without this acquisition, 'keeping up' was yet another source of risk – at least as significant as the combined integration, regulatory, cultural and financial risks involved in buying West.

A Common Ailment

A rampant underestimation of the perils of the status quo is something I have observed consistently over a career of attempting to foster change and innovation as a strategist. I have often been hired by management teams that were sufficiently unhappy with the status quo to want to consider options for change. I would work dutifully with them to come up with alternative options to the status quo. We would then 'reverse-engineer' each new alternative to determine what would have to be true for each alternative to be an attractive option. What would have to be true about the customers, the market, the competitors, the cost structure, etc.? For example, if one option was to significantly broaden the firm's product line, we would have to believe, amongst other things, that 1) customers would welcome and reward a broader line, 2) the distribution channel would be willing to carry a broader line, and that 3) we could manufacture a broader line without our costs getting out of line with those of our competitors.

Out of this list of important elements that would have to hold true for the option to be sound, we would identify the biggest risks – i.e. the things that we were *least* certain would hold true. In this case, perhaps the most worrisome condition was that we would have to be able to produce a broader product line without our costs getting out of line due to the added complexity. I would then work with the team to analyze and model the condition of greatest concern to attempt to mitigate the risk associated with it. For example, how could we change our fundamental approach to manufacturing to deal cost-effectively with a broader product line?

In the end, there were always risks associated with the proposed new options that could not be mitigated or wished away. The resulting phenomenon – which I saw repeated over and over – was that, having spent an intense amount of effort on understanding and 'marinating' in the risks of the proposed new initiatives, the management team would come to view all of the options for change as "too risky." They would choose to stick with the status quo – despite the fact that the point of the entire exercise had been to improve from the unsatisfactory status quo.

What I came to believe is that the only way to help management teams consider the risk of alternative options in the proper context was to insist that they take a *further* step and also reverse-engineer the status quo. That is, determine what had to be true for the current strategy to be a sound option.

When management teams reverse-engineered the status quo, they typically found it to be far from the risk-free scenario they had imagined. Rather, it was embedded with risks that were of similar or greater intensity to the risks of the alternative options. What happened next was interesting: many management teams would actually dismiss the status quo as "too risky" an option to consider. But this would only happen if they performed the reverse-engineering exercise, specifying what had to be true for the status quo to be optimal, and asking themselves whether those features were certain to be true.

I would argue that Canadian capital markets participants need to engage in this very exercise whenever a company proposes making a major investment aimed at transforming it from a largely Canadian company to a Canadian-based global company: they need to assess not only the risks of the new initiative itself, but also those of the status quo, and they need to do this with the same thoroughness, using the same standards.

What they will find, I predict, is that the status quo is much riskier than they – largely by neglect – ever imagined. By remaining national instead of going global, the company in question invites other competitors in the global arena to take the lead in building global scale and reaping the cost and quality advantages that global scale enables. The risk of irrelevance and either eventual takeover or destruction by global players is high.

In far too many sectors – automotive, branded pharmaceuticals, beverages, consumer packaged goods, consumer electronics, to name a few – there are currently no Canadian companies of consequence. All have either been bought or blown out of their markets by competitors who had their eyes set on the global market. And even more sectors would have already been banished from the small list of winners were it not for regulatory protection.

The bottom line is that the risk of turning a blind eye to global competition is not systematically lower than the risk of going global: they are just different forms of risk. Would **Loblaws** have been better served by an aggressive international growth strategy instead of focusing on defending its Canadian fortress against **Wal-Mart**? If **Falconbridge** or **Inco** had moved sooner to expand internationally, would they have been immune from foreign takeover? In hindsight, the answers seem clear.

While the capital markets may be satisfied with the acquisition of a Canadian company by a global player and the one-time benefit investors receive from the acquirer paying a control premium for the takeover, the biggest payoff to investors lies in the building of a global company. Eschewing the risk of globalization simultaneously sacrifices the upside that comes with global consequence. The returns to investors of Manulife going from a substantially Canadian company to a global leader were huge – as has been the case for **Magna**, **Gildan**, Couche-Tard and Thomson.

The payoff for pursuing an aggressive strategy to be a player of international consequence is well illustrated by **Canadian National Railway**. When it emerged from the cloistered life of a Crown Corporation with its privatization in 1995, it embarked on an aggressive strategy to become a leading North American player. It benchmarked its costs against its major non-Canadian competitors and sought cost competitiveness, recognizing that in a free-trade world, its century-old east-west network had to be expanded aggressively to become north-south. This was accomplished via a series of U.S. acquisitions, and within a decade, its strategy for international competitiveness made it the fifth-largest railway in North America and the third largest by market

The Myth of Canada's 'Hollowing-Out' by James Milway

Much has been written of late about the 'hollowing out' of corporate Canada. The rhetoric on the issue bypasses the question of whether corporate Canada actually is being hollowed out to get on to the more enjoyable topics of how bad the hollowing out is for Canada, and what we could do about it.

At the **Institute for Competitiveness and Prosperity**, we decided to check on whether Canada was actually being hollowed out before we joined the discussion of what to do about this supposed problem.

While there is no doubt that Canadian-owned companies are being acquired by foreign firms, that is not tantamount to hollowing out. It is arguable that our most important companies are our Canadian-owned globally competitive companies. We define these as Canadian firms that rank in the top five of their industries worldwide in revenues earned in their industry globally. We did the research, and found that Canada had 72 such firms at the end of 2006 (see **Figure 1** on p.8.).

The hollowing-out argument would hold that we have many fewer such firms than we used to because we are being systematically 'hollowed out'. To test that premise, we looked at the situation in 1985 to determine whether we had many more globally-competitive firms, and we found that the opposite is in fact true: we had fewer than half of the global leaders we have today – only 33. And those firms were, on average, smaller in revenues, even measured in constant dollars. The truth is, we are not being hollowed out at all: we are growing globally-competitive firms faster than we are losing them.

Having said that, in the past several years, a number of Canadian-owned firms have been acquired by foreign firms, including **ATI**, **Falconbridge**, **Inco**, **Intrawest**, **Masonite** and **Zenon Environmental**. The fact is that in the rough-and-tumble world of global business, good Canadian global firms will be acquired by even-bigger global players. What we need to do is make sure that we are producing just as many new globally – competitive firms, as quickly as possible.

The rethoric of 'hollowing out' directs the argument to the wrong place – to the protection of existing Canadian firms. The issue is the growth of new Canadian firms whose sights are set from the inception on the global market; firms like **Research in Motion**, **Cognos** and **Husky Injection Molding**. Accelerating the production of globally-competitive Canadian companies should be our prime focus, rather than the protection of the existing ones. We should be pleased with our progress in the past two decades, but must avoid complacency. I think we can all agree that Canada can never have too many global leaders.

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capitalization. In fact, it would have become the biggest had its proposed merger with second-biggest **BNSF** been allowed by the protectionist U.S. transportation authorities.

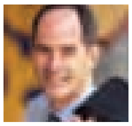
Canadian Pacific Railway faced the same opportunities, minus the added challenge of transforming itself from a government-owned entity. While it has expanded its network to take into account the North American realities and has become the sixth-largest railway on the continent, its network is a step-function below the third, fourth and fifth players in size, at about 70 per cent of the size of Canadian National's. Its profit margin is only half that of CN's, because it has not aimed as high in cost effectiveness. As a consequence, CN's market capitalization stands at over US$24 billion, while CP's is under US$9 billion. Canadian capital market participants were obviously better served by Canadian National's goal of global significance than by Canadian Pacific's 'less-risky' approach.

In closing

It's been said that the only certainties in life are death and taxes, and to that I would add that the only certainty in modern business is that there is no escape from risk. The key is to recognize that the risks of globalizing vs. those of 'staying at home' are two sides of the same coin: both entail risks that must be carefully considered.

It is exceedingly unhelpful to Canadian firms for the capital markets to fixate on the risks of globalizing while largely ignoring the risks of staying at home. In doing so, they avoid the consequences of failed efforts to globalize, while at the same time eliminating much of the upside that they could also enjoy through the successful globalization of Canadian firms. In discouraging such globalization, they are inadvertently threatening Canada's long-term prosperity in our increasingly interconnected world.

It is high time for Canada's capital markets to take a closer look at the other side of the risk 'coin' and bring more balance to their assessment of risk. When Canadian firms are insightful and courageous enough to go to bat on the global stage, it's the very least that they can do. ***R***



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Canada's 72 Global Leaders Today — Figure 1

Abitibi Consolidated Inc.	Magellan Aerospace Corp.
Agrium Inc.	Magna International Inc.
Alcan Inc.	Major Drilling Group International
Ashton-Potter	Manulife Financial
ATCO Group	Marsulex Inc.
Automation Tooling Systems	McCain Foods Ltd.
Axcan Pharma Inc.	MDS Inc.
Barrick Gold Corp.	Methanex Corp.
Bombardier Inc.	Mitel
CAE	North American Fur Auctions
Cameco Corp.	Nortel
Canam Steel	NOVA Chemicals Corp.
Canfor Corp.	Open Text Corp.
CCL Industries Inc.	Patheon Inc.
Celestica	Peerless Clothing Inc.
CHC Helicopter Corp.	Potash Corp.
Chemtrade Logistics	Quebecor World
CGI Group Inc.	Research in Motion Ltd.
Cinra	Ritchie Bros. Auctioneers
Canadian National Railways	Scotia Mocatta
Connors Bros. Income Fund	ShawCor Ltd.
Coolbrands International	Sierra Wireless
Cott Corp.	SNC-Lavalin
Couche-Tard	Spectra Premium Industries
DALSA Corp.	Sun Gro Horticulture
Finning International	TD Waterhouse/Ameritrade
Fording Canadian Coal Trust	Teck Cominco Ltd.
Four Seasons Hotels and Resorts	Tembec Inc.
Gildan Activewear Inc.	Thomson Corp.
Harlequin Enterprises Inc.	Timminco Ltd.
Husky Injection Molding	TLCVision
IMA Exploration Inc.	Tree Island Industries
Jim Pattison Group	Trimac Group
Linamar Corp.	Wescast Industries Inc.
MAAX Holdings Inc.	Weston Foods
MacDonald Dettwiler Corp.	Zarlink Semiconductor Inc.

Canadian Global Leaders in 1985 — Figure 2

Abitibi-Price	Laidlaw
Alcan	Lumonics
AMCA	McCain Foods Ltd.
Asbestos Corporation Ltd.	Mitel
Atco Ltd.	Moore Corporation Ltd.
Bombardier	National Business Systems
Canada Malting	Northern Telecom
CCL Industries	Scott's Hospitality
Falconbridge	Seagram Co.
Finning International	SNC
Geac Computer Corp.	Teck Cominco Ltd.
Harlequin	Tembec
Hiram Walker	Thomson Travel
HBC Fur Auction (now N. American Fur Auctions)	Timminco
Inco	Trimac
	Trizec
	Unican Security Systems