

DPA law updated version

SECRET

PURCHASE OR SALE OF IMASCO SHARES

General

Canadian trust and loan companies legislation may significantly restrict the Group's ability to buy or sell Imasco shares. Assuming that the necessary consents can be obtained the following possibilities have been examined.

1. The sale of the whole of the Group's Imasco holding would have a severe effect on Group published profits and the resource generated would be limited by the substantial tax burden on disposing of the Westanley holding.
2. The sale of the BATUS Imasco holding would not significantly reduce Group profits and create resource in the US. (The tax problems on the sale of the Westanley shares ~~do~~ not arise and in fact a sale of the BATUS shares would solve the problem of tax on the Imasco dividends.)
3. *former* Increasing the Group holding in Imasco to just over 50% is affordable *without* and would substantially increase pre and post tax profits. The attributable profit effect is small.
4. Increasing the Group holding to 100% would only be affordable if the Trustco divestment is accelerated and other disposals are carried out.

The discussions of these ^{not detailed} options are in general terms. If it is decided to develop them further work will be necessary. In particular the location of a holding company to acquire further shares in Imasco deserves careful study in the light of the adverse effect of US tax reform on dividend receipts from Canada and the very low UK tax relief on acquisition interest. If as a result of these preliminary findings it is decided to pursue the option to acquire 100% of Imasco much more time will need to be devoted to quantifying the effect of ~~expenses~~ *processes from the sale of non strategic businesses.*

Trust and Loan Companies Legislation

Because of the Imasco ownership of Canada Trustco the Group dealings in Imasco shares may be restricted. Mr Crawford believed that under the then Loan Companies Act Imasco would have been unable to purchase Genstar if BAT had owned more than 50% of Imasco.

I understand that under the existing legislation the position is obscure but has been clarified in the latest draft of the Trust and Loan Companies Act.

1. If BAT should decide to sell Imasco shares, ministerial approval will be required to sell more than a 10% holding in Imasco to a *single* purchaser.
2. If BAT should decide to buy shares in Imasco, ministerial approval will be required if the purchase increases the BAT holding in Imasco. Participation in rights issues are thus presumably possible without ministerial authority, but permission would be required were BAT to seek an increase in holding over 40%.

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It is not possible to say what the ministerial attitude would be to any proposal put forward by BAT. However it may be appropriate to note that the ownership of trust and loan companies is currently a sensitive issue in Canada. Both opposition parties and the influential finance committee of the Canadian House of Commons favour a 10% limitation of ownership of these companies and Imasco regards itself as fortunate in being able to keep a 65% interest in Trustco. It may be that the only way an overseas company could acquire a controlling interest in Imasco would be with the support of Imasco. (Imasco's lobbying was successful in enabling Imasco to keep 65% of Trustco.)

Disposal of all the Group Imasco Shares

The current Imasco share price (4 February 1988) is C\$25.125 so that BAT's total holding would be valued at C\$1211 million or £541 million at C\$2.24 to the £. However a substantial capital gains tax liability would arise in Westanley which at at 35% rate amounts to £115 million, leaving net proceeds of £426 million. (There may be a small tax loss on the sale of the BATUS shares which could be used against capital profits elsewhere, but this has been ignored in arriving at net proceeds.)

Because of the Genstar acquisition the Group share of the net tangible equity of Imasco at 31.12.87 is only estimated at C\$90 million or £40 million so that a surplus on disposal of some £386 million will arise. The effect on the Group debt/equity ratio would be as follows at 31.12.88:-

	Plan £ million	Sale of Imasco Shares	Adjusted
Gross debt	1427	-426	1001
Shareholders funds	4943	+386	5329
Debt/equity ratio	28.9%		18.8%

The total resource generated by the sale would be about £620 million (£426 million cash and borrowing capacity of £200 million assuming a debt/equity ratio of ~~22%~~ ^{27%} of the increased Group equity.)

Investment of the £426 million at - say - ten percent interest will produce £43 million pre-tax. It is difficult to say what the tax rate on this income would be, but even assuming 7%, the Group's published profit would be severely impacted. In the table below no account has been taken of the withholding tax and US income tax on the Imasco dividends, which *currently reduces the Group's income*

	Imasco 1988 budget @ £=2.24 £ millions	Income on disposal proceeds £ millions	Shortfall
Pre-tax profit	107	43	64
Taxation	(34)	(3)	(31)
After tax profit	73	40	33
Minority interest	(11)	-	(11)
	<u>62</u>	<u>40</u>	<u>22</u>

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improvement

From an annual cash flow perspective the Group share of the Imasco 1988 dividends forgone before withholding tax is £22 million so the sale of the Imasco shares would ~~impose~~ *improve* Group cash flow in the short term. The precise amount of the improvement would depend on the actual tax paid on the income earned on the disposal proceeds and to a lesser extent the UK and US tax on the Imasco dividends that would no longer be payable ~~received~~. *after tax*

It may be that higher proceeds than market price could be obtained if all the Imasco shares were sold to a single purchaser that would be in a favourable position to gain control of Imasco. The amount of any premium may, however, be small because of the difficulties stemming from the Canadian trust and loan companies legislation.

Disposal of the BATUS investment in Imasco, but not Westanley

BATUS has 12.26 million common shares in Imasco which would produce C\$308 million or £138 million at a price of C\$25.125 each with a tax advantage rather than a tax liability. This would result in a surplus on disposal of £128 million. Assuming the proceeds can be offset against debt, the Group debt/equity ratio compares as follows:-

at 31.12.98 will be affected

	Plan £ million	Sale of Imasco Shares	Adjusted
Gross debt	1427	-138	1289
Shareholders funds	4943	+128	5071
Debt/equity ratio	28.9%		25.4%

The total resource generated by the sale would be about £200 million (£138 million plus a borrowing capacity of £64 million assuming a debt/equity ratio of 50% on the increase ⁱⁿ Group equity.)

As a result of the US tax reform BATUS is likely to suffer a heavy US tax burden on dividends received from Imasco. This can be mitigated slightly by reducing the BATUS holding in Imasco to under 10%, but US tax plus Canadian withholding tax will still amount to about 50% of gross dividends.

Taking this factor into account the effect of the sale of the BATUS investment in Imasco is as follows:-

	1988 profits arising from BATUS holding in Imasco £ millions	Income on disposal proceeds £ millions	Shortfall
Share of Imasco's Pre-tax profit	27.2	13.8	13.4
Share of Imasco's Taxation	(8.6)	(4.7)	(3.9)
Tax on dividend	(2.8)		(1.8)
After tax profit	15.8	9.1	6.7
Minority interest	(2.8)		(2.8)
Attributable profit	13.0	9.1	3.9

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The shortfall in profit at the attributable level is £3.9 million though higher amounts are involved at the pre and post tax levels. These amounts are on the assumption of a 10% pre-tax return on the proceeds from disposal, and at the after tax level shortfall increases by £1.8 million on the assumption of 8% pre-tax income.

Group cash flow is positively affected in that the BATUS after tax dividend receivable for 1988 from Imasco will only amount to £2.8 million.

Purchase of an additional 10% of Imasco to secure a 51% shareholding

The acquisition of an additional 10% of the Imasco common shares would give BAT control and substantially improve Group profits at the pre and post tax levels and negligible at the attributable level.

At C\$30 a share the cost would be C\$357 million or £160 million. The effect of the purchase on the Group 1988 budget would be as follows:-

	Imasco as a 50.4% owned subsidiary £ million	Acquisition Interest £ million	Imasco as a 40% associate £ million	Net effect £ million
Pre-tax profit	264	(16)	(107)	141
Taxation	(84)	1	34	(49)
After tax profit	180	(15)	(73)	92
Minority				
- direct	28			
- 49.6%	76			
	(104)	-	11	(93)
Attributable profit	76	(15)	(62)	(1)

Note If a way could be found of getting acquisition interest allowed at 35% for tax, attributable profit would increase by £5 million.

The goodwill arising from the purchase would be about £150 million, however for debt/equity ratio purposes the Imasco and Trustco minority interest would rank as shareholders funds. These are fairly substantial amounts that are estimated below.

	C\$ millions
Imasco preference shares	206
59.6% of Imasco shareholders equity	112
Imasco finance corporation (estimate)	510
	828
£ million @ 2.24	370

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at end.

Purchase of 60% of Imasco so as to secure a 100% interest in Imasco

If the Group should decide to acquire the whole ^{share} of the outstanding shares of Imasco a premium of 20% or C\$30 a share might be appropriate. On this basis the total cost would be C\$2146 million or £950 million and goodwill would be £890 million excluding any possible gains on revaluations for fair value purposes.

The effect on the Group debt/equity ratio at 31.12.88 would be as follows:-

	Plan f million	Purchase of 60% of Imasco f million	Adjusted f million
Gross debt	1427	1300 250 + 1250	3697 2227
Shareholders funds	4943	-890 + 370	4423

Debt/Equity ratio 29% 848 81%

There would still be a positive effect on Group profits if 35% tax relief would be because of the higher purchase consideration there would probably be a ~~significant~~ ^{positive} effect on group attributable profits. ^{on acquisition interest} in detail below at 10% premium 9/83

	Imasco as a 100% owned subsidiary f million	Acquisition Interest f million	Imasco as a 40% associate f million	positive Net effect f million
Pre-tax profit	264	(95)	(107)	62
Taxation	(84)	33	34	(17)
After tax profit	180	(62)	(73)	45
Minority	(28)	-	11	(17)
Attributable profit	152	(62)	(62)	28

^{35%}
Note The increase in attributable profit is entirely due to getting tax relief on acquisition interest.

However if Imasco were to be consolidated with B.A.T Industries it would be necessary to include approximately C\$340 million Imasco Finance corporation debt with the anticipated balance sheet debt at 31.12.88 amounting to C\$2687. Together they amount to ~~£1350 million~~ ^{£2912 million} or £1452 million ²⁵²²

The effect on the Group debt/equity ratio is as follows at 31.12.88:-

	Plan f million	Purchase of 10% of Imasco f million	Adjusted f million
Gross debt	1427	1300 160 + 1250	2827 1887
Shareholders funds	4943	-150 + 370	5163

Debt/equity ratio 29% 578 56%

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The 57% would seem to be a slight overstatement in that by 31.12.88 there would be included as equity retentions of £40 million if 1988 profits are achieved and plan dividends are paid. Also there would be some abatement of the goodwill because of "fair ~~and~~ accounting".
Value

The incremental dividends that the Group would receive as a result of the additional investment of £160 million to achieve control would be £5.5 million gross: this is short of acquisition interest to finance the additional investment in Imasco. There may be some scope to increase the Imasco dividend after acquiring control. However any increase would have to be at arms length because of the large 49.06% minority. A 10% increase on the Imasco plan dividend would yield an extra £3 million gross if BAT had a holding of just over 50%.

A very large minority interest in Imasco would also presumably preclude the Group from making major restructures and disposition of Imasco businesses. However it does seem that the Group could afford to offer as much as C\$30 a share to achieve control of Imasco. The effect on Group pre and post tax profits would be substantial and the effect on attributable profits ~~small~~ negligible. It would however be some time before cash flow from Imasco dividends covered acquisition interest.

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PDL/PAC/imasco-shares
9 February 1988

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