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What's the risk of losing a significant number of corporate head offices now located in Quebec?

What should be done about it?

By

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2016

Opinions expressed in this paper are the authors' alone.

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September 2016

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More than six months after the fact, the sale of Rona to Lowe's, a U.S. corporation, continues to generate political controversy. Lowe's' first attempt to acquire Rona in 2012 turned more or less hostile in nature, sparking a strong reaction from the Quebec government at the time. The government ordered the financial institutions under its control (Investissement Québec) and pressured those under its influence (the Caisse de dépôt et placement and the Fonds de solidarité de la FTQ) to take up a blocking position in Rona's shareholdings, which was done to keep the head office in Quebec.

At the time, Lowe's withdrew from the transaction. But negotiations resumed in 2015, to achieve this time around a "friendly" transaction. Rona's board of directors eventually approved the sale of the company to Lowe's, without the Quebec government voicing any objections to the gradual disappearance of Rona's head office.

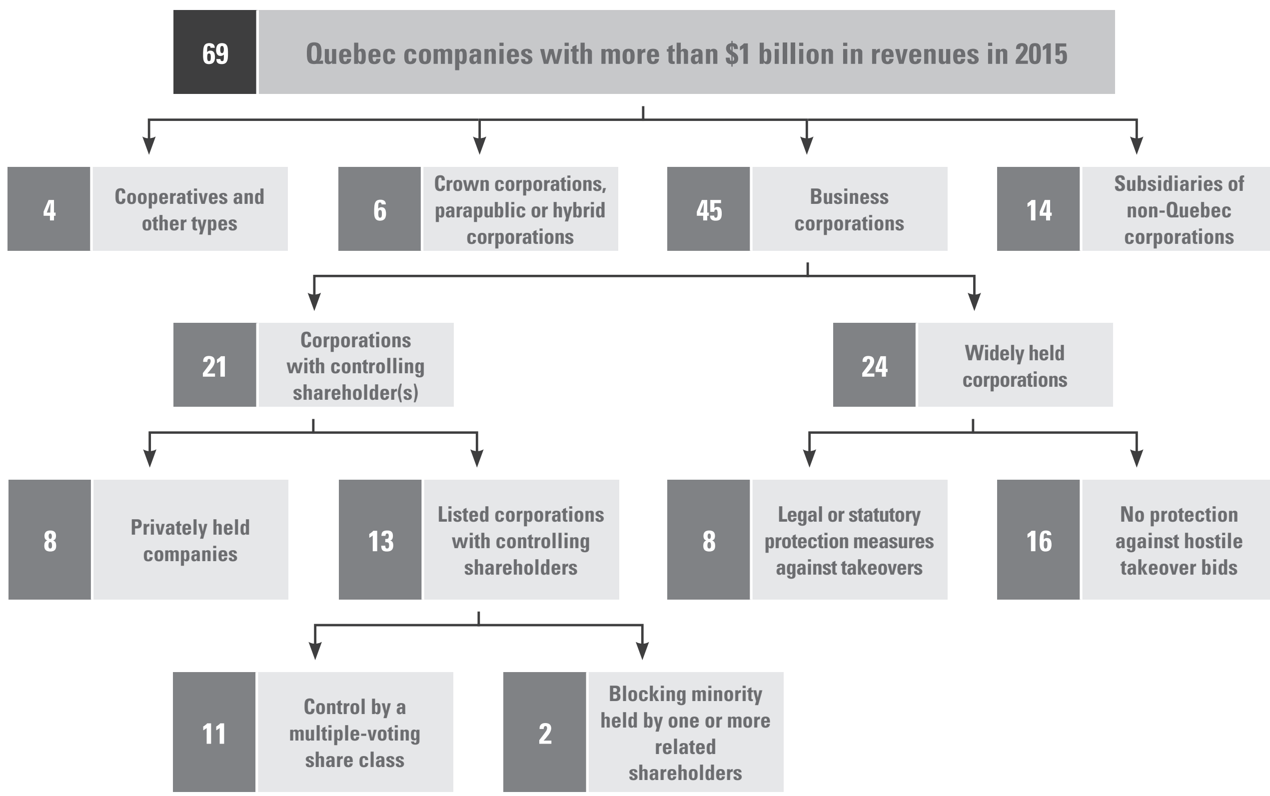
Whether as a result of a *hostile or friendly* process, how many large Quebec corporations are vulnerable to a foreign takeover with the consequent loss, sooner or later, of the strategic functions associated with their head offices?

LARGE QUEBEC CORPORATIONS AT RISK OF A HOSTILE TAKEOVER

Taking as a starting point the list of the FP500 (the largest Canadian corporations based on their *revenues* in 2015), we chose to define as "large" firms, those posting revenues of more than $1 billion.

In 2015, some 69 firms with headquarters in Quebec qualified as "large" corporations. Which of these 69 firms are vulnerable to an unwanted, hostile, takeover bid? The answer resides in the ownership structures of these companies, the full spectrum of which is shown in Figure 1.

Figure 1



Source: classification of the FP500 (2015 revenues) with adjustments by IGOPP.

The largest Quebec enterprises include *six State-owned* or parapublic corporations, *four* cooperatives (or a similar form), and *fourteen* foreign subsidiaries (for whom the head-office issue is already resolved).

Of the 45 business corporations, *eight* are privately held companies and 37 are traded on an exchange. No less than 11 of the latter have opted for a dual-share class structure, meaning that the founding entrepreneur or entrepreneurs or their family hold absolute control of the shareholders' voting rights.

Two other firms (Saputo and Cascades) have shareholders who, without holding 50% of the votes, have a blocking position[1] against any unwanted takeover bid.

Finally, *eight* other firms are protected by articles of incorporation which cap the percentage of votes that can be exercised by any shareholder, or by statutes that limit the ownership or percentage of votes exercised by non-Canadian shareholders. This is the case for CN, the Bank of Montreal, National Bank[2], Laurentian Bank [3], Industrial Alliance, Air Canada, Transat A.T. and BCE.

At the end of the day, *only 16 of the 69 largest Quebec corporations have no protection against a hostile takeover bid*. They are Metro, Gildan, SNC-Lavalin, WSP Global, Dollarama, Valeant,[4] TransForce, Resolute Forest Product, CAE, the Canam Group, Tembec, Aimia, Uni-Select, Amaya, Stella-Jones and Colabor.

SHOULD THESE 16 CORPORATIONS BE PROTECTED, AND HOW?

For reasons outlined below, hostile takeover bids have become relatively rare. According to the report of the ***Task Force on the Protection of Quebec Businesses***,[5] made public in February 2014, there were only seven hostile takeover bids in Quebec over the past 12 years. However, the Quebec government could consider some of these 16 corporations as "strategic" and that their unwanted acquisition by companies located outside Quebec would have sufficiently negative consequences to prompt it to intervene.

1 With respect to Cascades, the Lemaire family holds over 30% of the shares, while the Saputo family holds 44% of Saputo's shares.

2 The Canadian Bank Act caps ownership of shares at 20% for large banks but those shareholding restrictions pertain to banks with equity of $12 billion or more; the National Bank does not quite meet that threshold. However the Bank Act gives the federal Minister of finance broad powers to intervene and prevent any bank takeover, whatever its equity base.

3 The Laurentian Bank's equity is considerably below the $12 billion threshold but, given the broad powers granted to the Minister of finance by the Act, a "hostile" takeover is highly unlikely to be approved.

4 Valeant is a pseudo-Quebec firm whose head office and legal domicile are located in Laval strictly for tax purposes.

5 Task Force on the Protection of Quebec Businesses, *The Maintenance and Development of Head Offices in Québec*, Report prepared for the Quebec government, February 2014.

Yet, the Quebec government has little room for maneuver in these cases.

- Once a credible bid to buy a Canadian company has been made public, all authority of its board of directors to reject the unwanted offer has been removed by the Canadian securities commissions. As a result of regulations adopted in 1986, Canada has now in place a regulatory framework strikingly different from the legal context that prevails in the United States, where boards of directors still have the authority to "just say no" to an unwanted offer to buy the company. This Canadian evisceration of board authority has been criticized and denounced on many occasions but, despite the AMF's efforts, it remains relatively unchanged.
- The Quebec government could modify the Quebec law governing business corporations to enact provisions over-riding the securities commissions' restrictions on the authority of the board in situations involving hostile takeover attempts. However, of the 16 "vulnberable" corporations in question here, *only four of them were incorporated under Quebec law*. Any legislative change would only protect these four corporations. [The federal statute could also be amended, but this is an unlikely prospect.]
- Whenever a hostile takeover bid for a Quebec firm, which is deemed "strategic", becomes public, the government could pressure Quebec financial institutions to acquire a sufficient number of shares for them to collectively own a blocking minority (i.e. $33^{1/3}$% of the votes). This approach was taken in the case of Rona in August 2012, with all the political fallout that ensued. This type of maneuver can be costly for taxpayers or the beneficiaries of the funds participating in such a blocking scenario. Indeed, the participating institutions buying shares after the price has been driven up by the public offer, would pay top dollar; but if the move is successful in blocking the transaction, the share price will then fall back down to its pre-takeover bid level. In the case of Rona, Investissement Québec (IQ) paid $13.00 on average for the shares purchased in 2012. As soon as the takeover "threat" faded, the share price returned to its previous $10-$11 level. IQ's 12 million shares therefore lost some $30 million in value. This was the price of IQ's intervention. Of course, Rona was sold to Lowe's three years later generating a large profit for the shareholders at the time (as well as for its senior management).

- Perhaps, as some observers have suggested, the government should push and shove Quebec financial institutions to create a fund to purchase blocking positions *before any hostile bid has materialized*. These positions could be limited to the firms among the sixteen "vulnerable" ones that are considered strategic for Quebec. Which are those and which criteria would be used to determine their "strategic character"? Moreover, since this information would not remain confidential for long, the characterization of any firm as "strategic", and thus targeted for blocking moves, would have the effect of depressing the value of its shares because doing so would eliminate the control premium inherent in share price. Finally, for how long should such crypto-governmental investors hold onto these shares, regardless of the stock's performance or their investment policy? Of course, institutional funds in Quebec could, on their own, take significant ownership interests in vulnerable Quebec firms.

None of these options is particularly appealing or effective. The Quebec government should continue to advocate, and try to enlist the federal government and the governments of other provinces to change the laws and regulations governing mergers and acquisitions, along the lines of the AMF proposals of 2013. The goal, a very reasonable one, would be to give Canadian boards of directors a decision-making authority akin to what is granted to U.S. boards of directors by, for example, the state of Delaware in cases of a hostile attempt at takeover.

LARGE QUEBEC CORPORATIONS AT RISK OF A "FRIENDLY" TAKEOVER

There was a time not so long ago when the senior executives of a corporation tended to be staunchly opposed to any attempt to buy the company which employed them. The reason was quite simple: the risk of losing their employment and the various adverse economic and family consequences naturally spurred them to oppose any transaction even if it might have been advantageous for the corporation and its shareholders. Hence the decision in 1986 of the Canadian securities commissions to essentially eliminate this putative "conflict of interest" by removing all authority from boards of directors when a bid to buy their company has been made public.

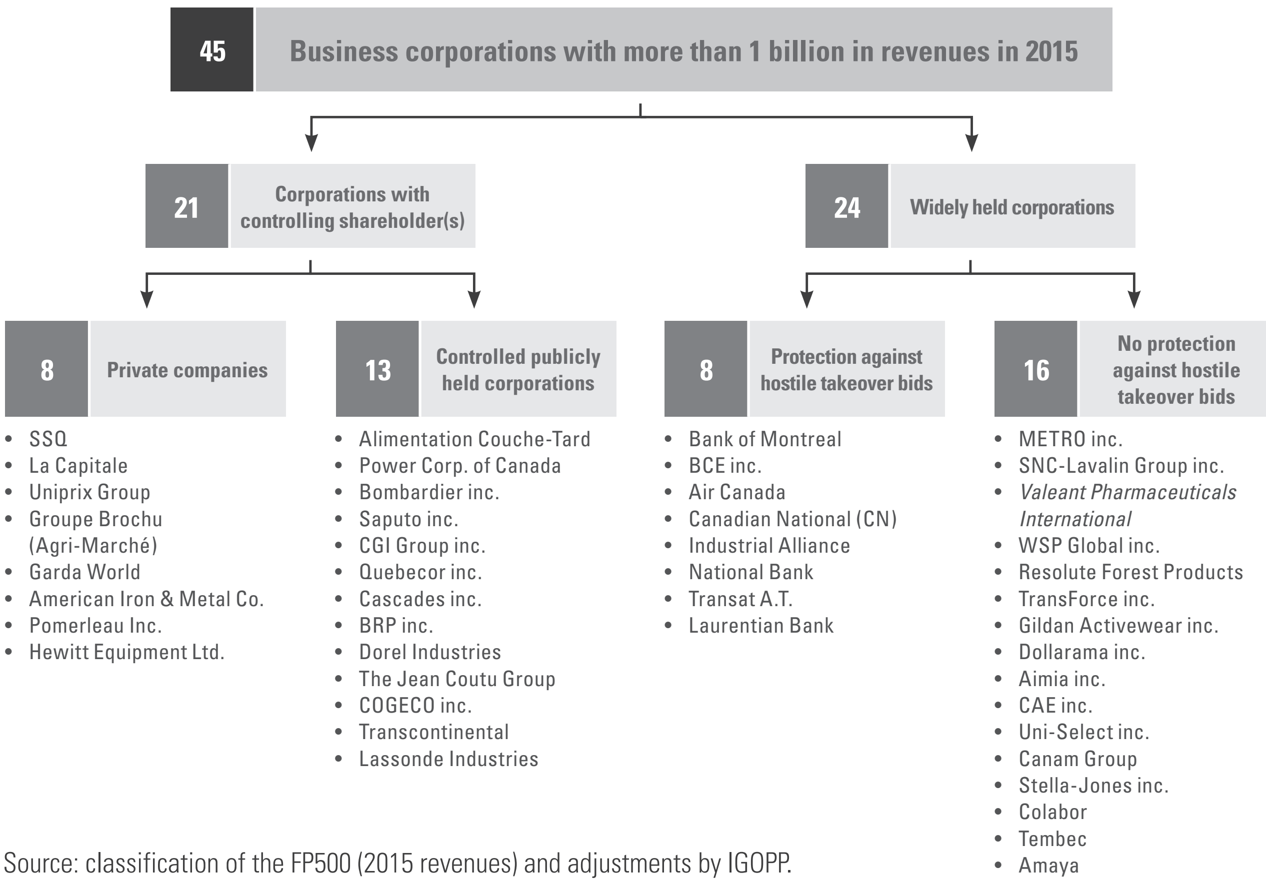
But, since the 1986, the compensation of corporate officers has radically changed in quantum and nature. It now includes large incentives based on stock price. During the same period, the compensation of members of boards of directors also changed to include “participating units”, whose value is linked to the share price. Thus, all the compensation systems are now designed in such a way as to align the interests of the senior officers and directors with those of the institutional funds, who are henceforth collectively the majority shareholders of widely-held corporations. Furthermore, top management contracts now include change-of-control clauses which, among other benefits, promise that all their variable incentives, vested or not, will all be redeemed *at the price of the takeover transaction* as soon as a change in control occurs.

As a result, corporate officers and directors of corporations only rarely do express strong opposition to a takeover bid. On the contrary, *officers and directors may have become too receptive to takeover bids, even where they are not in the best long-term interests of the corporation and its stakeholders*.

Therefore, as matters now stand, except for corporations such as the banks that are subject to legal restrictions, all private and publicly held corporations, with the consent of their boards, may be sold to foreign interests, leading to the total or partial, immediate or deferred, loss to Quebec of the strategic functions associated with a headquarter.

As Figure 2 shows, 37 of the 45 large business corporations (45, less the 8 corporations subject to rules of control, such as the banks and insurance companies) are “at risk” of a “friendly” takeover bid. The recent sales of the private companies, Les Rôtisseries St-Hubert, Cirque du Soleil, Van Houtte and Cossette, are good illustrations of this phenomenon.

Figure 2



Source: classification of the FP500 (2015 revenues) and adjustments by IGOPP.

Should the government or Quebec society be concerned? Or is this simply the usual capitalist logic with its lot of consolidation, growth and monetization? Quebec firms acquire foreign firms, while foreign firms acquire Quebec firms.

A study conducted by the firm of KPMG-SECOR[6] for the ***Task Force on the Protection of Quebec Businesses*** examined all purchase and sale transactions of businesses exceeding $1 million occurring between January 2001 and July 2013. It concluded that "*the net result in terms of asset value is evenly balanced*".

6 KPMG-SECOR, "Les sièges sociaux au Québec – Leur évolution, leur contribution et leur expansion" (translation: Head Offices in Quebec – Their Evolution, Contribution and Expansion), Presentation of the analysis report prepared for the Task Force on the Protection of Quebec Businesses, November 7, 2013.

Any intervention by governments in this area would therefore be ill-advised, except for some sensitive and strategic industrial sectors. Historically, has the federal government not always protected the banking sector against any takeovers, whether foreign or even Canadian for that matter? For the air transportation sector, telecommunications and others, the federal government has limited the percentage of votes which foreign shareholders could collectively hold.

Are all, or some, of these 36 Quebec corporations so important that the Quebec government would be justified in trying to block their takeover by foreign corporations?

The answer to this question depends largely on the political and economic ideology to which a government happens to subscribe. However, systematic political opposition to takeovers by the Quebec government would only induce corporations to establish their head offices elsewhere.

However, boards of directors do design and approve the financial terms granted to management in case of a change of control (such as selling the company). They should ensure that, in the future, change-of-control arrangements for management (and board members) do not provide too powerful an incentive to sell the company. Thus, the value of stocks and options received as part of their management incentives when cashed at the time of a change of control could be priced in such a way as to reduce the attractiveness for management to sell the company. *The boards of directors of publicly traded corporations bear a heavy responsibility in this regard.*

COVERT LOSS OF HEADQUARTERS' STRATEGIC FUNCTIONS

The political debate in Quebec is particularly focused on the loss of head offices as a result of the takeover of Quebec corporations by firms outside Quebec. However, the strategic functions associated with a head office may be lost without any change in the head office's location. It may take a covert form, go unnoticed and cause more damage than the outright loss of a head office. Here are some examples:

- The **Bank of Montreal** continues to refer to the address of its head office as 129 St-Jacques Street in Montreal; however, since 1977, this institution has gradually moved its entire management to Toronto. According to its Information circular filed with SEDAR, *none* of the 14 senior executives of the Bank of Montreal resided in Montreal or Quebec in 2015.
- • While the address of its head office is indicated as: 1 Carrefour Alexander Graham Bell Building A, 4th Floor, Verdun, Québec H3E 3B3, over the past 10 years, **BCE** has moved all of the strategic functions of its head office from Montreal to Toronto, without any announcement to this effect. Thus, in 2005, 11 out of 18 senior executives of BCE resided in Quebec. In 2015, just one of BCE's 14 officers still resided in Quebec.

This slow exodus of the strategic functions of large corporations, without the displacement of their official head offices, may prove more damaging than the back-and-forth movement of acquisitions. The Quebec government, as all governments, is responsible to minimize, deal with, any incentives, fiscal, financial or political, for a company to move, formally or informally, its headquarter out of Quebec. Otherwise, the Quebec government is even more ill-equipped to deal with this type of covert migration of strategic functions, unless, having detected it, it brings its full weight to bear as a major client, when this is relevant.

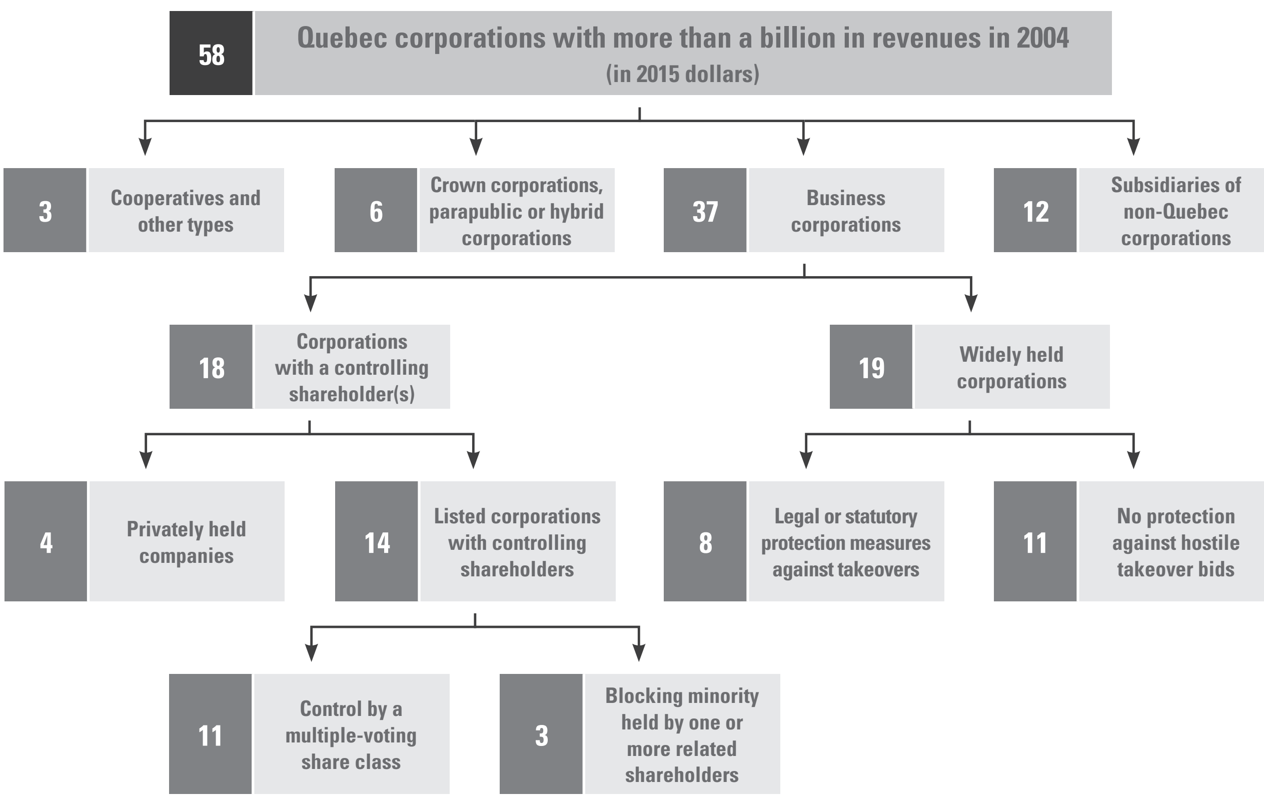
QUEBEC'S ENTREPRENEURIAL VITALITY AND THE RENEWAL OF LARGE CORPORATIONS

The economic playing field always entails its share of failures, stagnation and acquisitions; some companies will inevitably disappear from the group of large corporations. What is important is the *rate of replacement and renewal* of large corporations with headquarters located in Quebec.

We have reviewed the entry and exit of firms from the group of "large" corporations between 2004 and 2015. While Figure 1 shows that **69** Quebec companies qualified as large corporations in 2015, Figure 3 indicates that **58** companies posted revenues of $820 million (the equivalent of $1 billion in 2015) or more in 2004.

Thus, there has been a significant increase in the number of large Quebec-based business corporations from **37 in 2004** to **45 in 2015**. The number of corporations with no protection against hostile takeover bids went from **11** in 2004 to **16** in 2015, and the number of large *private* companies, from **4** to **8**. The number of cooperatives, State-owned enterprises and corporations with controlling shareholders remains stable.

Figure 3



Source: classification of the FP500 (2004 revenues) and adjustments by IGOPP.

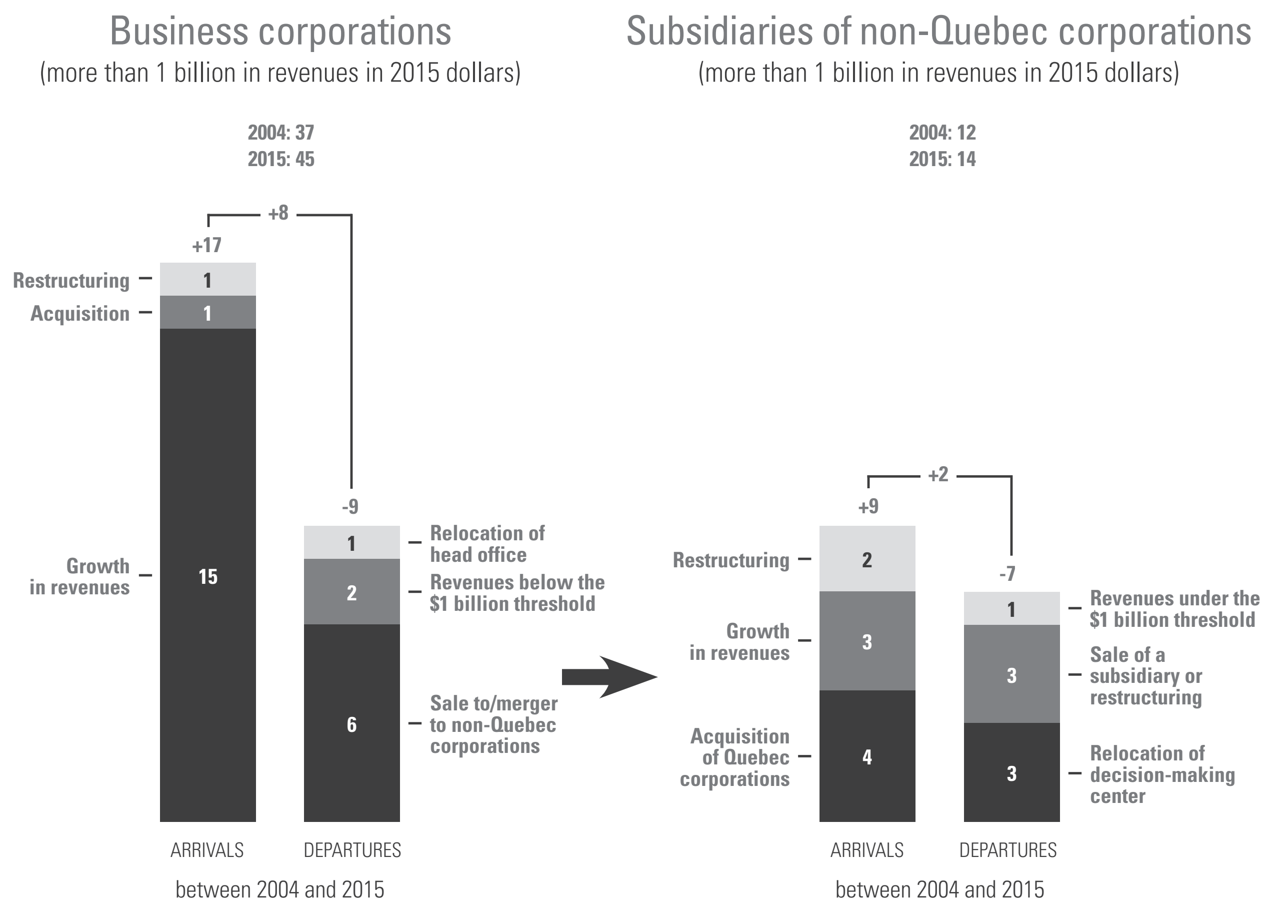
The fluidity in the number of business corporations from 37 in 2004 to 45 in 2015 is mapped out in Figure 4. Thus, 15 companies joined the group of "large business corporations" through a substantial growth in their revenues, one through acquisitions (Genivar became WSP) and one through restructuring (Aimia, a spin-off of Air Canada).

Of the 9 firms that qualified as large corporations in 2004, but which have disappeared from this group by 2015, 6 were acquired by, or merged with, non-Quebec companies, 4 of which now show up in the group of subsidiaries of foreign companies in 2015.

These data indicate that there is a definite vitality in Quebec's economic activity with 50% (17/37) of the group of large corporations being new arrivals, and 25%, departures (9/37). This vitality should give some comfort to those who worry about the departure of head offices. However, the fact that 6 of these 37 corporations were purchased by (or merged with) foreign interests or passed under foreign control (Novamerican Steel Inc., Alcan Inc., Domtar Inc., Molson Inc.[7], RONA Inc., Telesystem) may still be cause for concern.

7 In fact, the Molson-Coors transaction is a merger of equals, each party holding one-third of the voting power. Molson has not been "acquired" by Coors and is not a subsidiary of Coors.

Figure 4



Sources: classification of the FP500 (2004 and 2015 revenues), KPMG-SECOR Presentation (2013), and research by IGOPP.

Tables 1 and 2 in the Appendix contain lists of the firms included in some of these groups.

CONCLUSIONS AND RECOMMENDATIONS

It would seem that the risk of losing head offices located in Quebec, while real, is not primarily due to hostile takeovers by companies outside Quebec. Friendly transactions represent a greater risk in the current context. But a market economy inevitably leads to the disappearance of companies from the group of so-called "large corporations". What is important is the entrepreneurial spirit and Quebec's ability to renew its stock of large corporations.

Our first recommendation is specifically addressed to *these up-and-coming, future, large corporations*:

1. ***Entrepreneurs can grow their company quite large without tapping in the public financial markets, as demonstrated by a number of companies on out list (Pomerleau, Garda, for instance). However, should the entrepreneur decide to carry out an initial public offering (IPO), he or she might adopt a capital structure with a dual class of shares but with clear protections for other shareholders.*** For instance, the ***Canadian Coalition for Good Governance*** has proposed that the entrepreneur(s) and related parties should at least 20% of the shareholders' equity to retain the absolute control of the corporation (50%+ of votes), the election of a third of board members by the shareholders of the share class with a single vote, a protection clause for minority shareholders in the event of a sale of control of the corporation (coattail clause, already a requirement of the TSX), a sunset clause designed for the particular nature of the corporation. It is a fact that many Canadian (and American) companies have achieved enormous success with, and sometimes because of, this capital structure.

Should the threat that hostile transactions might deprive Quebec of the corporate headquarters of some of the 16 so-called "vulnerable" large corporations, attempting to create blocking funds before or after the announcement of a hostile bid is avery ineffective means of coping with this threat. The most effective way to defeat hostile bids will come from the following recommendation:

2. ***The regulations of the Canadian authorities governing mergers and acquisitions must be changed. The goal would be to give Canadian boards of directors the equivalent decision-making powers to those which, for example, the state of Delaware grants to boards of directors of U.S. companies in hostile takeover bid situations. The leadership of the government of Quebec on this issue is crucial.***

However, there is a real, but partially inevitable, risk of losing decision-making headquarters in Quebec from "friendly" transactions, as eventually occurred with Rona. One could decrease the allure to the management of concluding such friendly transactions by reducing the huge financial benefits which accrue to management, and sometimes to the members of the board, from the sale of their company. Accordingly, the implementation of the following recommendation is becoming increasingly urgent:

3. ***Boards of directors of publicly held corporations should ensure that the financial incentives for management (and board members) in the event of a change of control do not constitute a strong motive to sell the company.***

ANNEXES

Table 1

Changes in the composition of Quebec business firms posting revenues of more than $1 billion†

2004	DEPARTURES	ARRIVALS	2015
Abitibi-Consolidated Inc. (which became Resolute Forest Product Inc.)	Novamerican Steel Inc. [a]	*Aimia Inc.*	*Aimia Inc.*
Novamerican Steel Inc.	Alcan Inc. [a]	Amaya Inc.	Air Canada
Alcan Inc.	Domtar Inc. [a]	American Iron & Metal Co. Inc.	Alimentation Couche-Tard Inc.
Alimentation Couche-Tard Inc.	Intertape Polymer Group Inc. [b]	Canam Group Inc.	Amaya Inc.
Air Canada	Kruger Inc. [c]	COGECO Inc.	American Iron & Metal Co. Inc.
Bank of Montreal	Molson Inc.*	Colabor Group Inc.	Bank of Montreal
Laurentian Bank	Reitmans (Canada) ltd[b]	Garda World Security Corporation	Laurentian Bank
National Bank	RONA Inc. [a]	Dollarama Inc.	National Bank
BCE Inc.	Telesystem International Wireless [a]	Hewitt Equipment Ltd.	BCE Inc.
Bombardier Inc.		Lassonde Industries Inc.	Bombardier Inc.
BRP Inc.		La Capitale Financial Group	BRP Inc.
Cascades Inc.		Pomerleau Inc.	CAE Inc.
CAE Inc.		Stella-Jones Inc.	Canam Group Inc.
Canadian National Railway Company (CN)		Uni-Select Inc.	Cascades Inc.
Domtar Inc.		Valeant Pharmaceuticals Int. Inc.	Canadian National Railway (CN)
Groupe Brochu (Agri-Marché)		Gildan Activewear Inc.	COGECO Inc.
CGI Group Inc.		WSP Global Inc.	Colabor Group Inc.
SNC-Lavalin Group Inc.			Garda World Security Corporation
Uniprix Group			Dollarama Inc.
Industrial Alliance Inc.			Groupe Brochu (Agri-Marché)
Dorel Industries Inc.			CGI Group Inc.
Intertape Polymer Group Inc.			The Jean Coutu Group Inc.
Kruger Inc.			SNC-Lavalin Group Inc.
The Jean Coutu Group Inc.			Uniprix Group
METRO Inc.			Hewitt Equipment Ltd.
Molson Inc.			Industrial Alliance Inc.
Power Corporation of Canada			Dorel Industries Inc.
Quebecor Inc.			Lassonde Industries Inc.
Reitmans (Canada) Ltd.			La Capitale Financial Group
RONA Inc.			METRO Inc.
Saputo Inc.			Pomerleau Inc.
SSQ, Life Insurance Company Inc.			Power Coporation of Canada
Telesystem International Wireless Inc.			Resolute Forest Product Inc.
Tembec Inc.			Quebecor Inc.
Transat A.T. Inc.			Saputo Inc.
Transcontinental Inc.			SSQ, Life Insurance Company Inc.
TransForce Inc.			Stella-Jones Inc.
			Tembec Inc.
			Transat A.T. Inc.
			Transcontinental Inc.
			TransForce Inc.
			Uni-Select Inc.
			Valeant Pharmaceuticals Int Inc.
			Gildan Activewear Inc.
			WSP Global Inc.
37	-9	+17	45

Sources: classification of the FP500 (2004 and 2015 revenues) and adjustments by IGOPP.
†in constant 2015 dollars; the threshold is therefore $820 million in 2004 dollars.
[a] disappearance due to a sale transaction or merger
[b] revenues less than $1 billion in 2015
[c] relocation of head office
* In actual fact, the Molson-Coors transaction is a merger of equals, each party holding one-third of the voting power. Molson has not been "acquired" by Coors.

Table 2

Changes in the composition of the subsidiaries of non-Quebec companies posting revenues of more than $1 billion†

2004	DÉPARTS	ARRIVÉES	2015
Alcoa Canada Ltd.	AXA Canada Inc. [a]	Iron Ore Company of Canada (IOC)	Alcoa Canada Ltd.
AXA Canada Inc.	St. Lawrence Cement Group Inc. [c]	CST Canada Co.	Iron Ore Company of Canada (IOC)
St. Lawrence Cement Group Inc.	Abbott Laboratories Ltd. [b]	L'Oréal Canada Inc.	CST Canada Co.
Imperial Tobacco Canada Limited	Lafarge Canada Inc. [c]	Lowe's (RONA)	Imperial Tobacco Canada Limited
Abbott Laboratories Ltd.	Mittal Canada Inc. [a]	Molson-Coors*	L'Oréal Canada Inc.
Lafarge Canada Inc.	Rexel Canada Inc. [c]	Rio Tinto Alcan Inc.	Lowe's (RONA)
McKesson Canada	Ultramar ltd.[a]	UAP Inc.	McKesson Canada
Mittal Canada Inc.		Valero Energy Inc.	Molson-Coors
Pratt & Whitney Canada Corp.		Weyerhaeuser (Domtar)	Pratt & Whitney Canada Corp.
Rexel Canada Inc.			Rio Tinto Alcan Inc.
Lloyd's Underwriters (Canada)			Lloyd's Underwriters (Canada)
Ultramar Ltd.			UAP Inc.
			Valero Energy Inc.
			Weyerhaeuser (Domtar)
12	-7	+9	14

Sources: classification of the FP500 (2004 and 2015 revenues) and adjustments by IGOPP.
†in constant 2015 dollars; the threshold is therefore $820 million in 2004 dollars.
[a] disappearance due to a sale transaction or merger
[b] revenues less than $1 billion in 2015
[c] relocation of head office
* The Molson-Coors transaction is a merger of equals, each party holding one-third of the voting power. Molson is not a subsidiary of Coors.

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