

# PwCCF Capital Markets Flash

Volume II, Issue 20 • May 29, 2009

## PwCCF Credit Barometer



## The little engine that couldn't???

Economic data and news send “mixed messages” this week. Negative news continues to be accompanied by claims that *rates* of declines are decreasing, and, an expected GM bankruptcy filing, potentially the largest industrial filing in history, is greeted with relief. Equity and credit indicators are mostly optimistic, however, there was some inter-week volatility.

This week, PwCCF takes a closer look at Canadian consumers, previously considered to be governed by more sound financial principles than their American counterparts. Is this indeed the case?

	May 29, 2009	Crisis Extreme	Sept 1, 2008	Pre-Crisis Extreme <sup>1</sup>	Week-over-Week
CDN\$ / US\$	\$0.914	\$0.771	\$0.936	\$1.091	▲
S&P 500	919	677	1,278	1,565	▲
S&P / TSX	10,370	7,567	13,300	15,073	▲
LIBOR <sup>2</sup>	0.66%	4.82%	2.81%	1.11%	▼
TED Spread <sup>3</sup>	0.53%	4.64%	1.10%	0.14%	▲
S&P / LSTA <sup>4</sup>	1,210	895	1,293	1,335	▲
CBOE VIX <sup>5</sup>	29	81	21	10	▼
Baltic Dry Index <sup>6</sup>	3,298	663	6,691	11,793	▲
WTI Crude Oil <sup>7</sup>	\$66.31	\$33.87	\$111.55	\$146.85	▲

Source: Bloomberg

## PwC Corporate Finance Contacts

Toronto  
Vince De Luca\*  
416 815 5185

Keith Mosley\*  
416 941 8307

Dean Mullett\*  
416 814 5724

Montreal  
Nicolas Marcoux\*  
514 205 5302

Vancouver  
James McGuigan\*  
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Vanessa Iarocci  
Kyle Drewitt  
Dianna Paw  
Andrew Lu

## Notable Events this Week

- Canadian Liberal leader Michael Ignatieff calls for the removal of Finance Minister Jim Flaherty, after disclosure that the government will run a record \$50 billion deficit in 2010, up from the \$33.7 billion forecast in January. Mr. Ignatieff demanded: “*Canadians just cannot trust this government with their money. Will the Prime Minister fire this Minister of Finance?*” Ironically, Mr. Ignatieff’s party also calls for increased government spending.
- The Bank of Canada and Canadian Mortgage Housing Corporation announce that Canadian bank credit to households and businesses expanded 10.3% and 6.4% year over year, respectively. The growth in household credit represents a year over year acceleration driven primarily by strength in mortgages and lines of credit.
- Statistics Canada announces:
  - Retail sales rose 0.3% in March, the third consecutive month of gains. Despite this improvement, the broader trend is still negative, with retail sales down 4.8% year over year. More specifically, a provincial dichotomy in retail sales is widening with sales in March plunging 1.8% and 1.4% in Alberta and British Columbia, respectively. No other province exhibits similar declines; in fact, sales were up in 7 of the 8 remaining provinces in March.
  - The number of people collecting unemployment benefits surged more than 10% in March to 681,400, the largest increase since October. Alberta and British Columbia report recipients have more than doubled in the past year, making these provinces the hardest hit.

1. Over five-year period.

2. BBA US LIBOR, three month.

3. Difference between rates on interbank loans and three month US Treasuries. Indicator of perceived credit risk.

4. Mirrors market weighted performance of leveraged loans. Tracks returns in leveraged loan market.

5. An expectation of the market’s 30-day volatility, measured by tracking the money calls on companies in the S&P 500. Historically, VIX values greater than 30 are associated with high volatility and values below 20 are associated with low volatility.

6. An indicator that predicts future economic activity by measuring global shipping supply and demand for commodities, such as building materials and coal.

7. West Texas Intermediate (WTI), also known as Texas Light Sweet, is a type of crude oil used as a benchmark in oil pricing and the underlying commodity of New York Mercantile Exchange’s oil futures contracts.

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## Notable Events this Week (cont'd)

- Write-downs continue to erode some Canadian banks results. Select Q2 announcements reveal:
  - CIBC incurred a net loss of \$51 million due to a series of write-offs, including \$475 million related to the run-off of its structured credit activities, \$168 million from the impact of narrowing credit spreads, \$100 million of valuation charges, and an increase in the loan loss provision of \$65 million.
  - Royal Bank incurred a net loss of \$50 million due to a \$1 billion goodwill write-down and close to \$1 billion in provisions for loan losses.
- The US Commerce Department announces that April orders for US durable goods rose 1.9% from the previous month after a revised 2.1% drop in March that was more than twice as large as previously estimated. A rebound in automobile orders and a jump in defense spending spurred the gain. Despite the uptick, orders still hover near 13 year lows.
- Moody's affirms that the US government's triple-A credit rating is stable *"even with a significant deterioration"* in the nation's debt. Despite the reassuring announcement, 10-year Treasury yields rose by 18 bps on Wednesday, steepening the spread between the two and 10-year notes to a record 276 bps on concern the flood of supply will overpower buying from investors and the Federal Reserve. The spread contracted from the high and ended the week at 255 bps.
- GM announces plans to file for bankruptcy next week in what will be the largest industrial filing in history. After an intense week of negotiations, a group of GM's largest bondholders has accepted a proposal offering up to a 25% stake in the company (10% in equity and warrants to acquire an additional 15%) in exchange for support of GM's reorganization plan. The US Treasury, which has already invested \$19.4 billion in GM, said it will inject an additional \$30 billion into GM in exchange for 72.5% of the stock, with between 11% to 12.5% of this stake allocated to Canada. The remaining equity will be allocated to the United Auto Workers health-care trust (17.5%). The restructuring, which also contemplates numerous asset sales, should result in a much leaner GM carrying only \$17 billion in debt.
- The Japanese Finance Minister announces a moderation in Japan's export slump, helping the country to post an unexpected trade surplus, with exports rising by 1.9% in April, a second straight monthly gain. In fact, the minister reports that exports to the US, China and Europe all fell at the slowest pace this year. Similarly, Japan's industrial output rose 5.2% from March to April. The country's retail sales, however, dipped 2.9% in April for the eighth straight month, although the drop was less than the 3.8% expected. Overall, these signs add weight to Bank of Japan Governor Masaaki Shirakawa's contention that the economy will resume growing this quarter.
- Commodity contract prices are following spot prices and are beginning to fall for the 2009-10 contract year, a reversal of recent annual increases. With 2009 coal contract prices down as much as 60% year over year. The first announced 2009 contract for an iron ore major has been settled between Rio Tinto and Nippon Steel in May 2009 at a 33% year over year price decline.
- Oil rises to a new six-month high above \$65 a barrel, a 28% increase this month, after government data showed a surprisingly sharp drop in US crude inventories. The data reveals that a brighter economic outlook is prompting companies to revive production despite lingering concerns over mounting Western government debt. OPEC's decision to hold production steady also supports the upward trend.
- In response to North Korea's nuclear weapon threat, the US and Japan seek a United Nations Security Council resolution to cut North Korea's financial ties to the world and forbid the regime from selling weapons to raise money. China, who opposes North Korea's action but has not used any strong measures as yet, has the power to cripple North Korea as China currently accounts for 73% of North Korea's international trade.

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**Notable M&A and Financings this Week**

- Nortel Networks confirms that it is looking for a buyer for its majority stake in a South Korean joint venture with LG Electronics Inc. The announcement that Nortel would seek to sell its 50% plus one share in LG-Nortel came after rumours of the move swirled among analysts and in the media in recent weeks.
- Toys R Us acquires troubled high-end toy retailer FAO Schwarz. Toys R Us will operate FAO Schwarz's flagship store in New York City and a second store at Caesar's Palace in Las Vegas. FAO Schwarz's Web site and catalog will continue to use the company's name. Financial details were not disclosed.
- ANZ, Australia's fourth largest bank, announces intentions to enter the race for some of RBS's Asian assets, signaling that it will fund a prospective bid by launching a \$2.3 billion rights issue.
- Bharti Airtel of India and MTN Group of South Africa announce merger plans that will create the world's third largest telecommunications company, an entity that would have \$20 billion in annual revenue and 200 million subscribers.
- PNC Financial Services raises more than the \$600 million called for by the federal stress test results through the sale of 15 million shares. The bank issued the new common shares via a new issuance at market value. PNC was the smallest of 10 banks identified by regulators as needing more equity.
- Manulife Financial plans to raise \$350 million by issuing 14 million preferred shares priced at \$25 per share. The preferred shares will be entitled to receive a non-cumulative quarterly fixed dividend yielding 5.6% annually.
- The Ontario Teachers' Pension Plan reduces its position in BCE, selling 30.6 million shares of BCE worth \$713 million.
- Although the North American trailer market remains sluggish, Canadian trailer builder Manac acquires select assets of the now-bankrupt Trailmobile Canada. According to a statement from Manac, the purchase includes production equipment and raw-materials inventory, but no land or buildings. Financial terms were not disclosed.
- The Rev. Robert A. Schuller, son of the Rev. Robert H. Schuller who founded Crystal Cathedral in Southern California, has announced that he has partnered with Dallas entrepreneur Chris Wyatt to acquire AmericanLife TV. Financial terms of the deal weren't disclosed. Wyatt did say that the network was worth \$100 million in 2000, when it was half its current size. Robert A. Schuller, who left Crystal Cathedral and its television program "Hour of Power" in 2008, will have his own media ministry on the new channel.
- Canadian parts maker Magna International is closer to the successful acquisition of General Motors' German unit Opel. The two parties are currently negotiating a memorandum of understanding that would serve as the basis for bridge financing of €1.5 billion as well as a trustee solution that would protect Opel from creditors in the event GM files for Chapter 11. Although Fiat reaffirmed its interest in Opel late today, CEO Sergio Marchionne indicated that Fiat's priority is Chrysler: *"We need to get [Chrysler] kickstarted with it comes out of Chapter 11... That remains our primary objective. If the Opel transaction is not available to Fiat, life will move on, you know."*
- Chrysler seeks approval to sell its stronger operations to a "New Chrysler" owned by Italy's Fiat, labor unions and the US and Canadian governments, in exchange for \$2 billion paid to lenders. Attorneys for Chrysler argued that divesting the assets to Fiat is the company's only hope to avoid selling itself off piece-by-piece. Many Chrysler dealers, bondholders and former employees say they are being steamrolled by the bankruptcy proceedings.
- Buy-out firm TPG Capital agrees to buy \$80.5 million of convertible bonds in Daphne International Holdings, a leading Chinese women's footwear retailer. The unsecured convertible bonds, due in 2014, will be convertible into new ordinary Daphne shares at \$0.45 each. TPG will also receive 10 million warrants with an initial price of \$0.52, with the right to subscribe for one ordinary share per warrant. Once the bonds are fully converted and the warrants fully exercised, TPG will hold around 14.5% of the total enlarged share capital of Daphne. The company intends to use the investment to expand its Shoebox and Daphne shoe shop chains.

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## Notable M&A and Financings this Week *(cont'd)*

- Macquarie announces it will buy Canadian energy investment bank Tristone Capital Global for \$116 million: \$57 million in cash on closing and \$59 million in exchangeable shares over five years, up to a total of four million shares. In addition, key Tristone employees will receive \$15 million in “retention securities” in the form of exchangeable shares and options. Macquarie maintains that the deal will enhance its energy offering by integrating Tristone’s energy advisory and capital market capabilities within Macquarie’s global resource activities. Citigroup analysts believe Tristone Capital was acquired at less than 8x earnings.
- Group Danone plans to raise \$4.2 billion in a rights issue to reduce debt and improve credit metrics, as well as support its organic growth model and finance potential acquisitions. The rights issue will be structured as an offering of preferential subscription rights to existing shareholders, enabling them to preserve their proportionate interests.

## Notable Restructurings and Insolvencies this Week

- Bondholder Harbinger Capital Partners wins approval to file a reorganization plan for bankrupt copper mining company Asarco LLC, with a proposal to spend \$500 million to reorganize the company and pay creditors. The bankruptcy judge’s decision pits the creditor against Asarco’s parent Grupo Mexico SAB and India’s Sterlite Industries Ltd. in their efforts to take control of the company through their own Chapter 11 plans.
- Two Michigan-based, auto-parts makers file for Chapter 11:
  - Metaldyne Corp, a unit of Japan’s Asahi Tec, has reached non-binding agreements to sell most of its assets under a court-supervised sale process. Private-equity firms RHJ International and Carlyle Group have separately submitted letters of intent to buy different parts of their assets. Their filings do not include their non-US entities or operations, and Asahi is not part of the filing. Metaldyne has secured \$18.5 million of DIP financing from Deutsche Bank and certain customers.
  - Visteon Corp, with total assets of \$4.58 billion and total debts of \$5.32 billion, receives a commitment from Ford, its biggest customer, to support DIP financing for the restructuring and to ensure long-term continuity of supply.
- Anchor Blue Retail Group, a casual clothing chain retailer, files for Chapter 11 protection due to exposure to the California market. The California-based company, an affiliate of Sun Capital Partners, operates specialty retailer Anchor Blue and outlet store retailer Levi’s & Dockers Outlet by MOST. As part of the filing, the company reached a stalking-horse agreement with Levi Strauss & Co. regarding the purchase of the 73 outlet stores. Anchor Blue has secured \$20 million in DIP financing from its existing lender, Wachovia Capital Finance, to provide working capital to meet ongoing obligations during the reorganization.
- A bankruptcy judge moves up the Coyotes court case to June 9<sup>th</sup>, almost two weeks earlier than originally scheduled. The judge handling the hearing on whether Canadian billionaire Jim Balsillie can buy the Phoenix Coyotes from team owner Jerry Moyes for \$212.5 million and relocate it to southern Ontario over the objections of the NHL, promises a ruling shortly after June 9<sup>th</sup>.
- R.H. Donnelley, print and on-line Yellow Pages publisher, files for voluntary Chapter 11 after years of growth through leveraged buyouts. The company also reaches an agreement in principle with key creditors to reduce its debt by around \$6.4 billion, eliminate approximately \$500 million in annual interest expense and extend its bank maturities out to 2014. R.H. Donnelley said its more than \$300 million of cash on hand and projected positive cash flow will be sufficient to fund operations during the restructuring. According to a filing with the SEC, the company had assets of \$12.1 billion and liabilities of \$12.9 billion as of March 31.

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PwCCF Credit Barometer



## Consumer Debt in Focus – I owe, I owe, it's off to work I go...

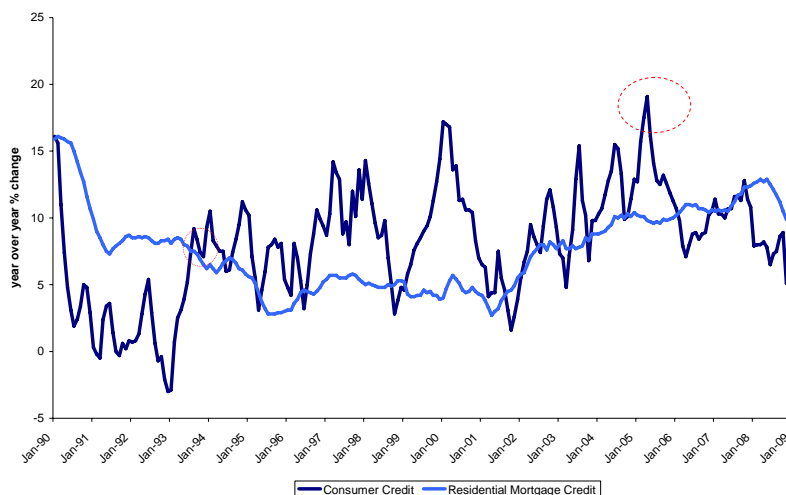
North American consumers appear to have woken up from a decade-long spending spree with a collective debt hangover. There is much adieu about US consumer debt, however, our discussion this week centers on the Canadian consumer landscape – what has happened here and what does it mean?

## A closer look at Canadian household debt – All the great houses and all the great men...

Despite improvements in consumer confidence indicators and claims that Canadian consumers will fare better than their US counterparts, according to a recent survey, Canadian household debt is at an all-time high of \$1.3 trillion, an increase of 66% in nine years. There are two alarming aspects of this rising trend.<sup>8</sup>

1. **Household credit was incurred for consumptive purposes.** The Bank of Canada segments household credit into: a. Residential Mortgage Credit, and b. Consumer Credit (broadly defined as credit card loans, personal lines of credit, auto loans, and other personal loans). Since 1993, year-over-year growth in consumer credit has, in most periods, outpaced growth in residential mortgage credit by a significant margin. Consumer credit growth hit an astounding peak of 19% in April 2005, a historic high. Surprisingly, even in today's tight credit environment, consumer credit in Canada continues to increase year over year (unlike the contraction in the US). In fact, the March 2009 annual growth rate in total consumer credit registered at 9.4%, still higher than the pre-crisis 13-year historical average of 6.5%. Unlike residential mortgage credit, which at least leaves debtors with valuable assets (a home), consumer credit was by and large utilized to purchase depreciating assets or for one-time services. This debt binge left Canadian households with a debt to asset ratio of 19%, notably higher than the 14% ratio earlier this decade, but still lower than current US rates of 27%.<sup>9</sup>
2. **Income growth did not accompany credit growth.** In recent years, annual Canadian household credit growth outpaced income growth by a significant margin. Not accounting for inflation, in the period 2002-2007, consumer credit grew at an average annual rate of 11% whereas incomes only grew at rate of 5% – less than half. This has culminated in a current Canadian debt to personal disposable income ratio of 137%, inline with US ratios, which are viewed as “unsustainable”, and double the long term average of 65%. At these levels, it will be a struggle to service debt, let alone take on additional credit going forward. Witness the recent 57% spike in Canadian consumer insolvencies this March as evidence of such.

Canadian Household Credit



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8. CGA Survey, *The State of Canadian Household Debt in a Stumbling Economy*  
9. CGA Survey, Bank of Canada

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**The Bottom Line – ...can't get consumers spending again...**

The implication of too much debt with too little income and collateral is that personal savings rates will need to increase and consumption will need to decline, the impacts of which include:

- **A paradox of thrift:** The Canadian savings rate increased to 4.7% in December 2008, TD Bank economists forecast that the personal savings rate in Canada will average 6%-7% over the next five years, double the rate of the last five years, but closer to historic precedent. While a positive long term trend, the immediate economic impact of increased savings is decreased GDP. As evidenced in Q4 2008 Canadian GDP data, declines in consumer spending of 3.3% contributed substantially to the overall quarterly GDP decline of 3.4%. Consensus is that personal consumption will continue to have a negative impact on Canadian GDP until the consumer deleveraging process is complete.
- **Prolonged sector-specific weakness:** Most expect that bias towards saving will inflict direct pain on consumer-driven businesses. Specifically expect that the housing and retail sectors will experience moderate growth, at best. Forecast housing starts, for example, are a tame 170,000 as opposed to levels near 200,000 as seen in recent years. Many expect that the automotive, home building, home development and furniture industries will be hit hard for some time.
- **New sources of growth:** To resume growth in light of prolonged North American consumer weakness, Canada will need to rely on productive domestic and non-US market demand. CIBC economist Avery Shenfeld expects that exports and related capital spending will be the key drivers of GDP growth in the near term, with technology and materials linked to Asian consumption the key sectors to watch. Many also anticipate that BRIC economies, whose consumers are notoriously thrifty, will be the drivers of consumptive growth.
- **US inflation may set in to combat the consumer crisis:** Some expect that the US fiscal and monetary authorities will seek to engineer inflation to combat the consumer debt crisis: Outspoken economist Marc Faber announced this week that he is "100% certain" that the US will experience hyperinflation precisely due to the fact that the Fed will be hesitant to increase interest rates in light of high debt loads. Permitting US inflation to run high, even for a few years, would significantly lower the consumer debt burden, in real terms, and stabilize or boost nominal US house prices. Keep in mind that a 5% inflation rate over five years would result in a 27% reduction in the real value of household debt – a fact that governments may view as a "quick fix" for overleveraged households. The counter-argument is that inflation will not arise during a period of weak consumer demand. This question cannot be answered qualitatively. If the reduction in consumer demand is exceeded by newly created money, consumer price inflation remains possible. It should also be noted that inflation need not occur across all asset classes, it may be limited to select asset classes, consumer goods not being one of them.
- **Further financial system strain:** If consumer deleveraging is achieved via some form of default on existing debt, such as real estate foreclosures and bankruptcy, the problem of consumer debt is simply shifted to the balance sheet of lenders that extended the loans. As a countermeasure, these lenders may further reduce consumer credit availability.

Many in Canada have long been critical of the malevolent culture of consumption in the US. However, as the old adage goes "people in glass houses should not throw stones" – the data shows that Canadian consumers exhibited many of the same behaviours as their US counterparts and, as a result, will likely suffer some of the same consequences.

**Suggested Action of the Week – The king was in the counting house, counting all his money...**

Appreciate that thrift may be in vogue for some time. Capitalize on, rather than suffer under, the shift. Focus on ways to create value for consumers.

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## PwC Happenings and Upcoming Events

As part of our "Managing in a Downturn" campaign, PwC is pleased to bring to you and/or participate in the following upcoming events.

- **May 29 – Episode 13. Strategy Talks with Dean & Helen: The PwC Managing in a Downturn Podcast Series.** In Episode 13, Dean and Helen welcome guests Steven Henderson, a PwC Advisory Services partner and Sarah MacGregor, a PwC Advisory Services director. They discuss ways in which a company's fraud risk may increase during a recession. After listening to the podcast, please take a moment to participate in our poll, or share your comments with us. We want to hear from you. Listen to, or download the podcast now at [www.pwc.com/ca/strategytalks](http://www.pwc.com/ca/strategytalks).
- **June 2 – Toronto. Launch of Global Performance Management Research Report.** The Report is a collaborative effort of PwC's Performance Management practice and international partners. The survey targeted private- and public-sector organizations to explore the relationship between effective performance management practices and superior strategic, competitive, operational and financial outcomes. To attend the launch event on June 2, visit [www.pwc.com/ca/pmlaunch](http://www.pwc.com/ca/pmlaunch) to register. Visit [www.pwc.com/ca/pmreport](http://www.pwc.com/ca/pmreport) to obtain a copy of the report online.
- **June 2 – Saskatoon. PwC's Reaching New Heights: Selling your Company for the Highest and Best Price.** PwC Corporate Finance, in partnership with Canadian Western Bank, is holding this informative session on practical strategies to sell your business for the highest and best price. To RSVP, call the registration line at +1 866 221 4290, or for further details, call Sherilyn Smith at +1 403 509 7309.
- **June 4 – Mississauga. 2009 GTA Alumni Knowledge Series Session: Driving strategy into sustainable performance.** Our PwC experts, who have worked extensively with private companies, will present and discuss PwC's point of view on performance management; the importance of performance management in both good and bad times; and how PwC is helping clients through the use of PwC's new Performance Management Review diagnostic. For further details, call Rob Merk at +1 416 941 8383, ext. 13355.
- **June 17 – Waterloo. PwC Managing Risk and Opportunity Breakfast Session.** Presented by PwC, the session will begin with a brief capital markets update, followed by an interactive panel discussion on risk and opportunity in a downturn. For further details, contact Rozanne Kibel at [rozanne.kibel@ca.pwc.com](mailto:rozanne.kibel@ca.pwc.com).



[www.pwc.com/ca/managinginadownturn](http://www.pwc.com/ca/managinginadownturn)

*All dollar amounts are expressed in US dollars, unless otherwise indicated.*

*Sources: Bloomberg, Reuters, Capital IQ, Dealogic, Random Lengths, Pulp & Paper Weekly, US Census Bureau, CMHC, NAHB, Statistics Canada, company websites and press releases, National Post, The Globe & Mail, The Associated Press, RBC Capital Markets, CIBC World Markets, Scotia Capital, Bank of Canada, FT Alphaville, TD Securities, S&P Case Shiller, Nouriel Roubini, RGM Monitor, Forbes, Spratt Asset Management, Barton Biggs (Newsweek), CGA of Canada, "The State of Household Debt in a Slumbling Economy" Statistics Canada, Bank of Canada.*

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