



March 9, 2011



Accounting Alerts!

SNC-LAVALIN GROUP INC.

CONNECTING THE MISSING ALTALINKS

COMPANIES MENTIONED:

SNC-Lavalin Group Inc.
TSX - SNC
Previous Close: \$55.76

Canadian Pacific Tower
100 Wellington Street West
Suite 3110, PO Box 80
Toronto, Ontario, Canada
M5K 1E7

tel: (416) 866-8783
fax: (416) 866-4146
www.veritascorp.com



Industrials

Michael Yerashotis, CA, CBV
myerashotis@veritascorp.com

Veritas Investment Research Corporation owns the copyright in this report. This report may not be reproduced in whole or in part without Veritas' express prior written consent. Any such breach of this copyright is contrary to ss. 27(1), 34, 35 and 42 of the *Copyright Act*, R.S.C. 1985, c. C-42 and will be liable for damages.

CONNECTING THE MISSING ALTALINKS

SNC-Lavalin Group Inc. ("SNC" or the "Company") announced on February 11 that it will acquire the remaining non-controlling interest in its 76.92%-owned subsidiary, AltaLink L.P. ("AltaLink"). The Company will acquire the remaining 23.08% interest in AltaLink from its partner, Macquarie Essential Assets Partnership ("MEAP"), for \$213M. We highlight the following from our analysis of the transaction and SNC's accounting practices related to AltaLink:

- The transaction provides investors with a valuation proxy for SNC's second most valuable infrastructure concession investment, implying an equity value for AltaLink of \$923M, or \$6.10 per SNC share;
- AltaLink's implied price-to-earnings and price-to-funds flow from operations multiples are substantially less than most of its comparable publicly-traded peers. This may imply doubts regarding AltaLink's projected growth, or that public company multiples in the regulated utilities sector are overheated;
- The only accounting that will change as a result of SNC's increased ownership interest in AltaLink is the elimination of the 23% non-controlling interest related to AltaLink in SNC's consolidated net income. In F10, this amount represented approximately 2% of SNC's income;
- Based on AltaLink's recent regulatory filings, construction-related sales from SNC to AltaLink will increase substantially in F11. Given that SNC's management is guiding to flat-to-declining engineering and construction services income in F11, a potentially significant decrease in income from third party engineering and construction contracts is implied; and
- Don't bet on an AltaLink spin-off any time soon. SNC will want to maintain control of the company to ensure it's awarded a new construction services contract in April 2012, the date when its existing 10-year exclusive contract with AltaLink expires. However, a spin-off of a minority stake is possible some time before 2012 if utility assets remain popular with yield-hungry investors.

[All amounts in Canadian dollars, unless otherwise noted]

THE TRANSACTION

SNC will acquire MEAP's 23.08% non-controlling interest in AltaLink for \$213M. Based on the Company's press release, SNC exercised a right of first refusal to purchase MEAP's interest in AltaLink after MEAP received an offer for its interest from another (undisclosed) party.

The \$213M purchase price implies a total equity value of \$923M for AltaLink. This transaction, as well as the Canada Pension Plan's ("CPP") recent purchase of a 40% interest in the 407 ETR, provides useful valuation proxies for SNC's two most valuable infrastructure concession investments ("ICIs"). The total equity value of the 407 ETR implied by the CPP's purchase is

*An implied
equity value of
\$923M, or \$6.10
per SNC share*

approximately \$8.9B¹, equating to a \$1.5B value for SNC's 16.77% stake. Combined, these ICIs represent a value of approximately \$16 per SNC share (\$6.10 from AltaLink and \$9.90 from the 407 ETR).

The AltaLink transaction also provides a benchmark for valuation multiples in the regulated electric utility sector. A summary of multiples implied by the transaction and relevant peer comparisons is as follows:

Figure 1

AltaLink - Key Valuation Metrics and Peer Comparisons

(Amounts in millions, except as noted)

Lower valuation multiples for AltaLink

	AltaLink	Fortis Inc.	Canadian Utilities Limited	Emera Inc.
Implied Equity Value / Market Capitalization	923	5,745	6,285	3,598
TTM P/E*	14.0	20.2	14.3	18.8
TTM Price-to-FFO**	6.8	7.8	8.5	10.7

* Based on consensus adjusted earnings for Fortis, Canadian Utilities and Emera

** FFO based on AltaLink management's definition: cash from operating activities before working capital adjustments (unadjusted).

Sources: companies' financial statements and Reuters

The above clearly illustrates much higher earnings and cash flow valuation multiples for AltaLink's publicly-traded peers. Of the three peers noted, Canadian Utilities Limited ("CU") is probably the most comparable, as it has a similar geographic profile to AltaLink, primarily operating in Alberta.

The lower valuation multiples for AltaLink appear inconsistent with the seemingly impressive growth profile of the company. AltaLink's net income grew 17% from F09 to F10 and FFO increased by 19% over the same period. Also, according to regulatory documents filed with the Alberta Electric System Operator ("AESO"), the company is forecasting substantial capital spending increases, from approximately \$480M in F10 to \$975M in F11 and \$2B in F13². We believe that AltaLink's relatively low valuation multiples could be attributable to one or more of the following explanations:

Possible explanations...

1. The undisclosed third party bidder underestimated the value of MEAP's interest in AltaLink;
2. The undisclosed third party bidder believes that public utility company valuation multiples are too high; and/or
3. There are risks to AltaLink's future prospects that justify its lower multiples.

¹ The CPP made two ownership stake purchases. Calculation is based on the 10% ownership purchase from Cintra Infraestructuras S.A. for \$894M. The remaining 30% stake separately purchased involved additional assets aside from the 407 ETR.

² Source: AltaLink General Tariff Application filed with the AESO in December 2010.

We believe explanation #1 to be unlikely, as a third party bidder with \$200M+ in capital would likely do sufficient due diligence to come to a reasonable approximation of AltaLink's fair value. More importantly, the bidder would likely have had access to non-public information regarding AltaLink's business.

With respect to explanation #3, AltaLink's lower implied valuation multiples may be attributable to the risk that budgeted capital spending won't materialize. The AESO expects to be issuing a new draft recommended competitive procurement process for electric system operators in the province in the first quarter of 2011³. This change in the bidding process could result in a substantial decrease in the projects awarded to AltaLink. The expected change may also explain why AltaLink's multiples are comparable to those of CU, which could also be negatively impacted by a more competitive bidding process in Alberta.

Once new regulations are adopted, if there is an adverse impact on AltaLink, SNC would be indirectly impacted- both through its ownership in AltaLink's earnings and the construction services it provides as a contractor for the company.

CHANGES TO SNC'S ACCOUNTING FOR ALTALINK

AltaLink's Business

The financial results of AltaLink are currently consolidated within SNC's financial results. AltaLink's balance sheet, income statement and cash flow statement are "rolled-up" line-by-line into SNC's consolidated financial statements. However, because AltaLink has not been a 100%-owned subsidiary until now, a non-controlling interest ("NCI") value was recorded in SNC's balance sheet and income statement, offsetting the AltaLink income and net assets recorded in SNC's financial statements by 23.08%.

The adoption of International Financial Reporting Standards ("IFRS") in 2011 will not change the accounting methodology described above. The only difference in 2011 will be as a result of the change in SNC's ownership. From a balance sheet perspective, the change in AltaLink ownership will not change SNC's consolidated book equity (although there will be changes to the gross value of assets and liabilities).

On SNC's income statement, the NCI value will be reduced and consolidated net income will increase. In F10, the NCI related to AltaLink deducted to arrive at SNC's consolidated net income was approximately \$10M, representing 2.3% of net income of \$437M.

SNC's Sales to AltaLink

SNC sells construction-related services to AltaLink, resulting in SNC recording revenues, expenses and profits. Normally under Canadian GAAP ("C-GAAP"), intercompany profits are required to be eliminated when consolidated financial statements are prepared. However, a special exemption under C-GAAP requires that intercompany profits with rate regulated subsidiaries, such as AltaLink, not be eliminated on consolidation.

IFRS, like C-GAAP, generally requires the elimination of intercompany profits. However, unlike C-GAAP, there is no special exemption that requires the

*A bump in
ownership increases
SNC's share of
AltaLink's income
to 100%*

³ Source: Canadian Utilities Limited Q4-F10 MD&A.

recognition of intercompany profits from rate regulated subsidiaries. Although we are unsure what the specific rationale would be, management has stated that it intends to continue recognizing intercompany profits from AltaLink sales under IFRS in 2011.

Intercompany profits won't change

Assuming management follows through with its intention to continue recognizing intercompany profits post-IFRS adoption, there will be no change to the revenues, expenses and income recognized by SNC from its transactions with AltaLink as a result of the change in AltaLink ownership⁴. However, based on our review of regulatory filings, AltaLink is forecasting an increase in the construction-related services it purchases from SNC in 2011. If AltaLink's forecast is accurate, and assuming that management follows through with its intention to not eliminate intercompany profits, sales to AltaLink could contribute as much as an \$80M increase to SNC's net income in 2011.

Figure 2

Breakdown of SNC's Actual and Estimated Intercompany Revenues and Profits with AltaLink
(Amounts in millions, except as noted)

	F09A	F10A	F11E	F12E	F13E
Revenues from sales to AltaLink	200	263	840	1,335	1,833
Estimated profit at 18% margin for F10 onward*	32	47	151	240	330
Estimated after-tax profit at 23% approx. avg. tax rate	25	36	116	185	254
YoY increase in after-tax profit - \$		12	80	69	69
- %		48%	219%	59%	37%
Profit on AltaLink sales as % of SNC's non-ICI income	7.6%	10.3%			

* Using average Packages margin in F10 of 18%. 16% actual used for F09.

Sources: Company's MD&A and financial statements, AltaLink's General Tariff Application with the AESO, and Veritas estimates

Flat-to-declining F11 E&C income + increase in intercompany profits = potentially significant decline in F11 profits from third parties

Although it appears that intercompany transactions with AltaLink will continue to grow significantly, details remain undisclosed by SNC's management. Irrespective of the IFRS accounting treatment approved by SNC's auditors in 2011, it is our view that SNC's transactions with AltaLink amount to little more than moving cash from one pocket to another so-to-speak. This is because, from an economic perspective, no operating cash flows are received from third parties in the period intercompany profits are recognized.

Going forward, we advise investors to view any reported operating income growth within SNC's bread-and-butter engineering and construction ("E&C") business with skepticism, as a great deal of reported growth may be derived from intercompany profits with AltaLink. In this regard, we highlight that on SNC's Q4 earnings call, management guided to flat-to-declining E&C income in F11. Given AltaLink's projected increase in required services from SNC, flat-to-declining F11 E&C income would imply a potentially significant decrease in income from third party E&C contracts.

⁴ Normally, when intercompany profits are eliminated between a parent and subsidiary company, a change in the ownership share of the subsidiary would result in a change to the profit that must be recognized between the two entities.

CONCLUSION

Even with a new competitive bidding process in Alberta and a potential deceleration in AltaLink's capital spending, AltaLink will continue to grow in importance for SNC. Utility assets are a hot commodity in today's market and as long as SNC continues to record intercompany profits, it will continue to have a channel to grow income, even if engineering and construction contract wins from third parties were to decline.

Is a spin-off in the cards for AltaLink? Probably not in the near future. SNC's 10-year exclusive construction services contract for substantially all of AltaLink's direct assign projects will come to an end in April 2012. It is likely that SNC would want to maintain control of the company until at least that time to ensure the successful negotiation of a new long-term contract. However, a pre-2012 spin-off of a minority stake is possible. The valuation multiples sported by some of AltaLink's peers may present an opportunity to realize a quick investment gain too tempting for SNC to pass up. *Transaxio déjà vu.*



VERITAS INVESTMENT RESEARCH CORPORATION

Director of Research

Neeraj Monga

Accounting & Special Situations

Anthony Scilipoti, CA, CPA
ascilipoti@veritascorp.com

Michael Yerashotis, CA, CBV
myerashotis@veritascorp.com

Retail & Consumables

Michael Palmer, MBA
mpalmer@veritascorp.com

Kathleen Wong, CA, CFA
kwong@veritascorp.com

Power Funds, Utilities & Business Trusts

Darryl McCoubrey, CA
dmccoubrey@veritascorp.com

Industrials

Jason Miller, MBA
jmiller@veritascorp.com

MARKETING

Anthony Scilipoti, CA, CPA
ascilipoti@veritascorp.com

Financial Services

Ohad Lederer, CA, CPA, CFA
olederer@veritascorp.com

Yuting Liu, CA, CBV
yliu@veritascorp.com

Energy & Special Situations

Sam La Bell, MBA
slabell@veritascorp.com

Michael Valicek, CFA
mvalicek@veritascorp.com

Telecommunications & Technology

Neeraj Monga, MBA
nmonga@veritascorp.com

Desmond Lau, CA
dlau@veritascorp.com

Gold & Energy

Pawel Rajszel
prajszel@veritascorp.com

PUBLISHING & ADMINISTRATION

Michelle Mercer
mmercer@veritascorp.com

Nancy Cardoso
ncardoso@veritascorp.com



ERITAS
INVESTMENT RESEARCH

Canadian Pacific Tower
100 Wellington Street West
Suite 3110, PO Box 80
Toronto, Ontario, Canada
M5K 1E7

tel: (416) 866-8783

fax: (416) 866-4146

www.veritascorp.com

Veritas Investment Research Corporation ("Veritas") its directors, officers, employees and their immediate families are prohibited from trading any position in the securities profiled in a report thirty (30) days before and five (5) days after the publication date where the report involves coverage initiation or a change of opinion. Veritas has not offered any consulting, financial advisory, investment banking or underwriting services to the companies mentioned. Veritas does not accept research fees from the companies profiled herein. The information contained in this report has been obtained from sources believed reliable however the accuracy and/or completeness of the information is not guaranteed by Veritas, nor does Veritas assume any responsibility or liability whatsoever. All opinions expressed are subject to change without notification. This report is for information purposes only and does not constitute and should in no way be construed as a solicitation to buy or sell any of the securities mentioned herein. The intention of this report is to provide a forthright discussion of business, accounting and financial reporting issues, as well as generally accepted accounting principles and the limits of their usefulness to investors. As such, please do not infer from this report that the accounting policies of any company mentioned herein are not allowed within the broad range of generally accepted accounting principles, or that the policies employed by that company were not approved by its auditor(s). This report may not be reproduced in whole or in part without the express prior written consent of Veritas. Veritas is a 100% employee owned firm. ©2011 Veritas Investment Research Corporation.