

# Acquisition opportunities are plentiful

Business owners and executives often look to corporate acquisitions as a key component of their company's growth strategy. But where can attractive opportunities be found?

By Howard E. Johnson, FCMA

**I**f corporate acquisitions are an important component of a company's growth strategy, then an active approach to finding deals must be undertaken. It is not sufficient for the buyer to alert its auditors, lawyers and investment bankers that the company is on the acquisition trail, and hope that the phone will ring with an opportunity. Rather, the buyer must actively search for opportunities, either by committing internal resources or by engaging external resources to undertake that task.


An active search for deals offers several benefits to the buyer. First, it forces the buyer to pre-establish its set of acquisition criteria. This helps the buyer to avoid spending time and resources exploring acquisition opportunities simply because they become available, as opposed to being a strategic fit.

Second, an active search helps the buyer to find proprietary deals. In many cases, business owners have not given much thought to selling their company. There are numerous reasons for this phenomenon, including the fact that business owners tend to defer succession planning discussions, and because they might believe no buyer would be interested in their company.

By uncovering proprietary opportunities, the buyer can avoid an auction process, which often compels the seller to seek the highest price. This is not to suggest that an active search will allow a buyer to take advantage of a seller by undervaluing the target company. Rather it allows the buyer and seller to work together on a more confidential and expedited basis in order to structure a deal which is believed to be fair to both parties.

Buyers that venture on an active search process should not expect that it will yield immediate results. In many cases it can take several months, or even years, to entice a business owner to engage in discussions about selling their company. However, a





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prolonged process can allow for a trusting relationship to develop between the buyer and the seller, which can help the buyer identify things that are important to the seller beyond maximizing price (e.g. ensuring that the target company's employees are taken care of).

An active search can also be used for public company acquisitions, particularly small cap public companies that may be below the radar of large corporate acquirers.

### Equity positions in turnaround situations

As the economy begins to show signs of life following the recent downturn, companies are anticipating better times ahead. However, many businesses have found themselves in a weakened financial position and thus inadequately capitalized to take advantage of the recovery. In some cases the owners of these businesses will look for an equity partner rather than having to sell their company at fire-sale prices.

An equity investment can be an attractive alternative to an outright acquisition for many reasons, including:

- It reduces the amount of capital deployed, and hence the level of risk to the buyer;
- The existing owners still have a meaningful equity position in the business, which makes them motivated to succeed; and
- The ability to structure the investment in creative ways to reduce risk, such as using convertible debt (which provides the buyer with a preferred return on capital as well as upside potential) and “ratchet” clauses, which allow the buyer to receive an increased equity position if certain performance criteria are not met.

However, a minority equity position in a privately held company carries additional risks as well. This includes risks arising from the inability to control the affairs of the target company and the diminished level of liquidity normally attached to minority interest positions that are not freely tradable. These risks can be mitigated to a large extent through a well-documented shareholders agreement that provides the investor with the ability to veto major corporate decisions and minimal (if any) restrictions on transferability.

Ideally, the shareholders agreement would provide the buyer with a call option to acquire the balance of the shares at some time in the future. In any event, the buyer should be afforded a right of first refusal on the sale of the remaining interest in the target company.

### Debt acquisitions

Beyond turnaround situations, as a result of the recent economic downturn many companies have found themselves in dire straights with their bank or other creditors, and at

a point where those lenders may seek to realize on their security. This can be a challenging and emotional situation for business owners. A strategic buyer may be viewed as a “white knight” that can help the target company to continue as a going concern (usually in some downsized form) as opposed to being liquidated.

Buyers that are interested in debt acquisitions should approach the special loans division of major financial institutions. In many cases, the buyer has an opportunity to acquire the debt against the target company at less than its face value where the lenders believe that such an offer would yield greater returns than those available by realizing on their security.

Debt acquisitions often present numerous challenges for the buyer, such as those associated with post-transaction layoffs (e.g. wrongful termination), disenchanted suppliers (e.g. tighter credit terms) and concerned customers (e.g. reputational risk). Furthermore, debt acquisitions often are met with some remorse by the seller, who may believe that the buyer has taken advantage of their situation. The buyer should plan for increased transition risk in its valuation and pricing analysis, as well as its integration plans. Sound legal advice will also be essential.

### Small cap public companies

The public equity markets are filled with companies that, in many cases, should not be public. This is particularly the case in Canada, where approximately 63 per cent of the 3,000 public companies traded on the TSX, TSX Venture, and Over-the-Counter markets have a market capitalization of less than \$25 million [see Exhibit on p.g. 21].

Many small cap public companies are closely held and thinly traded which has resulted in their major investors becoming “stuckholders” — individuals who are effectively unable to divest of their interest in the public markets.

Public companies have been faced with increasing challenges and costs in recent years. The growing demands of corporate governance, financial reporting, and now the required implementation of IFRS have eroded public company earnings. Furthermore, many small cap public companies are undercapitalized, and it may be difficult for them to raise capital through the public equity markets on a cost-effective basis.

There are several benefits to looking at small cap public companies as a source of acquisition opportunities. First, it is easier to pre-qualify public companies. This is because the public information available in the form of financial statements, annual reports, management discussion and analysis, the management information circular, annual

information form and other documents, allows the buyer to gauge whether the potential target company meets its acquisition criteria (such as size, markets served, etc.) prior to initiating contact.

Second, and perhaps more important, is that the market price of the shares is already established. This provides the buyer with a significant advantage in terms of negotiations. While the shareholders and directors of the public company can argue that the market price understates the true value of their company because of thin trading, restrictions on disclosure, and a variety of other reasons, the fact remains that the market price exists. The buyer may be in a position to offer a meaningful premium to the market price (say in the range of 30 to 50 per cent), and still receive good value for money.

However, the takeover of a public company can pose other challenges, such as compliance with prevailing securities laws and the requirement for the board of directors of the target company to discharge their fiduciary responsibilities to the shareholders and other parties by ensuring a fair process. The buyer will need to retain legal counsel who is familiar with the relevant securities legislation.

### Private equity portfolios

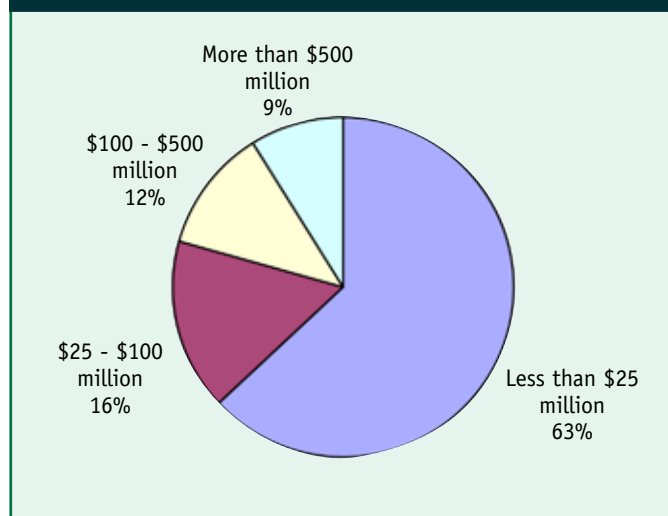
Many private equity firms have found themselves in a challenging situation over the past couple of years. This is because the ability to raise new capital is significantly more difficult today than it was during the 2005 to 2008 era. Furthermore, the market for divestitures and initial public offerings has been depressed in recent years, which has meant fewer liquidity events. Consequently, many private equity firms have found themselves unable to meet their obligations either to their investors (in terms of a return on capital) or to provide follow-on financing to their portfolio companies. In order to do so, they need to divest some of their holdings.

Many private equity firms operate on the so-called “2-6-2 rule.” That is, for every 10 investments, two will be a total write-off, six will essentially move sideways, and two will be home runs. Private equity firms need to finance the companies that they believe have home run potential as those successes generate the returns for the entire portfolio. Therefore, private equity firms may have a need to divest of portfolio investments with modest upside potential in favour of supporting those investments with great potential.

Private equity firms may be keenly interested in divesting of portfolio investments that they have held past the desired holding period (e.g. five years) of the fund. Private equity firms often post their portfolio companies on their web-sites, along with their investment criteria (such as industries of

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interest). This facilitates the buyer's efforts in identifying the right private equity firms to approach.

Buyers of private equity portfolio companies should be wary of the unique challenges that they may present. For example, private equity firms often provide senior management of their portfolio companies with significant incentives such as stock options and other forms of equity participation. The buyer may find it impractical or undesirable to offer similar incentives following the transaction. This may increase transition risk with respect to the potential loss of key employees, and possibly key customers as a result.

The current economic environment has created tremendous opportunities for companies to create shareholder value through acquisitions. Companies that have identified corporate acquisitions as a key component of their business strategy should take an active approach in order to identify proprietary deals. In addition, buyers should look for opportunities such as turnaround situations, debt acquisitions, small cap public companies and private equity portfolios. While these avenues can offer attractive upside potential, they are not without risk, and appropriate financial and legal advice should be sought. ■

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