Market Insights: Succession Planning in Canada

August 2015

Management Buyouts as an exit strategy

Succession planning for many small- and medium-sized businesses is often a secondary thought: the *Canadian Federation of Independent Business* estimates that only 40% of owners have addressed the issue and just 10% have a formal succession plan in place. This is a significant issue, as the 'baby-boomer' generation nears retirement. Having a well-defined plan not only ensures a smooth transition but also maximizes the value that owners secure for their hard-earned success over the years.

One way to facilitate this succession is via a management buyout (MBO), whereby a company's management team takes over from previous ownership by leveraging existing assets and operations.

In this issue of our Market Insights, we draw on reports by *Deloitte, Abbott Capital, McKinsey and RR Donnelley*.

Why an MBO vs. a company sale?

When planning a transition to new owners, many factors come into play and few are as contentious as 1) aligning vision, culture and long-term objectives between parties, and 2) preserving the integrity of the firm (e.g. a desire to retain all employees in the current location)

A third-party, understandably, has its own set of values and goals and it may not be optimal for a buyer to keep the acquired company as is.

Instead of selling to a third-party, existing owners can invite their management team to buy into the firm via an MBO. Doing so addresses the two key issues identified above because management is typically far more aligned with existing owners than any third-party would be.

Furthermore, an MBO provides the lowest risk with respect to business continuity since the new owners already know the company, its operations and its employees and are now far more incentivized. This structure also safeguards confidentiality by keeping the deal internal and allows for a much shorter due diligence and transaction time frame. Arriving at an agreeable price is typically less controversial as well.

Enabling MBOs with leverage

MBOs usually require large amounts of capital relative to what the management team is able to contribute in cash. There are three main types of capital available to bridge the gap:

- Term Debt: For healthy cash-flowing or fixed asset-rich businesses, banks and other alternative lenders can provide term loans.
- Equity: Term Debt is typically capped at 3-4x TTM EBITDA in the lower mid-market. If the purchase price is higher, equity injections may be required from management or alternatively a private equity fund.
- Vendor Take Back (VTB): Alternately, or in combination with equity, the seller may opt to help finance the purchase by extending a loan to the management team.

The case study on the right provides an example of the judicious use of senior and junior term debt to enable the operating shareholder to take full control of the company from the other two, passive shareholders, each owning a third of the company.

MBOs require strong underlying cash flows as well as some level of fixed long-term assets to support the new interest and principal repayments. Junior or mezzanine debt providers can stray somewhat from these requirements but their involvement comes at an additional cost. And it goes without saying, financing a transaction with debt introduces the risk of default.

Why not always do an MBO then?

Most of the time, strategic buyers can pay more than a management team because strategics can generate cost and/or revenue synergies with their current operations. Therefore, if the primary goal of existing ownership is to maximize cash in their pockets and they don't mind what the company looks like post-transition, then a sale to a strategic may be more beneficial.

FirePower Capital Case Study

FirePower's Capital Advisory practice has facilitated numerous MBO transactions and understands how to optimize outcomes for our clients in these often complicated deals.

Our client was a one-third shareholder of an infrastructure services firm, worth approx. $21 million. He was the main operator of the business and the rest of the management team was on his side; the other two shareholders were passive. The three shareholders disagreed about strategic direction: our client pushed for more investment in growth, whereas the other two wanted to 'milk' the business of all its cash to finance their lifestyles.

A shareholder agreement was in place and thankfully included a "shotgun" clause - a useful but risky mechanism to resolve disputes. FirePower discreetly arranged a full financing package ahead of our client exercising the shotgun. Because our client had significant financial resources already invested in the business, he was not required to contribute any further equity, and the program was as follows:

Senior Term Debt	$10,000,000
Senior Line of Credit	$2,000,000
Junior Debt	$4,000,000
Debt Injected	**$16,000,000**

This new debt injection levered the business heavily, as it equated to 3.3x EBITDA for the current year. FirePower advised our client to take less senior term debt than was made available to him by the banks. Even though senior debt is far less costly than junior debt, it is more restrictive and at these high leverage multiples, the risk of covenant breaches becomes more likely. The junior debt was pricey (12% + upside) but didn't call for principal repayments for a few years and the lender committed to injecting more capital to finance inorganic growth opportunities such as future acquisitions.

This deal has been tremendously beneficial to the operating shareholder, his management team, and the company:

- The operating shareholder nearly tripled his stake (see point below) without adding any capital of his own, other than the advisory, legal and accounting fees to execute the deal;
- Key managers were granted small equity stakes as part of the deal and are now unmistakeably incentivized to grow the firm;
- With the strategic direction of the company now clear, sales have accelerated and acquisition targets are under investigation - the company is far better positioned to generate substantial value for its shareholders.

Leveraged Buyout Insights
August 2015

FIREPOWER CAPITAL

LOWER MID-MARKET INSIGHTS

Who are we?

FirePower Capital is Canada's entrepreneurial investment bank. We focus exclusively on advising private lower mid-market companies in Canada on their strategic M&A and non-dilutive capital financing transactions.

We formed the firm in 2012 because **we believe that private lower mid-market companies in Canada should have access to the sophisticated transactional advisory services that are typically reserved for much larger companies.**

The need proved to be real: we are now one of the largest independent firms in Canada. As of August 2015, we are managing **12 active sell- and buy-side mandates worth an estimated $122 million, and 8 financing assignments worth $58 million**.

Our team of 16 dealmakers are smart, passionate and driven by a fierce determination to not only succeed, but exceed our clients' expectations. **We love what we do, we are good at it, and our clients love us for it.**

What do we do?

Our **Mergers & Acquisitions Practice** understands the difficulties and complexities around the decision and process of selling or buying a business. Typical transaction sizes range from $5 to $50 million, and span most industries except for resources and life sciences. We deliver on the full spectrum of M&A transactions:

- Sell-side
- Buy-side
- Asset sales & purchases
- Cross-border
- Hostile acquisition or defense
- Spin-offs and other corporate restructurings

Our **Capital Advisory Practice** provides objective transactional advice and seamless execution capabilities to our clients with respect to non-dilutive capital financings. Typical transaction sizes range from $1 to $30 million, and span most industries except for resources and life sciences. We have extensive experience raising debt capital for most situations:

- Growth
- Leveraged buyouts
- Turnarounds & special situations
- Acquisitions
- Refinancing
- Shareholder events, e.g. dividend recaps or management buyouts

Why work with FirePower?

We are deal-makers, first and foremost: We are a 'pure' M&A shop: the only thing we do is deals. Our culture isn't diluted with accounting, tax, consulting or banking activities.

We're not typical Bay Street guys: We have made it our mission to excel in the lower mid-market, and not be 'tempted' by the larger, headline-grabbing deals. That means developing a deep understanding of how to overcome the challenges unique to this segment.

Our track record is extensive: During our short history, our team has already built a reputation for crafting deals the market has never seen before, providing expert transactional advice and getting deals closed.

We do things differently: We have built FirePower like a start-up, not a traditional advisory firm. We rely heavily on new technologies to produce competitive tension between buyers or investors, and create options.

We put our money where our mouth is: Most of our compensation is based on closing a deal that works for our clients. We are aligned with them: we succeed only if our clients succeed.

We have a global reach, but nurture deep Canadian roots: Exposing a deal to hundreds of buyers or investors worldwide is easier than ever, but doing it intelligently is still time-consuming and extremely complex. A network of relationships at home helps us balance our global efforts.

Our track record (recent sample transactions)

BNOTIONS

Company Sale
$4,750,000

The undersigned acted as the exclusive advisors to the Sellers

FIREPOWER CAPITAL

CONFIDENTIAL

Medical Clinics

Management Buy-Out
$5,002,000

The undersigned acted as the exclusive advisors to the Company

FIREPOWER CAPITAL

CONFIDENTIAL

Infrastructure Services

Management Buy-Out
$16,000,000

The undersigned acted as the exclusive advisors to the shareholder

FIREPOWER CAPITAL

KINGSMAN RESOURCES

Contagious GAMING

TELOS

Reverse Takeover
$28,200,000

The undersigned acted as the special advisors to the Company

FIREPOWER CAPITAL

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