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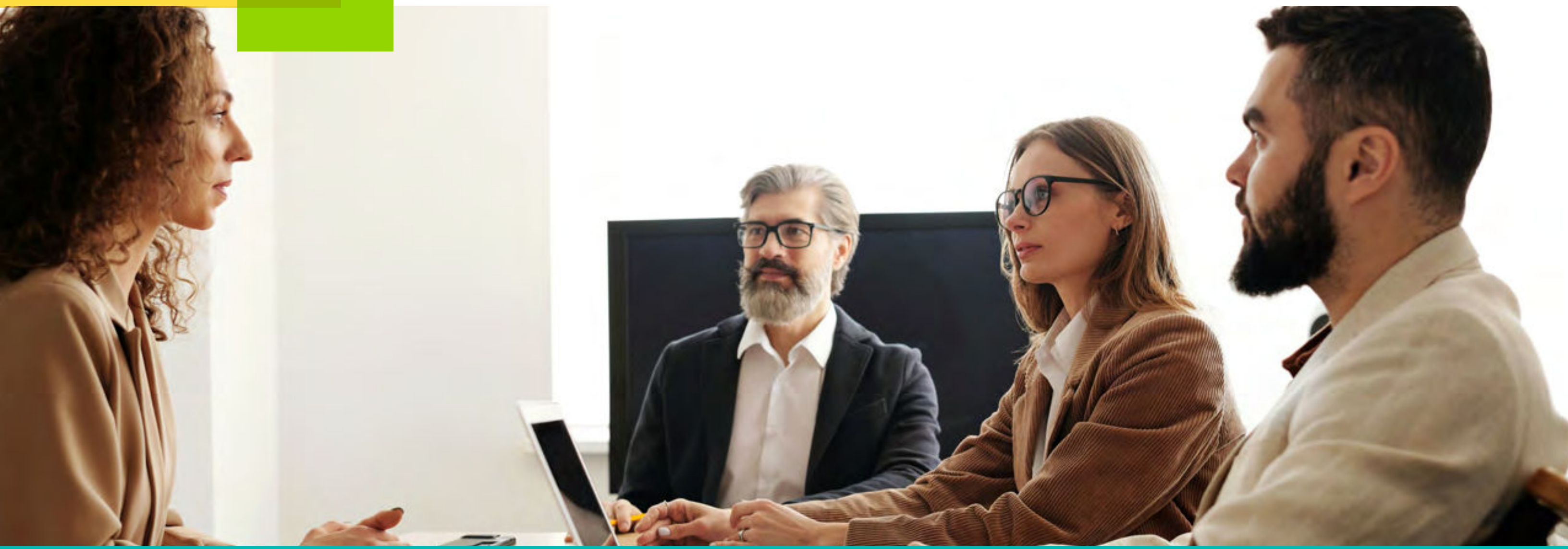
Ideas with impact



Foundational elements of a successful business acquisition

In business, there are many ways to grow. At Zeifmans, we've spent nearly 60 years assisting our clients in gaining market share and strengthening their business portfolios. We have decades of experience guiding small to mid-sized businesses as they implement our innovative strategies for growth- including countless acquisition scenarios that have led to notable financial gain.

Though our team has witnessed numerous acquisition success stories, studies conducted by the Harvard Business Review reveal that more than 60% of acquisitions end in failure. The fact is that while acquiring a business is an appealing and potentially very lucrative growth strategy, it's not without risk.

HBR has found that in almost every case, acquisition failures can be traced back to "insufficient discipline" in the evaluation process. It's easy to see how an entrepreneur can get wrapped up in the allure of a buying frenzy; in the adrenaline rush of swallowing up a competitor, or purchasing an impressive empire along with its bragging rights, the true business value may become obscured. And in the case of new and emerging markets like Cannabis or e-sports, nascent industry standards make accurate valuation much trickier.

When thinking about acquiring a new company, it's beneficial to consider how the newly acquired asset will contribute to your company legacy. What benefit will it provide to your existing customers? How will it affect your current employees? Seek acquisitions that add value beyond the enhancement of market share. Your legacy will be determined by how well you understand your customers, and how respectful you are of your stakeholders- both internal and external alike. Thus, it pays off to conduct thorough financial evaluations, and to choose wisely.

Sound like a lot of pressure? In many ways, it is. But that doesn't mean that it can't be an enjoyable process. With the assistance of a trusted business advisor who is well versed in due diligence activity, you can set your organization up for reliable success that has the potential to yield big results for years to come.

Understanding your acquisition

When considering the acquisition of a business, taking the time to gain a thorough understanding of all your options can be the key to success. There are several ways to structure a purchase, and there really is no "one size fits all" solution. Your strategy should be tailor-made to suit your specific needs, and structured to achieve exactly the results you desire.

Financing options

There are several ways to structure the financial component of your acquisition. Here are a few of the most popular options that we see on a recurring basis:

Traditional banking loans

Depending on your current financial situation, it may be a reasonable option to secure financing through a traditional bank loan. Depending on market conditions and interest rates, this can serve as an easy method for raising capital.

Government programs

In addition to traditional banking loans, government programs like the Canada Small Business Financing Program enable entrepreneurs to borrow more easily from participating financial institutions. Under the program, small business entrepreneurs can borrow up to $1 million, of which $350,000 can be used to finance the purchase or improvement of equipment and the purchase of leasehold improvements.

Vendor take back financing

Many negotiations include terms regarding vendor take back financing (VTB). Under VTB, the seller can agree to receive a portion of the purchase price over a period of three to five years. From the seller's perspective, this can be an appealing option as it assists in spreading the gain on sale of business over a number of years to help minimize any resulting tax burden.

Which to buy: Assets or shares?

The two main acquisition methods are a share sale, and an asset sale. In general, purchasers prefer asset transactions, while sellers prefer share sales. Let's take a closer look:

Asset transaction

In an asset transaction, all or some of a company's assets are purchased. These may include:

- *Equipment*
- *Inventory*
- *Real property*
- *Contracts*
- *Lease agreements*
- *Licenses*
- *Trade names*

Asset transactions are more complex, since they require paperwork for the transfer of each asset. In many cases, these transfers will also require the permission of third parties who currently hold control, as in the case of a Lease.

Purchasers tend to prefer these agreements because they can choose the assets they wish to purchase, for instance only buying the assets that the company owns outright. There is also less risk for the purchaser in buying assets. Though the purchaser is required by law to assume certain liabilities, they do not need to assume all liabilities of the existing business. Under this model, the purchaser is also free to use the assets to form a new company, reducing the risk of unforeseen liabilities inherited from the current company.

Lastly, the purchaser can reset the tax basis of assets acquired to the value as of the date of purchase. This may result in more depreciation expense being available to write off against future profits.

Share transaction

In a share transaction, the purchaser buys 100% of the company's shares. This type of sale is less complex as it only requires documentation for the transfer of shares, and in some cases the assignment of shareholder loans.

Vendors tend to prefer a share transaction because of the personal income tax benefits. Proceeds from the sale of shares are taxed as capital gains, and qualifying small businesses can also receive a capital gain exemption of about $970,000. From the buyer's perspective, any losses accumulated in the target corporation may be available to the purchaser to offset future income under certain conditions.

Purchase and Sale Agreement and Purchase Price Allocation

The Purchase and Sale Agreement (PSA) summarizes all the terms and conditions applicable to the acquisition, including the Purchase Price Allocation (PPA).

The PPA is an important consideration when buying the assets of a business because it determines the post-acquisition tax base of the various assets acquired, and therefore the rate and extent of amortization and depreciation expense available to deduct from the income of the newly acquired business.

Taking the time to develop a detailed and accurate PSA is critical to the future success of any acquisition. The terms must be suitable for both the vendor and the purchaser, as they not only set forth the clear description of what is being purchased, but also the protocol for liability moving forward. This agreement will typically include such details as:

- *Legal names/addresses of both parties*
- *Definition of terms*
- *Share or asset transaction classification*
- *Purchase price*
- *Method of financing (Cash, VTB, shares, etc.)*
- *Purchase price adjustments (for example, price reduction in the event that working capital threshold is not delivered)*
- *Deadlines, milestones, and payment terms*
- *Buyer's long-term liabilities*
- *Representations and warranties*
- *Post-closing rights and obligations*
- *Arbitration and dispute resolution protocol*
- *Closing date*
- *Governing Law*
- *Indemnification*

Due diligence

Due diligence helps to minimize risk and identify opportunities in an acquisition. This process will also help to determine the extent of representations, warranties, indemnification provisions, and whether escrows and holdbacks are necessary in the purchase agreement. Due diligence is especially critical in a share transaction, since the purchaser will inherit the target's obligations even if those pertain to operations prior to the acquisition date.

Consider some of the following topics of due diligence inquiry:

- *What do the historical financial statements reveal about the company's financial metrics and targets for future performance?*
- *Are financial statements audited?*
- *What are the company's working capital needs?*
- *Do the financial statements contain all liabilities?*
- *Are margins growing or deteriorating?*
- *Are all assets fairly valued and free of encumbrances?*
- *Is the target compliant with tax, business, and regulatory frameworks?*
- *What capital expenditures need to be made to keep growing the business?*
- *What are the accounts receivable issues?*
- *Has EBITDA been accurately calculated to include any adjustments?*

- *Who are the existing customers and what is the risk of losing them?*
- *What are the existing technology and intellectual property assets?*
- *How does this acquisition fit into the existing business of the buyer?*
- *What are the existing material contracts?*
- *Who are the employees and managers, and how do they operate?*
- *Is there any pending or historical litigation?*
- *What are the tax implications and historical tax issues?*
- *Have all third-party consents/approvals needed prior to completing the transaction been obtained?*
- *Are there antitrust and regulatory challenges?*
- *Which insurance policies will be inherited?*
- *What environmental issues does the company face?*
- *What is the competitive landscape?*

Tax planning

Tax implications are among the most important factors in any acquisition scenario. Taking the time to develop a strategic taxation plan at the outset of the purchase can have a profound effect on profitability for years to come.

A successful tax plan should take into account the following factors:

- *How is the transaction structured?*
- *How will it be financed?*
- *Who are the shareholders?*
- *Will Tax on Split Income (TOSI) rules have any impact?*
- *In an asset purchase, is the Excise Tax Act, Section 167 Election available to minimize the HST implications?*

Consulting with a tax professional early in the due diligence process can ensure that you identify risks and forge a path forward that can create real value. Without taking the time to thoroughly consider the tax implications of an acquisition, unintended consequences can result in unexpected costs. Though it's not often discussed, these tax implications can play a very large role in the failure of an acquisition, making them a critical component in the planning process.

Let's Talk

To speak to one of our acquisition experts, contact our office today at 416.256.4000 or e-mail us at info@zeifmans.ca

Trust the acquisition experts:

The decision to acquire a business is a significant one that can result in wide-reaching consequences or significant reward. The difference lies in the planning. When an entrepreneur puts in the up-front work required to fully investigate, vet, and strategize prior to an acquisition, they mitigate the risk of taking a misstep, and are able to avail themselves of every present advantage.

Working with an expert in the field of business acquisition strategy is an excellent way to increase the diligence of your purchase process, while also benefitting from the perspective of an unbiased and neutral third party. At Zeifmans, we have decades of experience advising on merger and acquisition transactions, creating strategies that lay the foundation for future growth and success.

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