TOP DEAL BREAKERS & HOW TO AVOID THEM

Moderator: ILAN JACOBSON, Founding Partner & CEO, FirePower Capital

Panelists: JAMES JOHNSON, Managing Partner, Signal Hill Equity Partners

ANDREW MARK, Executive Director, Rhyno Equity Group

ARLENE O'NEILL, Partner, Gardiner Roberts LLP

GORD RIDDLE, CEO, Applied Comfort Products Inc.

Focus: Deal breakers that can arise during the Letter of Intent ("LOI") and post-LOI stage of the deal process.

You have:

- Prepared for a sale
- Launched a process
- You've got offers in hand

What do you have to look for to make sure the deal progresses smoothly?

1. **Price:** What are the bidder's assumptions? More information about the assumptions underpinning a bid means that there is less opportunity for the bidder to try and "retrade" (renegotiate) on price during due diligence.

2. **Deal Structure:** Share sale vs. Asset sale…

   Sellers usually prefer share sales because:

   a. They are entitled to claim the Lifetime Capital Gains Exemption on the proceeds (up to $848,252 tax free in 2018);
   b. The buyer gets the business intact with all its assets, employees, customers, etc., as well as all the liabilities, with some typical exclusions.
   c. There is less documentation necessary and typically, are fewer third party issues.

   Buyers prefer an asset purchase because:

   a. They can allocate much of the purchase price across depreciable property thus "stepping up" the value of those assets resulting in a tax shield because of a larger depreciation expense;

b. They can “cherry pick” assets that they want and do not have to assume any excess assets, employees or liabilities that they don’t. (There are statutory exceptions to this premise especially where the buyer acquires all or substantially all the assets of the business.)

3. **Working Capital**: Define very clearly in the LOI what working capital means to the buyer and to you. Make sure any provisions related to working capital calculations leave no room for uncertainty.

4. **Payment Terms:** Payment of the purchase price is at least 2 payments (on closing, and after ~90 days to adjust for working capital), and payment can come in different forms. It’s important to understand what they are, along with their related risks:

   a. **Earn-outs:** Most often used to bridge the gap between a seller’s and buyer’s perception of value. Earn-outs are typically based on financial metrics such as revenue, gross profit, or EBITDA, or on other metrics such as non-financial milestones (e.g. successful grant of a patent). As an example, if you hit $12m of gross profit next year, we will pay you an earn-out of $4m. Keeping the earn-out metric simple reduces the likelihood of future disputes; more to the point: revenue or gross profit can be far less ‘played with’ than EBITDA.
   b. **Vendor-take-backs (“VTBs”):** A form of interest-bearing debt provided by the seller, very often subordinated to a senior lender. Arises generally where there is some shortfall in the buyer’s financing sources, or when the seller is content with leaving some money in the business.
   c. **Holdbacks:** An amount held back to address rep and warranty concerns raised by the buyer for 1-2 years, typically a small percentage of the deal unless the concerns are significant and specific. Can also be used to finance a shortfall in working capital 90 days after closing.
   d. **Rolled-over equity:** The seller retains some equity stake in the entity post-closing. The seller can thus participate in any upside until the buyer itself sells down the road, but, of course, there is downside risk as well.

5. **Due Diligence & Exclusivity:** An LOI should address how long due diligence will be and how it will be carried out. Typically, an LOI will state that due diligence is to last approximately 3 months (60-120 days is normal). For the vast majority of mid-market deals, a period of exclusivity (i.e. you cannot entertain other buyers) will overlay due diligence. The reason for exclusivity is that buyers will spend significant resources assessing the deal and they will want your full attention during that time. A key concern that should be addressed: how is access going to be managed to books, employees, locations, etc.

Once the LOI is signed and due diligence starts, negotiations continue on the definitive agreements. Issues to be aware of:

1. **Price renegotiations during due diligence**: You can mitigate the risk of being “re-traded” on price by being transparent with the buyer upfront (don’t hide the skeletons—address them candidly, and with practical mitigations), and ensuring the buyer provides you with a comprehensive set of assumptions underpinning the initial bid.

2. **Representations and warranties, liability caps*:*** A comprehensive set of reps and warranties is market. It is typical for a buyer to be indemnified for breaches of representations and warranties and for liabilities that arise after closing that originated prior to the closing date (e.g. environmental, litigation), for a few years and 7 years for tax (because the CRA can examine books for that period). As for caps on liability exposure for the seller, these are heavily negotiated based on bargaining power of the buyer and seller in the circumstances. Survival period on reps and warranties and caps on liability have recently been trending towards shorter time periods for survival of reps and warranties and lower caps on liability.

The sale process is complex and loaded with potential issues. Understanding the issues and knowing what questions to ask is an important step towards defusing potential minefields. We hope you leave our session feeling better equipped to ask the right questions!