



CBV INSIGHTS

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CROSS-BORDER M&A AND THE CURRENT ECONOMIC ENVIRONMENT

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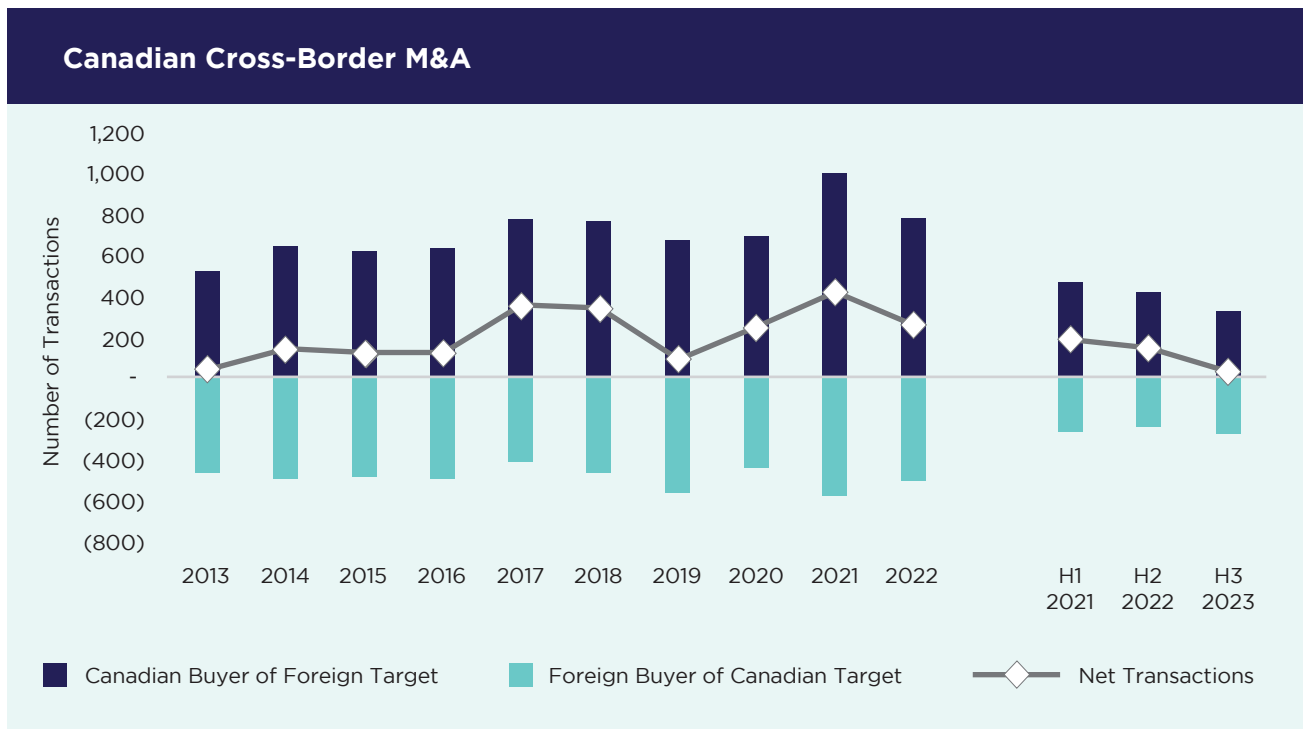
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INTRODUCTION

Over the past 10 years, foreign investors have represented approximately 30% of the total buyer pool of Canadian company acquisitions¹ – and despite a slowdown in the overall deal market in late 2022 and early 2023, foreign buyers of Canadian companies remained resilient.

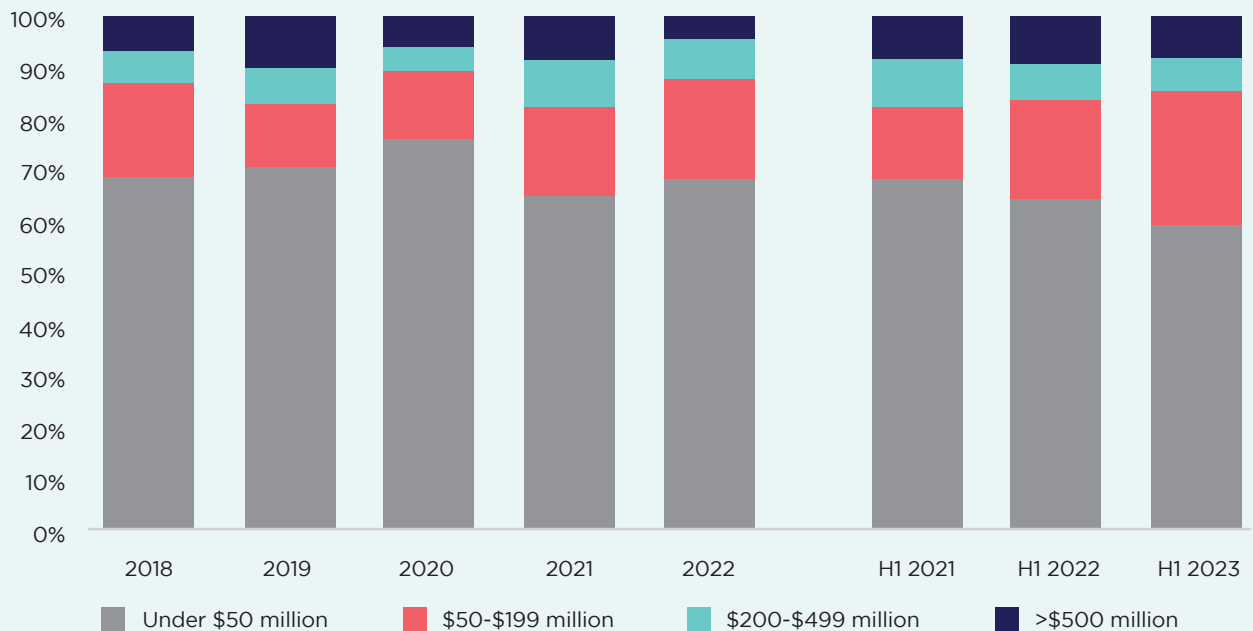
In the first half of 2023, there were 282 foreign buyers of Canadian companies, a slight increase over the 259 deals completed in the prior year.² Canadian buyers, on the other hand, were more hesitant in acquiring companies in general with 875 acquisitions completed compared to 1,068 in the same period as last year. Even when they were looking to buy companies, Canadian buyers focused on local companies with investments in foreign companies dropping by 15% in H1 2023 while local acquisitions only fell by 8.3%.



The Canadian M&A market predominately involves small and medium sized businesses with approximately 95% of Canadian sellers with a Total Enterprise Value (“TEV”) of under \$500 million.³ Cross-border transactions involving a Canadian seller is no different, with deals under \$50 million, \$200 million and \$500 million representing 59.2%, 26.3% and 6.6% of the market respectively in H1 2023. Recently, foreign buyers have moved up market with Canadian targets between \$50-\$199 million representing a larger proportion of deals when compared to the past five years.



DEAL VOLUME BY IMPLIED EV



This article will look at the cross-border deal market in Canada and the effects of recent economic events on the merger and acquisition (M&A) process. With the pandemic pushing deal processes to be more online, significant capital waiting to be deployed, and with increased globalization, foreign buyers continue to be interested in acquisition opportunities in Canada—especially our neighbors south of the border.

A More Online Deal Process

The COVID-19 pandemic caused a significant ripple in the market, the effects of which are still seen in 2023. In a post-pandemic world, the deal process has evolved into a hybrid approach, utilizing both the convenience of video conferencing and the more thorough and efficient nature of in-person meetings.

There are several advantages to a more online deal process. By distributing marketing information electronically, sellers can easily share detailed information (e.g. video footage of facilities and operations) and simultaneously gather data on each buyer's level of interest based on open rate and view time. And, during the initial marketing phase of the deal process, management can present the investment opportunity by webinar and answer frequently asked questions. This helps potential buyers get a better understanding of senior management's vision and personalities without the need to travel.

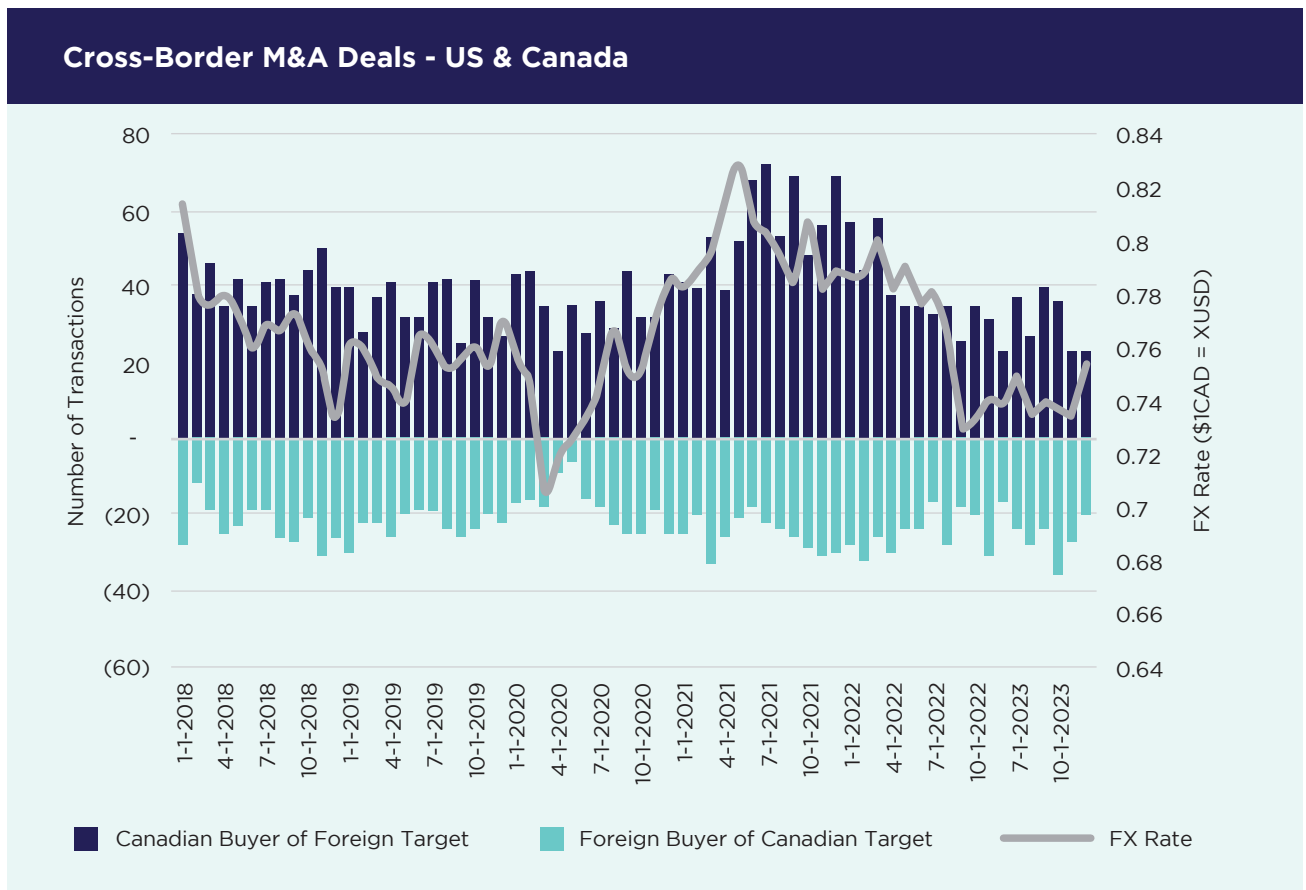
Further discussions after receiving indications of interests ("IOI") have reverted to an in-person format, as an in-person meeting allows both sellers and buyers to get a better sense of their compatibility and ability to partner in the future. After the management meetings are complete and a letter of intent ("LOI") is signed with one exclusive party, the process tends to revert to a hybrid model. Specifically, many due diligence streams aside from operational diligence have come to rely heavily on video calls and screen sharing, limiting the number of in-person visits to one or two, if needed at all.

Moving forward, the hybrid approach will provide foreign buyers with more access to management and increase information flow, lessening the local buyer advantage during the initial marketing phase; however, once IOIs are received and the field of candidates is narrowed to a handful of parties, in-person meetings will remain an important part of the deal process.



The Effect of Exchange Rates on Cross-Border M&A Between U.S. and Canada

Historically, as the Loonie strengthens against the U.S. dollar, investment from Canadian companies into the U.S. has increased. The top half of the below chart shows this trend,⁴ particularly in 2021 and 2022. This correlation meets a common-sense expectation that Canadian firms with increased buying power will take advantage of it. But surprisingly, the same cannot be said of U.S. firms – they are not always cross-border shopping for Canadian companies when their dollar strengthens relative to Canada’s.



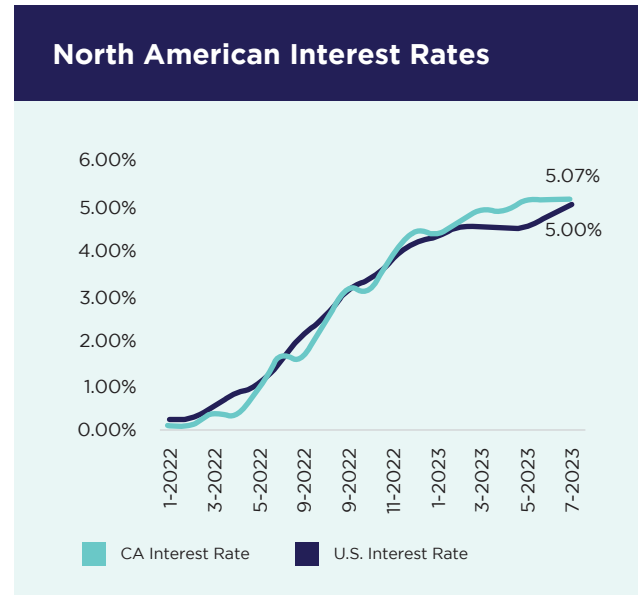
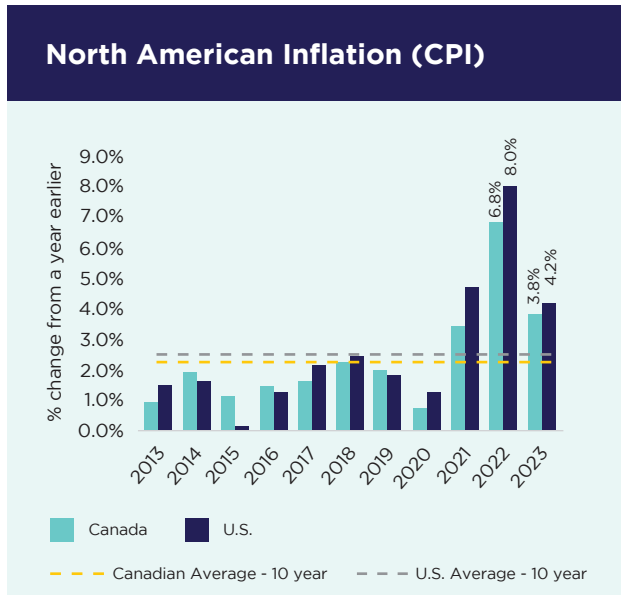
Instead, investment from U.S. companies into Canada shows an ambiguous correlation to the exchange rate, as shown in the bottom half of the chart.⁵ A few academic studies have investigated this phenomenon. A study published in the *Canadian Journal of Economics* found evidence that a real depreciation of the Canadian dollar will increase U.S. acquisitions of Canadian companies in Research & Development (R&D) intensive manufacturing industries.⁶ However it found no significant correlation for manufacturing industries with low levels of R&D intensity. Instead, low R&D industries demonstrated a stronger correlation to other influences such as U.S. domestic M&A activity.

What does this ambiguity mean for Canadian buyers and sellers in today’s economy? With the Canadian dollar reverting close to the long-term average against the U.S. dollar as of June 2023, investment in U.S. companies from Canadians has slowed compared to 2021 highs, while U.S. investment in Canadian companies remains resilient. While the exchange rate may be a factor to Canadian buyers looking to invest abroad, Canadian sellers should not base their exit timing solely on the strength of the Loonie. Instead, sellers should focus on building a differentiated business with growth opportunities that a buyer can execute on.



Inflation and Interest Rates are Tightening Wallets

Rising interest rates in both Canada and the U.S. caused a contraction in the deal market starting in 2022. The Canadian and U.S. governments issued 10 rate hikes each as of June 30, 2023, with the potential of additional rate hikes on the horizon. With a significantly higher cost of borrowing, buyers have become more selective with their investments.



As a result of the volatility and increased uncertainty in the market, buyers now demand a more thorough due diligence process which has extended the deal timeline. Financial sponsors and buyers alike are questioning potential “COVID-bumps” in historical performance. There is an increased focus on a company’s implementation of mitigating factors for supply chain disruptions as well as a company’s ability to manage profitability and volume sales amid increases in input costs. Improvements to financial performance (e.g., volume increases, margin improvements, cost reductions) are met with a skeptical lens and thoroughly stress tested to meet the more stringent requirements of financing partners. Quality of earnings (“QoE”) reports, a detailed analysis of the underlying drivers of a business’ performance, are being updated through to signing the purchase agreement, where previously a larger gap between the QoE and signing date was standard.

In response, sellers need to build more robust forecasts that include various stress tests and mitigation strategies including the use of currency and commodity hedging, matching customer and supplier contract durations and implementing redundancies to avoid service disruptions. Data availability is important now more than ever to provide quantitative proof that the company’s financial performance is defensible. Abnormal and non-operating expenses need to be properly documented and justified. Additionally, a strong monthly financial close process is crucial in avoiding delays in transaction closings.



Looking Ahead

Canadian M&A Transactions



Deal flow remained relatively stagnant to start the year, as parties on both sides sat on the sidelines with 848 transactions completed in the first half of 2023 compared to 925 deals over the same period last year.⁷ Potential sellers turned their focus on operations to stabilize their business and waited for the deal market to improve before starting a sale process. Resilient companies adapted their business to better handle the current economic climate (e.g., hedging supplier costs, renegotiating customer contracts), providing a clearer and more defensible forecast for the remainder of 2023 and beyond. With fewer quality deals in the market, strategic buyers – or buyers in the same industry looking for inorganic growth opportunities – were more selective in their acquisitions, focusing on organic growth and limiting acquisitions to specific target categories. Financial buyers – investors looking to buy and grow a company as an investment – took stock of the performance of their existing portfolio companies, preferring add-on opportunities to new investments.

As the year has progressed, it's become clear that a reversion back to 2022 deal activity and valuations is unlikely to occur in 2023. Instead, concerns of selling at depressed valuations have been abated as interest rate hikes began to slow and economies started to stabilize. Market activity showed that high-quality assets will still receive premium valuations, given the flight to quality by investors and lenders alike.

Valuations aside, the standard motivations continue to lead owners to consider a sale, including retirement, a focus on other business ventures, liquidity needs and burnout. Approximately 61.5% of small- to medium-sized businesses in Canada have a primary decision-maker over the age of 50, with 14.6% of businesses with a primary decision-maker over the age of 65.⁸ As business owners continue to age, transition plans become increasingly important as key man risk⁹ and a lack of business continuity post-transaction will negatively impact the company valuation.

Buyers continue to sit on a significant amount of cash that they are looking to deploy. Private equity firms, in particular, are behind on deployment of capital and are looking for quality companies to invest in. U.S. middle-market private equity groups have noted a higher deal flow in Q2 2023 compared to Q1 2023 and are eager to deploy capital in Canada. Cross-border M&A, especially interest in middle-market Canadian assets by foreign investors, will remain elevated through 2023 and into 2024.



Other Key Considerations

As foreign buyers continue to show significant interest in the Canadian market, sellers should be aware of several cultural differences between Canadian and international markets. For example, labour laws in Canada tend to be stricter than those in the U.S. (e.g., Canadian employees are entitled to severance pay when terminated while there is no federal law mandating severance pay in the U.S.). The seller should be able to explain how aspects such as severance are normally dealt with in a process to avoid alarming buyers at a later stage of the deal process.

Another common concern with international buyers is the issue of customer concentration, especially within sectors such as food and beverage and telecom, where there is a smaller customer base than foreign buyers are accustomed to. When approaching a foreign buyer on this subject, it's important to describe the marketplace in Canada—even if it seems obvious to local buyers. It's these differences, however, that generally make foreign investors a compelling partner. An international buyer's understanding of its local market is advantageous to the seller if the company is looking to grow its operations internationally.

The prevalence of cross-border M&A has also led to increased adoption of Representation and Warranty Insurance (“RWI”)—previously more popular in the United States. RWI is an insurance policy that generally covers most, if not all, of the seller's indemnification obligations for losses stemming from breaches of, or inaccuracies in, seller representations and warranties.⁷ According to Woodruff Sawyer, a U.S.-based insurance agency, 75% of private equity transactions and 64% of larger strategic acquisitions are insured.¹¹ There has been an increase in the usage of RWI in Canadian deals, especially those that involve a U.S. buyer, to help mitigate risk allocation and reduce the percentage of the transaction value held in escrow. Canadian RWI tend to have a longer coverage period of 12-24 months, compared to 12-18 months for U.S. RWI.¹² While RWI does provide risk mitigation, insurance underwriters require a more exhaustive QoE compared to uninsured processes. If a business owner is not prepared for the added scrutiny from the addition of RWI, the time to close will be extended as the company searches for the information required to satisfy the underwriter. Despite this, the demand for RWI in Canada, especially in cross-border deals, is expected to grow as the benefits of RWI outweigh the costs.

Cross-border M&A transactions also tend to have more complex tax structures compared to deals done with a local party. For example, Canada does not have entities similar to American LLCs that can be used as an acquisition vehicle. Foreign buyers generally want to incorporate a Canadian acquisition company that allows for the pushdown of any acquisition financing and Canadian tax-efficient repatriation of funds up to the purchase price without being subject to Canadian withholding tax. Business owners thinking of starting a sale process should consider speaking with a tax specialist to ensure their company is properly positioned to allow for a more streamlined and tax-efficient sale process.



Concluding Thoughts

Cross-border M&A has always been a significant part of the Canadian deal economy. With the recent push for a more online deal process, high cash availability in the U.S., a flight to quality, and a strong supply of Canadian companies hitting the market, the prevalence of cross-border transactions is expected to expand over the next several years. While there are added complexities to a cross-border deal compared to a localized deal spanning legal, tax and cultural differences, the benefits of a foreign buyer including their experience and connections internationally, a more competitive process involving more parties, and potential synergies through geographical expansion are key considerations when looking for the right partner.

In the realm of cross-border transactions, where diverse business practices, economic factors, and regulatory environments come into play, the insight and expertise provided by CBVs is invaluable. CBVs bring to the table a meticulous, standardized and analytical approach to valuing businesses that ensures stakeholders are equipped with accurate, reliable valuations. As foreign investment continues to rise, especially in the Canadian market, the role of CBVs becomes increasingly essential, offering assurance and credibility to international deal-making processes. The expertise of CBVs guarantees that both buyers and sellers can navigate cross-border M&A activities with confidence, understanding, and trust.

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