M & A As A Growth Strategy For Cleantech Companies

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Scaling Challenges of SMEs in Cleantech

- Many SMEs often hit a ceiling in terms of organic growth making it difficult to scale or raise growth capital
- Firms often want to grow into new geographic markets or verticals but are scared of the risk and financial burden in launching into the unknown
- Most PE firms have a minimum size criteria of $3M in EBITDA to consider an investment or acquisition
- Most strategic buyers also have a minimum revenue requirement for acquisitions as it “needs to move the needle” and costs the same to do a small deal as a much larger deal
- So ultimately SCALE IS EVERYTHING when looking for growth capital or an ultimate exit

Buy vs. Build

- Many SMEs that want to grow don't often consider either acquiring or merging with another entity that offers strategic value, cost synergies and greater scale

- Even opening a small satellite office in Canada or another country can easily be a $500K to $1M investment with no guaranteed return
  - This can often be a higher risk proposition than actually acquiring a company

- If M & A is done right, with the help of good advisors, this can be a lower risk way of growing as the acquired company should or often comes with good people, real revenues and real customers
  - The devil is in the detail as the strategic fit and integration plan must be sound, hence the need to take a disciplined and systematic approach to M & A

- You will still need capital to make an acquisition, but with proper financing and good deal structure you can often result with having to come up with only 10% to 20% of the acquisition price (zero if it is a merger)

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2025 Cleantech and Related Investment Trends

- As per latest Crunchbase report, global investment in sustainability is hitting a four-year low.
- Energy and related technology dominates the market for Cleantech investment
- Clean Energy Technology spending, including renewable power generation, storage, green hydrogen production, and CCS is expected to reach $670 billion.
    - Set to surpass investments in upstream oil and gas for the first time. Solar PV to account for half of all cleantech investments and two-thirds of installed megawatts.
- Capital intensive and related 'first of" Industries continue to face headwinds in investment Interest and actual investment

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Common Ways to Buy a Business

- There are three basic ways to buy a business:
  - Share purchase
    - Purchase of the shares of the corporation that owns the business
  - Asset Purchase
    - Purchase only certain assets or business operations from the company
  - Business combination (i.e. merger, amalgamation)
    - Two or more corporate entities are merged into one
    - Typically used in larger transactions or for tax driven reasons

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Asset Sale

Buyers generally prefer asset deals as they pose less risk:

- Can “cherry pick” only the assets they want
- Insulates the Buyer from hidden risks or liabilities in the corporation

Disadvantages to Sellers:

- Seller may be left with redundant assets or un-assumed liabilities
- Less tax advantageous (no capital gains exemption) as sellers need to find a way to strip cash out of the corporate entity
- May need approvals to assign contracts/supply agreements

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Share Sale

- Most private company transactions are structured as share purchases to optimize the tax benefit so that sellers can take advantage of family trusts and their capital gains exemptions
  - Asset purchases are more commonly used if a company has multiple lines of business and the purchaser is buying only one of them
- Sellers generally prefer a share sale for several reasons:
  - Simplicity - all the assets and liabilities go with the Buyer
  - Treated as a capital gain
- Disadvantages to buyers are:
  - Acquiring the entirety of the business "warts and all"
  - Buyer "assumes" all existing agreements and liabilities

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Typical Deal Structures

- Most private company transactions in the SME space are share purchases
    - This is primarily tax driven in Canada so that sellers can take advantage of family trusts and the capital gains exemption
- Deals can be for a minority stake, a control stake or a 100% acquisition
- It is important to distinguish between the enterprise value ("EV") for the business (i.e. what the total enterprise is valued at) and the purchase price of the particular stake that is being acquired for the business
    - Minority stakes usually have a discount applied to them due to a lack of control
- Deal structure has a major impact on the attractiveness of a deal and the "highest EV" does not always carry the day

Typical Deal Structures cont'd

- The purchase price or "consideration" for the stake being acquired is usually a combination of the following:
  - **Cash on closing** – this can be anywhere from 0% to 100% of the aggregate purchase price
  - **"Seller Note" or "Vendor Take-Back"** – this a promissory note payable to the seller by the buyer over a period of time (usually 3 to 5 years) and generally includes a market interest rate
    - Seller notes are a commonly used tool to finance a portion of the transaction and can be either unsecured or secured
    - A secured note would likely have to be in a second position to the senior lender to the business (Note: EDC has a product that will guarantee a seller note with a standby letter of credit)

Typical Deal Structures cont'd

- **"Equity Roll"** – often when a company is acquired by a financial or strategic buyer, the buyer wants the seller to continue to be actively involved in the business and will require the seller to "roll" a portion of the purchase price into equity in the new entity to ensure they have some "skin in the game"
    - This can be equity in the same business but often is in a Holdco or parent company where a roll-up or aggregation of several companies is part of the strategy
    - An equity roll is usually in the range of 20% to 30% of the purchase price but can be more

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Typical Deal Structures cont'd

- **<u>"Earn-outs"</u>** - an Earnout is a commonly used tool that ties a future payment to Company performance. An Earnout effectively re-sets the valuation to a higher level if performance targets are achieved and is a common method of bridging the valuation gap
    - Earnouts are rarely fully earned and we typically advise clients on the sell side that an earnout should be viewed as a "bonus" and not a critical part of the purchase price
    - This is especially true where the seller will be transitioning out of the business and no longer has control over the purse strings and how the company performs

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Valuations

- Most SMEs are valued on a multiple of EBITDA – ranging from 3X to 7X with a median of 4X to **5X**
- Rule of 40 – to achieve high growth company multiples, buyers often look for combination of growth rates and EBITDA % of 40% or greater (now moving towards 50%)
- Other factors that will impact valuation multiples:
  - Customer concentration rates
  - % of recurring or reoccurring revenues (buyers don't like project based businesses)
  - Client stickiness and churn rates
  - Industry growth rates (CAGR) and stage of the business life cycle for your industry
  - Current economic conditions
  - Other geopolitical risks or macro trends associated with the business
  - Market comparables for similar businesses

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Top Misconceptions About Company Valuations

- **There are standard industry-accepted multiples**
  - There is no such thing as a "standard multiple" and just "rules of thumb". No two businesses are alike and companies in the exact same industry can command very different multiples based on their performance.
- **The company's value is based purely on Its financial performance**
  - A firm's value is based upon not only the financial attributes, but also its non-financial and even intangible attributes as well including things like management team, growth rates, reputation, size, scalability and internal processes etc.
- **Maximum valuation is the determining factor for a seller in selecting a deal**
  - The best deal is not necessarily the deal that presents the highest valuation. Deal structure and the characteristics of the buyer are extremely important in determining the best fit for a seller. Issues like cash on close, seller notes and earnouts can dramatically affect your terminal value.

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Top Misconceptions About Company Valuations

- **A valuation report on the company is what it should sell for**
  - A valuation is merely a baseline indicator at a point in time and not a true measure of what a company is worth today. A company is worth what a willing seller will pay TODAY and this is often dictated by numerous intangible things about your company. Sellers should never share prior valuations with buyers and you should let them come to their own determination
- **The business value should be based on its future potential**
  - Buyers are not going to set a valuation for your business based purely on its "potential". Every seller thinks their business has enormous potential but businesses are primarily valued on their historical performance and where they are TODAY. As far as a buyer is concerned, if the business has so much potential you'd be exploiting that potential yourself

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How M & A Deals Are Typically Financed

- Buyers generally want as much leverage as possible on a deal as this translates into a higher return on equity and conserves cash
  - Sophisticated buyers typically look for a senior lender to underwrite 50% or more of the purchase price which in today's market translates into 2.5X to 3X of EBITDA of the **combined** entities (need to build pro forma financial forecasts of both companies together)
- In addition to senior debt, buyers will look to leverage their equity with a combination of seller notes and rolled equity
- An acquisition can often be a catalyst to raise private equity capital as PEs seek scale and love to invest in roll-ups and strategic acquisitions

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What A Typical Deal Might Look Like

- There is no such thing as a "typical" deal but most deals have common components
- This scenario contemplates acquisition of a company with these features:
  - $4M in revenues
  - 15% EBITDA ($600K)
  - Total enterprise value of $3M (5X multiple of EBITDA)
  - Buyer wants the founder to stay on with the business and help to grow

$3 Million EV Sale:

- $1.8 million cash on closing
- $600K seller note (payable over 4 – 5 years with interest)
- 20% equity roll ($600K value)
- Earnout of up to another $1 million over a 3-year period based on achieving predefined growth metrics
- Bank financing of 2.5X EBITDA = $1.5M (based solely on target company cashflow)
- Buyer equity contribution = $300K (10%)

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Questions?

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