

## Told You So!

by **Bob Shoniker**

Last year's edition of *Courage Capital* was entitled "A Time For Courage". We strongly urged investors "to take advantage of the opportunities that the current credit crisis/recession brings". We saw 2009 as "a once in a lifetime opportunity to invest or buy into long-term fundamentally sound businesses".

What a difference a year makes. Economic and financial Armageddon did not occur. While fundamentally we are on the road to a slow recovery in North America, the world of small cap stock market performance has been incredible. The BMO Nesbitt Burns Small Cap Index is up 80% from a year ago.

Did you invest?

Apparently not, as in 2009, Canadian private equity firms did about 20% fewer deals (99 vs. 120) and invested about 75% less capital in these deals than in 2008.

The private equity community pulled back from being aggressive buyers due to both the economic uncertainty of the business prospects of targets and the inability to attract debt to leverage their deals. This lack of debt leverage resulted in a reformulation of valuations, with EBITDA purchase price multiples shrinking to the 4.5-5.5 range, down from 7-8 times just 24 months earlier. Entrepreneurs weren't (and still aren't) prepared to accept these metrics, resulting in a seller's strike. Our 2009 sell-side assignments were for virtually all for businesses under duress—usually peering over the cliffs of bankruptcy.

Today, we see signs that the storm clouds are drifting away:

On the venture financing front, federal and provincial governments have announced more than \$500 million in new programs, targeted to early-stage, innovative, technology and green tech companies.

A handful of specialty and later-stage venture funds have successfully tapped "Fund of Funds" sources for new capital, and will be open for new business in 2010.

Several private equity funds have "reloaded" with aggregate new commitments of close to \$1 billion for new deals. More than \$20 billion of limited partnership commitments reside in Canadian buyout funds.

While the traditional mezzanine funders are still struggling to find institutional commitments for new funding, we are, on a deal-by-deal basis, finding new lenders in private wealth managers seeking current high yields for their clients. Given the pending demise of the Income Trusts, and the foreseeable extension of the current low level of interest rates, high net-worth money managers will be seeking more quality, high-yielding investments.

Traditional senior bank financing remains weak (regardless of bankers' public comments to the contrary). This is the first downturn cycle where we haven't seen a major bank go after SME market share. The fundamental reason nobody has is that the problems of the American banks drove Canadian subsidiaries of American companies into the eagerly awaiting lending arms of our major banks. Simply put, the bankers could get better credit, bigger loans, and wider spreads from American-owned subsidiaries than lending to Canadian entrepreneurs. The improving American

*continued on page 4*

# Inspiration for Fun & Profit

Here are this year's recommended mental work-outs and relaxations.

*What Would Google Do?* by Jeff Jarvis. The reviews for this exceptional book are outstanding and we concur. Jarvis reverse-engineers Google to discover forty clear and straightforward rules to manage and live by. His findings are counterintuitive, imaginative, practical, and above all visionary. It's a must for anyone looking for ways to hit real pay dirt in the new world of Web 2.0 marketing. Read it, then read it again!

*The \$12 Million Stuffed Shark: The Curious Economics of Contemporary Art* by Don Thompson. Why would a New York investment banker pay \$12 million for the decaying, stuffed carcass of a shark? The simple answer is ego, but reading Thompson's lucid and well-researched book will provide you with an irreverent but expert guide to the beguiling business of contemporary art. It's clear that contemporary art buyers are truly mad. Move over Bernie Madoff, the Ponzi scheme has a close cousin in the business of contemporary art! All in all, a fascinating read.

Speaking of art, a great cottage or airplane read is Ian Rankin's *Doors Open*, which is about an art heist by a bungling group of art-knowledgeable amateur thieves from Edinburgh's venerable financial institutions. Rankin is the acclaimed detective storyteller of the Inspector Morris series.

*My Paper Chase: True Stories of Vanished Times* by Harold Evans. If you're like me, and rarely read biographies and almost never autobiographies, make an exception and read this one. Evans recounts his journey, from leaving school at age fifteen, to becoming the editor of two of the most famous newspapers in the world, *The Sunday Times* and *The Times* of London. Along the way he cracks England's biggest spy scandal; exposes the cause of the world's

deadliest DC-10 crash; reveals shocking truths about the Northern Ireland political powder keg; and uncovers one of the greatest health scandals of the 20<sup>th</sup> century: the thalidomide affair. The second stage of his career as a book publisher running Random House just adds to the treasure trove of literacy successes. A great read for the aging boomer—like me!

*The Dying Light* by Henry Porter, Orion Books, 2009. This is a medium-good thriller, but it's real value is that it foreshadows the power implications of the on-going invasion of privacy, and does it in the most appropriate place: the United Kingdom, which has almost become the embodiment of Orwell's Big Brother state. This book makes the final, logical leap: the integration of all public and private information about individuals into one unified database to provide the government of the day with the means of persuading, blackmailing, or punishing everyone who does not agree with them. You might enjoy the fictional aspects of this story, but the underlying reality will certainly make you uncomfortable.

*The Age of Aging: How Demographics Are Changing the Global Economy and Our World* by George Magnus, John Wiley & Sons, 2009. We are entering an unprecedented time in human history, where the number of old people is expanding faster than any other age group. The implications of this are much more important than most people realize, and will affect everything, from politics, to consumer demand, to pensions and investment markets. Unfortunately, Magnus takes a dry subject – demographics – and makes it downright boring, but points out some hard truths along the way. We'd suggest that you cherry-pick some of the topics, and flip through the rest of the book, but this is a subject that you need to know more about.

## Andy's Music Picks

Dave Matthews Band: **Big Whiskey And The Gruxgrux King**. Their first studio album in 4 years, and despite the loss of founding member Leroi Moore, this album finds the Dave Matthews Band in top form. There are no long rambling jams on this album, just very well constructed tunes. If you listen carefully to each track you can pick up on how much is going on: syncopations, changing time signatures, guitar solos, funky horn lines. In any other set of hands it would sound like a huge mess, but they pull it off with ease.

Pearl Jam: **Backspacer**. I'm biased in favour of anything this band puts out as they were at their peak when I was young. The 8 years of GW Bush are over, so this album finds them less pissed-off than before, and you can tell that they are celebrating with a much more upbeat album than earlier ones.

Wayne Krantz: **Krantz/Carlock/Lefebvre**. This album is what modern instrumental music *should* sound like. This trio of NYC-based musicians is legendary in the jazz world partly because they held a weekly gig at New York's 55 Bar for over a decade. Hard as it is to believe, this is their first studio album as their previous releases were compiled from live gig recordings and pieced together afterwards.

Pete Yorn: **Back and Forth**. Pete Yorn was an instant hit with critics when he first appeared in 2001, but was eclipsed when John Mayer and his "bubblegum/wannabe Dave Matthews-for-tweens" sound became popular. Yet fans of more classic songwriters like Bruce Springsteen and Bob Dylan, and more modern ones like Jeff Buckley and Elliot Smith, were instantly drawn to Pete Yorn. This new album reflects a man in his mid-30's who sounds like he is comfortable in his skin, and we end up with 13 tracks of introspective gems.

*concluded next page*

# The Deal of the Year: Postponed to 2010?

The year 2009 was one of near-misses as far as having an exciting bang-up Deal of the Year. It could have been, should have been, arranging the start up financing for a new retail bank. We were working with an outstanding management team that had turned around P.C. Financial. Close, but no cigar on this one. Nobody wanted to finance a start-up regardless of the quality of management and the scalability of the opportunity.

This year's prime candidate for Deal of the Year is next door to being a start up. Rogue DNA is a Vancouver-based company that has a "must have" patented technology for counterfeit detection. DNA identifies human beings. Rogue DNA absolutely identifies a passport, bank notes, ID cards, etc., from the underlying material characteristics of the documents themselves.

Founded by an experienced group of serial entrepreneurs, Rogue DNA is a "must have" solution to a \$3 trillion annual problem: fraud, especially identity fraud.

So if you have a few million dollars looking for a world-class investment opportunity, please contact Bob Shoniker at (416) 863-6096 or email [bshoniker@couragecapital.com](mailto:bshoniker@couragecapital.com). \$\$

---

## Andy's Music Picks concluded

Astroid Power Up: **Googleplex**. This album came out back in 2003 but I just learned about it, and think it's some of the most ambitious and refreshing music to come along in a long time, and still sounds like it is from the future. It might be a bit too "out there" for some people, but I love it. \$\$

# Innovation Capital: A Job Creating Proposal

What is a sustainable new knowledge-based job worth? Well, if you look at two recent Ontario government initiatives, it's worth between \$27,313 per job (\$437 million in grants promised to Samsung for 16,000 sustainable jobs in green energy) and \$328,250 per job (\$263 million in aid to Ubisoft, a video game developer/publisher to create an 800-job studio in Toronto). At first blush, it looks like Samsung doesn't know how to negotiate; however, their deal did include lucrative 20-year Feed in Tariff contracts for Samsung power generation as well as preferential access to transmission lines. Quantifying the economic value of these deal features is impossible but it probably does raise the \$27K per new Samsung job significantly. Clearly the province is prepared to pay for sustainable, new, knowledge-based jobs in Ontario.

I have a modest proposal that is a derivative of the Ubisoft/Samsung grants. My proposal is that the federal and provincial government create an Innovation Job Fund (IJF) that provides a tax credit or financial rebate to Canadian-controlled startups/early stage companies based on the number of sustainable jobs created. Without getting too complicated, before they could qualify, these companies would:

- (1) have to have received Scientific Research and Development tax credits for a minimum of three successive years;
- (2) be financially solvent;
- (3) have been in business a minimum of 36 months; and
- (4) have employed knowledge-based workers for a minimum of 100 man-years.

Let's look at the economics of this proposal. Annual direct salaries for 100 man-year, knowledge-based workers

is probably a minimum of \$6 million. Income taxes paid to the provincial and federal governments probably total \$2.4 million if you assume a minimum personal tax rate of 25%.

My proposal is that the provincial and the federal government, after 36 months of operations, provide a one-time rebate/grant/return of \$25,000 per man-year to qualifying companies. The minimum threshold of 100 man-years is all about creating scale, size, sustainability, and economic contribution. At that size, you are probably looking at a high value-added business employing 50 people by the end of its third year of operations. This type of financial incentive is not a photo opportunity for a politician (the way the Ubisoft and Samsung initiatives were). However, unlike them it:

- (1) provides significant incentive for investing in early-stage, high value-added, innovative companies;
- (2) directly ties the financial grants to creating and sustaining high value-added employment;
- (3) represents a significant government commitment to fund the job engine of the economy: small- to medium-size enterprises; and
- (4) is funded from government programs that already exist. \$\$

---

## R.G. Shoniker & Associates Inc. / Courage Capital

Suite 900, 95 Wellington St. W.  
Toronto ON M5J 2N7

Voice: 416-863-6096  
Fax: 416-865-9550

[www.couragecapital.com](http://www.couragecapital.com)

*continued from page 1*

banking environment will reduce this type of lending opportunity to a trickle over the next year. The Canadian banks will therefore, and very reluctantly, return to SME lending again in 2010, but with very stringent conditions.

The world of traditional LBO leverage remains non-existent for private equity buyers who now find themselves putting over 40% equity into an acquisition. The need for this level of equity and the overriding 25%-30% IRR target have resulted in the EBITDA purchase price multiple being frozen at 4.5-5.0. As a result, the private equity buyout firm is no longer competitive with an industry buyer or the public stock market.

For Canadian private equity firms, a very short-term buyer's anomaly may exist, thanks to federal Finance Minister Jim Flaherty's legislation to eliminate the tax-free status of publicly traded income trusts by the end of 2010. More than 160 public income trusts face the decision tree of:

- Converting to a taxable corporation;
- Selling out to a third party; or
- Going private.

As the 2010 calendar marches on, going private will become a preferred choice for small capitalization income trusts. However, the private equity valuation metrics will be the major deal impediment unless the private equity buyer can find the courage to invest and remain flexible about future refinancing options when leverage returns—as it will. In 2009, the average takeover premium for a business trust unit was 32% and with an EBITDA multiple of 10.5 times, which is double the average EBITDA multiple that private equity buyers are prepared to pay today. Private equity buyers are going to have to be both creative, and value-adding if they want to participate in the recapitalization of income trust opportunity.

Alternatively, they can:

- troll amongst the larger companies and seek or initiate transactions for non-strategic business units;
- find tuck-in acquisitions for portfolio companies which, through the benefits of cost savings, redundancy, etc., can lower the purchase price multiple; or
- focus on the U.S. Northeast or Midwest as a rising capital gains tax rate in 2011 (from 15% to 25.4% of capital gains) will make some American entrepreneurs more receptive to selling in 2010.

And when the opportunity arises to back an outstanding management team this year, don't get hung up on the purchase price multiple. Do the deal! Outstanding management teams know how to build shareholder value.

So overall, our advice for 2010 is: Have Courage! Don't sit on your money, invest it! **\$\$**

# Serious Deal Seekers

In recent weeks we've been approached by five different entrepreneurial investors/buyers who are seeking equity opportunities outside of the natural resource, real estate, and retail sectors.

Investor "A" is a privately-controlled Toronto-based buyout firm that is seeking to acquire and actively manage a traditional business that is located within southern Ontario. The ideal opportunity will have an enterprise value of \$10-20 million and be a platform for scalable growth. Turnarounds will be considered.

Investor "B" is also a privately-controlled buyout entity seeking a similar size opportunity in the GTA in the \$10-20 million range. They have no interest in turnarounds, but have a particular interest in large, fragmented markets, which present "roll up" opportunities.

Investor "C" is a proven technology entrepreneur who is seeking to invest up to \$10 million in a software, telecommunications, or other proprietary technology company that has annual revenues of at least \$10 million. Ideally, this entrepreneur would become a significant shareholder, and a mentor to the existing management team, as well as the non-executive Chairman of the Board. Investor "C" will look at both private and small-cap public companies.

Investor "D" is a proven public company entrepreneur who has created substantial shareholder value for himself. He wishes to diversify his personal portfolio by investing into non-resource-based businesses with quality, aggressive management teams. Sectors of interest are water technologies, food technologies, wireless applications, and alternative health products and services. Investor "D" is prepared to invest in both private and public companies anywhere in Canada. Minimum investment is \$5 million for either majority, or significant minority, interests.

Investor "E" is a very successful individual and private equity investor who partners with strong management teams. He has no interest in being a "vulture" investor, and no interest in running a business day-to-day. He is looking for platform opportunities that require \$10 million of fresh equity. He can assemble up to \$100 million for a large deal. Private or small cap public companies would be considered. Partnering for a MBO would be ideal.

Please contact me at (416) 863-6096 or by email at [bshoniker@couragecapital.com](mailto:bshoniker@couragecapital.com) if you have opportunities for these courageous investors. **\$\$**