North Consulting Group

QUARTERLY NEWSLETTER
WINTER 2012

Editor's Welcome

Making Decisions That Count

When it comes to decision making, economists view the individual as an agent of rationality, seeking to maximize profits and minimize losses at every decision-facing instance. From the psychologist's point of view, human beings are biased by their experiences and desires to make less than optimal decisions. Ultimately, both schools of thought view the individual as a decision-making organism, continuously assessing wins and losses in the environment to guide our behavior.

Every single day, human beings are confronted with a multitude of small and large decisions to be made: deciding what to wear before leaving the house, to slow down or speed up at a yellow light, or whether to buy or sell a company. Some decisions will weigh more on us, with actual and perceived consequences garnering pride and regret — it is human nature. But what about decision making from the business point-of-view? According to mobile computing pioneer and neuroscientist Jeff Hawkins, if a company makes a single decision each day that is better than their competitors, then they will succeed in surpassing the competition.

There is a variety of strategies and matrices that some will apply in hopes of fail-proof decision making, but ultimately, formulating the right decision comes down to being informed and learning from previous mistakes. With 2012 off to a rapid start and the looming announcement of the 2012 federal budget, a maze of decisions lay in the year before us and, hopefully, beyond.

As such, I would like to welcome you to our first quarterly of 2012 by providing a few informative articles, which we hope will inspire and maybe even ease your decision making processes. We thank you for your support, and wish you a season of making great decisions!

North Consulting Group is dedicated to providing full-service strategic insights and resources to help you attain your business objectives. It is currently comprised of: NorthBridge Consultants (R&D tax credit consulting); NorthLink Capital Advisors (mergers & acquisitions, capital raising and succession planning advice); and NorthSpring Capital Partners (providing risk capital to privately-held businesses).

Until next time,
Ela Malkovsky
SR&ED Team Specialist and Editor-in-Chief.

Bridging the Funding Gap:

Non-Dilutive Risk Capital

North Innovation Fund is created to support Canada's knowledge-based industries. We are pleased to announce the launch of the North Innovation Fund (NIF), a privately-held alternative financing firm providing ongoing SR&ED accrual loans to early stage Canadian companies in a variety of technology-based sectors, today announced the launch of its first Fund.

The Fund was created to identify high growth and innovative companies that are in need of non-dilutive growth capital to accelerate their transition from early stage to commercialization. NIF's objective is to play a role in Canada's ecosystem through ongoing SR&ED accrual debt financing. The SR&ED program, a federal tax incentive program that encourages research and development activities in Canada, has long been the primary source of funding for early stage companies in Canada.

According to Thompson Reuters Canada, between 2000 and 2010, venture capital investment decreased by more than 80 percent from approximately $5.9 billion to $1.1 billion. During the same period, the number of companies receiving venture capital decreased by more than 64 per cent from 1007 to only 357 during that same period.

"We have identified an important gap in the early stage capital markets ecosystem. There needs to be more non-equity (i.e., non-dilutive) funding sources to bridge the funding gap. The SR&ED program in Canada works and provides much needed funding to early stage companies — the only problem I see, is the fact that they have to wait over 12 months to receive their cash", explained James Ro, Managing Director of North Innovation Fund.

"We want to play a role in helping Canadian technology companies reach their next level of growth by financing ongoing SR&ED accruals in advance so that they can use the proceeds to hire more staff, fund working capital needs and execute their growth plan."

For more information regarding North Innovation Fund and to contact the Fund regarding financing opportunities, please visit www.northinnovationfund.com or find us on LinkedIn and Twitter.

It's About More Than Just SR&ED

> What some people forget is Canada is no different than a company competing in the global marketplace — our country needs to market itself, communicate the advantages it provides...

Written by:
James Ro, Vice President of NorthBridge Consultants.

There are many reports stating that Canadian businesses are falling behind in terms of productivity and innovation. While I do not disagree, there are a number of reasons for this as you can't just point to one single factor (i.e., SR&ED). The SR&ED program is simply one aspect of the overall tax incentive system in Canada, which sets the stage for R&D investment. The issue of tax is one of the key factors in making a decision to do R&D in one country or another.

What some people forget is Canada is no different than a company competing in the global marketplace — our country needs to market itself, communicate the advantages it provides (e.g., attractive tax environment, skilled labour force, etc.) and compete with other countries in attracting R&D investment.

Once known as a manufacturing powerhouse, Ontario faces the pressures of global low cost manufacturers, which has helped turn the province into an expensive supplier of goods and services. When you take into account a low Canadian dollar, coupled with attractive tax incentives, you can quickly see how Ontario was cheaper than other countries many years ago — unfortunately, this is not the case anymore. The Canadian dollar has risen approximately 40% against the U.S. dollar over the past 10 years, which has eliminated any cost advantage that this country once held.

As such, it is not uncommon to see companies headquartered in Canada willing to outsource R&D and/or manufacturing activities to lower cost jurisdictions to minimize costs. Furthermore, President Barack Obama recently announced that he plans to slash the U.S. corporate tax rate from 35% to 28%, which will hinder Canada's capacity to compete in the highly competitive global economy. At the same time, British Columbia announced that it may raise its corporate tax rate and Ontario is expected to delay plans for further corporate tax cuts.

If Canada wants to remain competitive on a global scale, it is critical to have the proper tax incentive program in place, including SR&ED. For example, in 1996, only 12 Organization of Economic Co-operation and Development (OECD) countries offered R&D tax incentives; whereas today, 37 OECD countries offer such incentives — make no mistake, the competition for attracting global R&D investments is intensifying.

With a strong Canadian dollar and soon to be relatively higher corporate tax rates, the government cannot afford to tinker with the SR&ED program to the extent where it makes Canada an unattractive place for R&D investment. Enhancing the federal government's support for innovation through the SR&ED incentive program is an important step that will allow this country to be a strong export market and leader in innovation.

A Seller's View of Management Buyouts

Written by:
Blair Roblin, Managing Director of NorthLink Capital Advisors.

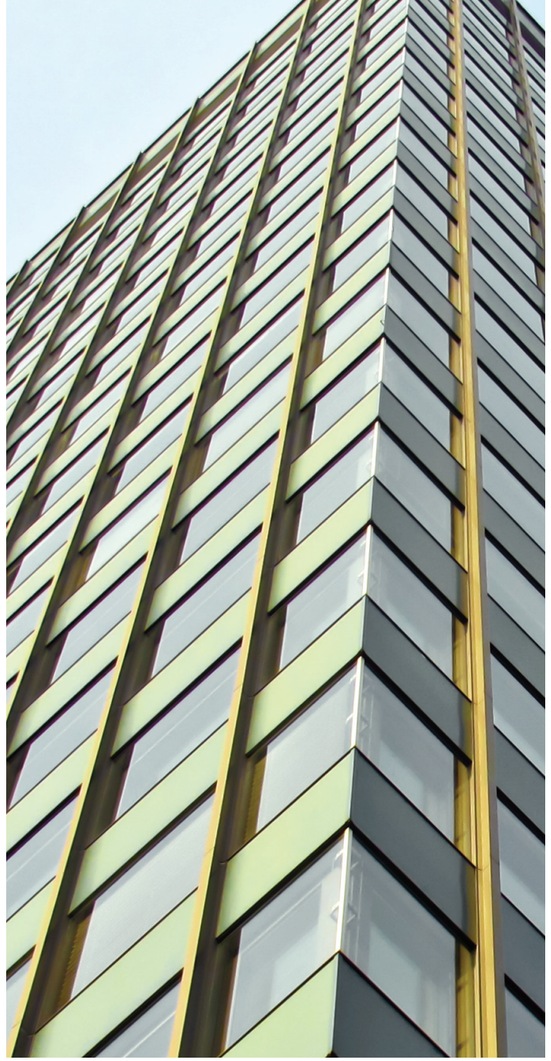
As business owners inch toward the day when it's time to depart — whatever the catalyst may be — the question looms as to who the logical buyer should be. By "buyer", I am including all available successors to the business, including family. For many owners, though not all, the prospect of selling the business to management is an enticing and logical one.

Certainly there are many "pros" associated with this avenue, not the least of which is a legacy issue — who better to take over the business than the trusted employees who have helped the entrepreneur grow the operation into the entity it is now? But there are other positives in the management buyout scenario as well.

> Often, the solution will be that the private equity group takes up the majority of the equity interest, while the management team retains enough equity to partake in the financial upside while maintaining operating control as well.

First, the ease of transition is likely at the forefront. There are likely to be few surprises for the management buyers, being intimately knowledgeable of the business and therefore not requiring a significant learning curve. Equally, there are bound to be few disruptions among suppliers, customers and employees, with whom existing relationships will remain intact. All of this is of benefit to the seller in the sense that issues of due diligence are not likely to complicate the transaction. This further streamlines legal documentation as it reduces the number and the extent of representations and warranties to be offered up by the seller.

Often the sense of trust that exists between the owner and his management group facilitates greater flexibility in terms of both the management transition and financing flexibility. The owner may be more willing to provide consulting advice as an ongoing mentor and on the financing side, solutions such as vendor take back financing may be more palatable to the owner.



The management buyout alternative also obviates the need for the owner to expose the business to the "market", where the most likely buyers are often competitors whose bona fides are sometimes suspect around confidential information. From the seller's perspective, the management buyout alternative can pose some challenges as well. A common one is for the management team to muster sufficient purchase price consideration, since management commonly does not have the deep pockets necessary to cover the full cost of the purchase.

This typically leads to the need to come up with external financing in the form of both equity and debt. On the positive side, third party financiers are often more willing to back a management team who is familiar with the business, particularly if they have a track record of success. The challenge, of course, is for the management team to retain a sufficient level of equity in the purchased business after the demands of a private equity investor are factored in.

(Continued)

Often, the solution will be that the private equity group takes up the majority of the equity interest, while the management team retains enough equity to partake in the financial upside while maintaining operating control as well. Typically, private equity firms will want the management team to be as fully invested as possible in order to ensure their commitment to the success of the business.

Some caution is in order, even where the management buyout alternative seems to be the smoothest route forward. The choice between selling to management and selling to a third party buyer is generally an "either, or" decision. A sale (auction) process that includes both internal (management) and external parties is not fair to either, since third parties will not want to compete with a management team with whom they eventually want to partner, and the management team will be placed in a clear conflict of interest if providing due diligence information to a third party with whom they are competing to buy the business.

All of this speaks to the fact that a management buyout alternative may preclude the owner from exposing the business to the market and, while we have noted earlier that this avoids issues around maintaining the confidentiality of information, it may also lead to a missed opportunity to maximize value by selling to a synergistic third party buyer.

Are You Ready for Your Next Opportunity?

Written by:
Brian Hunter, President of NorthSpring Capital Partners

NorthSpring Capital Partners ("NorthSpring") is a unique risk capital fund that focuses on providing capital solutions to small and mid-sized businesses, entrepreneurs and management teams. This article highlights how we participated in a recent opportunity faced by one of our current portfolio companies. Brian Hunter, President of NorthSpring, describes how "a Southern Ontario based vehicle parts manufacturer with sales in excess of $20 million, had experienced a near doubling of sales in the past two years.

As a consequence of this rapid growth, the company was experiencing capacity constraints, excessive overtime costs and quality issues. At our recommendation, a team of productivity improvement consultants conducted an in-depth review, which revealed significant opportunities to improve operations.

The consultants are currently implementing a six month project which is expected to deliver $1 million per year of productivity improvements and cost savings." NorthSpring financing was designed to fund the costs of implementing this six-month project. The repayment terms were structured such that the financing will be repaid from the cost savings produced by the project.

"The consultants are currently implementing a six month project which is expected to deliver $1 million per year of productivity improvements and cost savings."

This preserved the company's working capital to accommodate further sales growth. Annual savings are expected to be two to three times the cost of the project, making this a tremendous investment. Continuous improvement is the hallmark of successful companies. NorthSpring takes great pride in assisting its clients to strengthen and grow their businesses.

NorthSpring provides risk capital to small and medium sized companies with the goal of creating shareholder value. Investments range between $250,000 and $1 million in the form of subordinated/ mezzanine debt or minority equity across a variety of traditional industries located in Southern Ontario. Funds are available for:

- Management buyouts, mergers and acquisitions
- Major expansions
- Recapitalization/ debt restructuring/ shareholder withdrawals
- SR&ED claims
- Turnarounds, in select situations

Have an opportunity knocking at your door? Let's talk!