

## M&A INTERNATIONAL INC.

Our most recent semi-annual meeting of M&A International Inc. took place in San Diego May 1-3. We spoke with the principals from our 35 partner firms about the state of their respective economies and the M&A activities in their markets. What we heard was most encouraging, especially from US and Europe, and is a reflection of what we are starting to see here in Canada. Private Equity firms here and abroad are sitting on large amounts of cash. They and strategic buyers are moving with conviction to acquire strong operating businesses, particularly cash-flow positive "real economy" businesses, from both domestic and off-shore sellers. This bodes very well for Canadian business owners where an improving economy and easy access to the huge US market can be translated into better performing companies that attract premium pricing from potential acquirors. We're beginning to feel we've turned a corner.

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Specialists in mid-market acquisitions, divestitures, strategic alliances, valuations, and corporate finance — member of M&A International, global network of 35+ firms

## "NORMALIZATION" in Business Valuation

-- Kevin A. Tremblay

Normalization is a restatement of the historic financial performance of a business entity to identify discretionary expenses, non-recurring transactions and extraordinary items. Essentially, normalization is intended to reflect true and accurate earnings had any extraordinary events not transpired, and had the business operated in the hands of an objective "third party", dedicated to the most efficient and effective operation of the business, without any "owner bias."

This step is necessary regardless of the methodology for arriving at a value. This is particularly true when using an earnings-based approach to valuation, whether it is a simple multiple of EBIT/EBITDA or our preferred method, a discounted cash flow analysis, as true earnings and cash flow cannot be determined until "Normalization takes place."

From time to time we meet a business owner with the misconception that normalization is an exercise to make their business more marketable simply finding a way to improve the financial performance as reflected in past reported results. In reality the opposite may be true, in that all necessary transactions must be included, and recorded at fair market value, with either positive or negative impact.

As you would expect, the process of normalization is not black and white and most often involves a large element of judgment. As an example, perhaps the most common normalizing item when dealing with an owner/operator business is the normalization required for owner's compensation. Regardless of the form (bonus, salary) in which a shareholder is compensated, the required adjustment should reflect what would be considered normal market rates for a non- shareholder manager, not the actual compensation paid. But determining market rate compensation is likely not as scientific as one might expect. More often than not, this adjustment has a positive impact on earnings as above-market salaries or bonuses are used to reduce active business income and take advantage of the favourable tax treatment for small businesses.

Conversely, the owner of a business that is experiencing cash flow problems or reduced profitability, may decide not to take fair value compensation from the business in any given year. In those circumstances, a prudent buyer would incorporate a negative normalizing adjustment for a fair market value salary for those duties carried out by the owner/operator.

An owner's personal influence over the business can also impact financial results in other ways. An owner may support a particular charitable organization and, at their discretion, donate amounts that a buyer would deal with differently. Non-essential expenses can be incurred for items such as travel, which may not be essential to the short-term success of the business; salaries can be paid to family members; etc.

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CORNER

CLARITY



In an effort to reduce the complexity in M&A and Corporate Finance terminology, M&A Monitor includes a few definitions of terms whose meaning may not be obvious to those outside the industry:

**FIRST STAGE FINANCING:**

Generally, the third level of Venture Capital (after Seed and Start Up) required by a new business where sales have started, but additional capital is required for full commercial production and selling activities.

**FLOAT:**

This refers to the number of shares of a public company that is widely held by "non-insider" shareholders.

**GAAP:**

This stands for "Generally Accepted Accounting Principles," as established by the accounting body with jurisdiction. In Canada, this is the Canadian Institute of Chartered Accountants (CICA); and in the US, it is the American Institute of Certified Public Accountants (AICPA). While there are differences between the two, the standards are harmonized between the two countries, and to a great extent, amongst members of the industrialized world.

**A LITTLE FATHERLY ADVICE...**

-- Michael J. Walker

I am sure that most of us can think of many examples of valued advice we heard from our respective fathers. I can still hear my own late Dad saying, "Son, honesty in everything you do, a sincere smile and a good firm handshake will take you as far as you want to go in life"...and I have tried hard never to forget that.

He also left me a written summary of gems, which may bear repeating. Each time I re-visit it myself, I am renewed and refreshed by its messages.

My own Dad had, by anyone's measure, a fantastic business career. It was cut short by his untimely death some 20 years ago; but it was fantastic nonetheless. An entrepreneur in the classic sense, he started his first business with an idea and almost no money. He built it, sold it, and later retrieved it from the ill-fated purchasers for \$1. He re-built it and sold it again...for more.

The new purchasers were smarter and hired him to run it. He built it further, took it public and ultimately became CEO of the parent company, running a global business with sales in excess of \$½ billion...in 1983, that was a big company!

Before he died that year, he handed me a written summary of "Business Fundamentals for the Entrepreneur." It was never clear to me whether he wrote it himself or just found it somewhere and kept it. He told me that the messages in it were not new or unique; but that I should "read, learn and inwardly digest" them on a regular basis...and, as with most things, he was right. What you are about to read will not be news to you; but rather a re-affirmation of things you already know. So, here's a little fatherly advice. I hope it serves you as well as it has served me.

**Business Fundamentals for the Entrepreneur**

**Discipline**

It is the first lesson taught...by parents, by teachers, by leaders of all types; and it is by far the most difficult to master. Discipline is about having a sense of self. It is about having respect...for your competitors, your peers, and yourself. Discipline is about patience, observation, and waiting for opportunities to emerge, as you knew they would. It is about being decisive, having the courage of your convictions and knowing when to be proactive, reactive, or not act at all.

Discipline is a core attribute of any entrepreneur. It is key to building companies and it facilitates the consistent application of tactics. In a broader sense, it allows a company to fulfil its strategy...to achieve its goals. Discipline assures the diligence and attention to the daily details of business. It is the fuel of the enterprising spirit. It represents freedom, not restriction; and it creates mastery of the fundamental elements that allow dreams to prosper, businesses to flourish, or simply the day to end well.

**Common Sense**

Some are born with it...some develop it...and some never find it; but common sense is the essence of understanding what is important, when it is important, and how and why it is important, and for how long it will be important.

Each opportunity has its own unique integrity that is fundamental and defines it in relation to one's goals. It is easy to be distracted by an abundance of opportunity...greed. Enterprising people instinctively seek to generate infinite amounts of opportunity. But the sage entrepreneur knows that not all opportunities are right to pursue. To qualify them, each initiative needs to be sifted, coddled and caressed; then examined, understood and proven. For entrepreneurs, this is the application of some old-fashioned wisdom...plain vanilla, common sense.

**Hard Work**

It is a subjective thing...hard work; but it is a subtle and accurate measure to define an entrepreneur's character.

Hard work is not always sweat from the brow, work gloves and a lunch box; nor is it 14-hour days, weekends in the office and frantic travel. It's far deeper than that...it's an attitude...a relentless and focused application of skills, insights and a desire to do something well...and then, to do it better yet. Hard work takes good skills and makes them great; and turns weaknesses into strengths...hard work builds an entrepreneur's dreams as well as his or her character.

### JR/Janus forges new affiliation in SW Ontario

On April 24<sup>th</sup>, 2003 JR/Janus Merchant Brokers Ltd. formalized a collaborative business relationship with Muirfield Advisors Inc. of London Ontario. Muirfield is a recently launched independent advisory practice established by Peter C. Johnson after his retirement as a senior partner at the London office of McCarthy Tetrault LLP where he specialized in advising owners, families, entrepreneurs and management teams of both public and private mid-market clients. Peter has extensive experience with both technology based clients and established manufacturing and service companies. He graduated on the Dean's Honours List from the Richard Ivey School of Business at the University of Western Ontario with an HBA in 1974 and received an MBA in 1975; Peter later obtained an LLB from UWO. A highly respected member of the Southwest Ontario business and professional community and a lifetime London resident, Peter has served on the boards of public, private and non-profit companies and is currently a director of Stuart Energy Systems Corporation, London Hydro Corporation and the London Venture Group Inc.

We are delighted with our new affiliation with Muirfield Advisors Inc. that we believe provides an increasingly stronger link to mid-market businesses in Southwest Ontario. We also wish to welcome Peter to our group. His reputation for integrity and significant experience in M&A and corporate finance transactions is consistent with the commitment to client service quality that JR/Janus has become well known for over the past two decades.

### Business Fundamentals

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#### Planning

It's the difference between climbing the stairs and using the elevator...each go to the top; but how and when you get there is often more relevant to an entrepreneur. Planning is a core philosophy...the practice of coupling one's vision and energy with the ability to marshal resources and expertise. It is an incremental component to a fundamental process, which most often results in strategic thinking and the development of implementation tactics.

#### Experience

It does not come from books, a university degree or from access to media; but rather it is an attribute acquired in only one way...by doing. For only after an entrepreneur has done something can it be improved upon. A good memory is a start...the ability to recall, then recreate in a better form. Experience takes a good idea and makes it great...turns dreams into realities...capabilities on opportunity. And...there is just no substitute for it. A well-seasoned entrepreneur is a worthy and formidable force...never to be under estimated...and generally always to be supported.

#### Good Judgment

It is an acquired skill, not an inherent gift. Good judgment is the expression of accumulated knowledge and skill that determines a correct decision. It generally combines the fundamental attributes of entrepreneurship: common sense, discipline, experience, hard work, and planning. Born from humility, good judgment is more often acquired from one's mistakes than from success. It is a skill that defines, distinguishes and confirms an entrepreneur's achievement.

#### Integrity

Without it, all other business fundamentals become irrelevant. An entrepreneur can have but one reputation...and despite what some may say to the contrary, one must trust the heart as well as the head in its determination. Integrity is an attribute that is continuously practiced and consistently applied. It requires compassion and sensitivity...and its unmistakable reward of inner peace cannot be duplicated. An entrepreneur's successes and achievements, no matter how dynamic, are hollow and insignificant if not attained with integrity.

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### 'NORMALIZATION'

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In addition, an operating company paying rent to a related party for the use of its facilities will often require normalization. Typically rent levels are set to coincide with mortgage costs, realty taxes and other miscellaneous maintenance costs; and often this amount varies from fair market value rates.

When a customer falls into bankruptcy and there is a substantial receivable that becomes non-collectible, an argument can often be made that the particular bad debt was extraordinary. Sometimes such a conclusion is appropriate, but sometimes the answer that it is not. Clearly any adjustments must be reasonable in light of the company's past experience with bad debts.

Any revenue that should be considered a one-time sale because it is unlikely to be repeated in the future in the normal course of operations, should be deemed extraordinary and eliminated from the financial results.

Of equal importance in the process of normalization is a review of the balance sheet. Any asset which is not essential to the operation of the business must be identified. Any excess cash, (beyond normal working capital), unused land, securities, etc should be segregated from the business for valuation purposes. Such assets should be for the account of the owners, separate from the value of the business on a going-concern basis.

Regardless of whether a buyer considered normalizing adjustments when they first formulated their offer, a seller can be certain that all such adjustments will be challenged and must be reasonable, and supportable. A successful seller, or his or her agent, must present their assumptions, build a case as to why stated normalizing adjustments are necessary and track all adjustments back to the financial statements that conform to GAAP, all helping to ensure the seller realizes a fair value for their business. , Otherwise such normalized items can become the basis for a purchase price adjustment.

**CURRENT / PENDING  
SALE MANDATES**

**POP Display Manufacturer**

This Canadian private company was founded in 1968 and is now a multi-million dollar enterprise. It is the supplier of choice for a number of the world's leading market-oriented consumer goods manufacturers. Eighty per cent of sales are display product, and the company also manufactures some specialty equipment and is a contract manufacturer of certain original equipment components such as BBQ, fireplace, electronics, furniture, and refrigeration parts and products.

**Proxy Solicitation Firm**

Sole "full-service" firm operating in the US. The Company provides/coordinates the proxy voting process of listed companies and mutual funds by distributing materials, tabulating votes, and soliciting responses.

**Hotel Chain**

European hotel chain with sales of 180 million Euros, wants to either expand jointly with a partner, or attract a real estate investor who is interested in investing in hotels. Also looking for a partner to develop the catering and restaurants division.

**Specialty Food Manufacturer**

This family business is in its 73<sup>rd</sup> year. Consistent growth to approximately \$20 million revenue generates EBITDA of over 10%. Leading branded market share combines with both private label and food service success.

**Healthcare Manufacturer**

Revenue \$30 million; EBIT 20%. European based manufacturer and distributor of plastic injection moulded products for the healthcare sector.

**Gourmet Natural Foods Manufacturer**

With current year sales projected in the \$3.9 million range, this well-established 17-year-old family owned US Company operates nationally in manufacturing of specialty food products. The company distributes its products through specialty food, natural food, food service, gift pack, airline and private label outlets nationally.

**JANUS CORPORATE FINANCE  
MANDATES**

**Nutraceuticals**

This Canadian private company was formed in 1997 and has developed and patented (or has patents pending on) 10 separate nutraceutical product formulations with medical treatment applications for colon cancer, Type II diabetes and cardiovascular disease, including cholesterol reduction and anti-inflammatory capabilities. Fully tested in clinical trials, these nutraceuticals will compete head-to-head on a global basis with leading pharmaceutical products from multinational drug companies. The Company is profitable and cash positive, and seeks a financial/strategic investor in a minority role to facilitate more rapid growth of its business.

**ACQUISITION MANDATES**

**Canadian Manufacturer**

"A private mid-market company, located in Toronto, is seeking strategic add-ons, with revenue of \$3 to \$10 million. Profitable operations are preferred. The candidate business (entity, division or product line) should involve printing, textiles and/or should be manufacturing and marketing products relating to merchandising or promotion."

**Entrepreneur Buyers**

We always have a roster of qualified individuals seeking mid-market businesses in the \$5 to \$20 million range of value. They cover diverse industries and geographic preferences. A few will consider turnarounds.



For detailed information  
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