HARDING
SECURITY SERVICES INC.
UNLOCKING OPPORTUNITIES IN THE SECURITY INDUSTRY

SHARES VERSUS ASSETS- THE BALLGAME HAS CHANGED.

Thanks to our fiscally irresponsible, Liberal government, the situation for sellers of security businesses has now been made much more difficult. Now more than ever selling shares will be the way to go- this when alarm account buyers in particular have always liked to buy just the accounts- not the shares.

Many of you will know that as of June 20/24 the Liberals increased the amount of a capital gain in a sale of any assets (including alarm accounts) that is to be included as taxable from 50% to 66%. Really a dumb move on every score. While this may not seem like a big deal, my accountant tells me that this increase will mean a seller of assets in general will pay an extra 9% more than they did prior to this increase. Asset deals were already much more heavily taxed than a share deal. This change will just make it worse.

First why do I call this tax increase fiscally irresponsible. Since the tax increase was announced 6 months ago, most businessmen, economists and entrepreneurs are saying that this tax increase will discourage entrepreneurship and the overall ability to raise money in this country- not something that Canada needs to be doing at any time yet alone now when our average GDP/capita growth rate is falling behind most OECD countries. It is however very typical of the current Liberal gov't. But it is also short-sighted because these kinds of tax increases never raise what the gov't says they will raise. The Liberals claim that this tax increase will pull in an extra $19 billion over the next 5 years. Initial data already shows that this will not happen.

It is possible that a future Conservative gov't will rescind this latest increase in capital gains tax so one theory suggests that if you don't have to sell right now wait for a year.

As an offset to the increase in tax for asset deals, the gov't did increase the one- time capital gains exemption for the sale of shares of a Privately Controlled Canadian Corporation to $1,250,000 from where it was at about $950,000. This should drive sellers to seek share deals more than ever.

This increase in capital gains tax will have a big effect on alarm companies looking to sell because right now in Canada most of the bigger buyers of alarm accounts do not like to buy shares. Why is this? It is partly because the buyer cannot write off the purchase price against future income (Let's call this the loss of the tax shield) when buying shares and partly that share deals are generally more costly to do. There is more due diligence required, a lengthier purchase agreement to be agreed to and the cost to wind the company structure up after. Strangely enough most buyers of fire and guard companies are ok with buying shares.

I personally think there is both a need and an opportunity for some of the bigger buyers of alarm accounts to move with the times and agree to do share deals. If I was a seller of alarm accounts right now and had say 1000 accounts, I would hold out for a share deal. The after-tax, take-home pay between a share and asset deal is just too great now.

I experienced the effect of this change in capital gains taxation recently when trying to sell a mid-sized alarm account based in south-western Ontario. When looking at the initial offer from a particular buyer I thought the extra multiples being offered for an asset deal would make the asset deal much the favored route to take. However, the company's accountant made it clear that a share deal was going to be much more favorable. The share sale benefit was so great that the buyer had to change gears and offer to buy shares.

Then the next issue hit me. How much of a multiple reduction (due to the loss of the tax shield for the buyer) can a seller of shares expect to experience from an informed buyer as compared to an offer to buy assets. Conventional wisdom up until this deal happened was that the expected discount for a share deal was about 5-6 X Recurring Monthly Revenue. This discount was made up of the a) loss of the tax shield that occurred in buying shares and b) the extra time and risk involved in buying shares. However, when talking to an informed tax accountant about how much the loss of tax shield should be, I was surprised to hear tell me that in most cases it should be no more than 2-3X RMR- much smaller than I thought. Added to this tax shield reduction is the extra time and risk in doing a share deal. In total it became clear that from a financial point of view the total reduction for a share deal was closer to 3-4 X RMR. Whether alarm account buyers will accept this rationale is another matter.

One thing is for sure that unless alarm account buyers change their ways and start looking at doing share deals, then sellers of alarm accounts are going to get hurt by big time in selling assets.

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