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The Surge in Cross-Border Mergers and Acquisitions

By Michael Swistun

They say the grass isn't always greener, but this year it may be in the case of U.S.-Canada cross-border M&A activity.

For decades, the relative attractiveness of Canada versus the U.S. for foreign direct investment (in the form of mergers and acquisition [M&A] activity) has ebbed and flowed like a multiyear tide. During the Obama years, for example, and particularly after the U.S. federal tax increases on capital gains and dividends that came into effect in 2012, Canada enjoyed a strong inflow of foreign direct investment.

The more competitive tax advantage that Canada enjoyed made the country a favored destination for capital. These inflows were also propelled by booming investments in the energy and natural resource sector—particularly in the western portion of the country—that fueled large investments in numerous multibillion-dollar construction projects.

Having largely avoided the 2008-2009 financial crisis that devastated the U.S. housing and banking industries, the Canadian residential construction industry continues to sustain strong growth. This is particularly true for the housing markets situated in the lower mainland of British Columbia and southern Ontario, where sustained demand has created a somewhat parabolic increase in single-family and multi-tenant home prices. This is very reminiscent of the late-2007 American housing market.

The Tide Continues to Turn

As with all tides, the one that propelled the wave of direct foreign investment into the Canadian market began to subside and reverse when energy and commodities prices collapsed in 2014. Since then the Canadian E&C industry, particularly in western Canada, has struggled with overcapacity, as large capital projects initiated before 2014 were completed. Further anticipated capital investments were deferred or canceled outright. Although the Canadian forecast for put-in-place construction is forecast to increase 1.8% in 2018, the sector is still down (in nominal dollars), from its peak in 2014.

In addition, the tax reforms passed last year have made the U.S. more competitive than Canada on taxation. Rising business and consumer confidence—buoyed by improved corporate profitability and personal disposable income as well as the yet-to-be determined impact of the repatriation of foreign domiciled capital—has created the conditions for sustained strong U.S. economic growth.

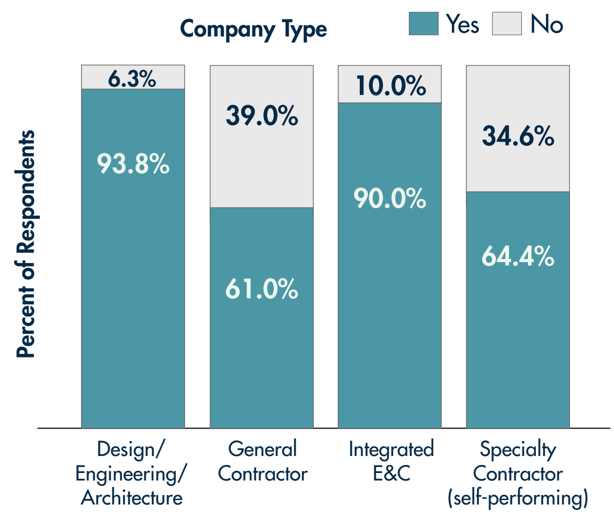
Although growth in Canada will remain positive in 2018, the relative strength of the U.S. has made the latter a more appealing destination for investors. Tellingly, in 2017, overall direct foreign investment in Canada dropped by 17% from the previous year.

Ownership Transitions Abound

Much like in the U.S., ownership transition—driven by longer-term demographic trends—will continue to grow and become increasingly urgent as the baby boomers retire. FMI's recent study on "Ownership Transfer and Management Succession" uncovered a significant shift away from an expectation of transferring ownership within family ownership groups to an expectation of transferring ownership to employees (or via a sale to a third party).

In western Canada, for example, the memory of the strong financial performance that the industry enjoyed during the peak cycle years of 2013-2015 is fading fast. As a result, owners' valuation expectations are resetting to the new market realities of a more intensely competitive, slower-growth environment. This sets the table for potential Canadian, American or international acquirers to find compelling value (relative to the current "hot" valuations in the U.S. M&A space) in the Canadian E&C market.

Exhibit 1. Are acquisitions a part of your current strategy?



Source: FMI's 2018 M&A Trends for Engineering and Construction

These trends aren't all negative for potential sellers in Canada. For larger general contractors (GCs), for instance, the increased margin pressures that the Canadian E&C industry is experiencing across the country will accelerate self-performance trends. Already well established in the U.S., this trend will drive acquisition activity, as large GCs look to efficiently internalize specialty trade competencies (see "FMI's 2018 M&A Trends for Engineering and Construction" for more details). In addition, the client-driven architecture/engineering firm consolidation trend will also pick up pace in Canada.

Exploring Cross-Border Opportunities

As more Canadian E&C companies seek relief from excess industry capacity and reduced margins in the highly competitive Canadian market, more are looking south to the U.S. for growth through acquisition. Many prominent Canadian E&C firms have recently made significant forays in the U.S. market through acquisition, with varying degrees of success. In addition to prominent examples like SNC-Lavalin's purchase of Atkins, acquisitions by Ellis-Don, Graham, PCL, Bird, The Flynn Group, Stantec and Entrec have all found compelling value in U.S. companies.

It is easy to understand the appeal of the U.S. market, where FMI predicts that total engineering and construction spend will increase by 7% in 2018, nearly double the strong 4% growth seen in 2017. The growth is expected across a broad swath of the economy and will be led by residential improvements (12%), single-family residential (7%) and office construction (9%).

It's important to note that the strong underlying market fundamentals, combined with abundant, affordable, available capital, have created significant upward pressure on valuations. Canadian buyers looking south must get comfortable with significantly higher multiples than they are accustomed to in Canada. The available universe of active buyers in the U.S. market, which includes strategic, private equity funds; family offices; and so forth, is much larger and more competitive on the buy side than the Canadian market. Buying into a "hot" market requires focus, discipline and diligence to ensure valuations are supported by value.

Common Elements of a Cross-Border Acquisition

Like any business deal, the successful cross-border acquisition requires the right dose of research, due diligence, negotiation and persistence. At a minimum, the common elements of a successful cross-border acquisition include:

1. **A clear strategy.** Before pursuing growth through acquisition, E&C companies need a well-developed growth strategy that objectively outlines how acquisitions will contribute to attaining goals for top-line and bottom-line growth. The strategy should define the target geographic and functional market segments and a clear vision of why they are key to the strategy.

2. **Good market research.** There is no homogeneous "American market." However, there are thousands of discrete local, state and national markets that exist simultaneously within the U.S. Prior to making any significant decisions on implementing an acquisition strategy, it is worth the time and investment to do market-specific research to quantify, qualify and rank, relative to the strategy, which markets are the "A" versus "B" versus "C" for the company.

3. **Use professional advisors.** This sounds somewhat self-serving, but retaining a qualified investment banking team will almost always generate a broader, more exhaustive list of qualified potential acquisition targets than an internal, company-staffed initiative. Using a professional team of investment bankers will also ensure that the process of searching for and closing acquisitions does not consume and distract senior management from running the business.

4. **Focus on the culture.** The late management guru Peter Drucker once famously said, "Culture eats strategy for breakfast." And, more to the point, my father once said, "Don't fall in love on the first date." Take the time to understand the culture of any acquisition under consideration. Also, be very clear on the degree and impact that integration of the target into the company will have on the combined entity's performance.

5. **Understand the value proposition to the company.** While no one wants to overpay for an acquisition, in many situations a premium is justified for a company that has superior management, a defensible market position or other competitive advantages. (Conversely, sometimes things are "cheap" for a reason.)

Like people, the spectrum of opportunities and nuances available through acquisition is virtually limitless, with all opportunities coming with their own advantages and disadvantages. The learning curve for companies embarking on an acquisition can be steep, but these obstacles can be mitigated by working with trusted advisors who specialize in and live in this market space.

For the foreseeable future, the momentum of the historic ebb and flow of cross-border M&A activity between Canada and the U.S. is tilted heavily southward. They say that the grass isn't always greener on the other side of the fence; but, then again, sometimes it is.

Michael Swistun is a managing director with FMI Capital Advisors, Inc., FMI Corporation's registered investment banking subsidiary. Based in Canada, Michael works closely with construction company owners on financial advisory, mergers and acquisitions, valuations and ownership transfer issues. He may be reached via email at *mswistun@fminet.com*.

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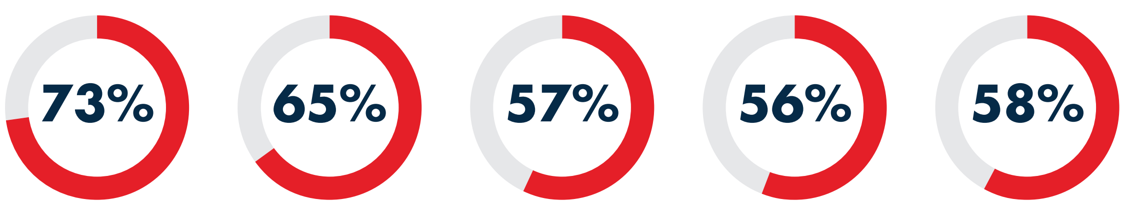
FMI Client Highlights



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