

View from the Top

Arcus Innovation Leaders Series

How business leaders use innovative approaches to shape their strategies.

Arcus Consulting Group has launched a major initiative to explore growth and change as key elements of business strategy. Arcus is privileged to have perspectives from over 2000 senior executives from a variety of industries on innovative approaches to shape business strategies.

What does it take to innovate? The majority of executives say it requires an effective risk management and a comprehensive approach to the creation of shareholder value. But how does one come up with new solutions, and can innovation really be part of a strategy plan? Arcus' multi-industry survey of senior executives found that of all the challenges companies face in this area, one of the biggest challenges is finding ways to innovate.

Arcus research indicates that innovation is the key to new vectors of growth and long term shareholder value. Our work is supported by ideas from comprehensive research to create and sustain growth in new and mature organizations. To benefit from disruption and create new growth businesses, senior executives need to make a number of rather counter-intuitive decisions. While short-term growth can be driven by tactical approaches, long-term growth requires a concerted investment in innovation. The perceived correlation between risk and innovation means most companies do not realize the significant growth potential of a long term innovation strategy. Arcus has identified five areas of opportunity to develop an effective growth strategy:

1. Balancing short-term and long-term growth strategies:

Extracting short-term and long-term value from growth strategies requires deeper insights into business, market and R&D strategies that work. The focus of an effective strategy is on creating future vectors of growth.

2. Flexibility:

An approach that combines scenario-based planning and a continuous assessment of a range of contingent strategies will enable C-level executives to identify and exploit growth opportunities quickly and effectively.

3. Idea generation:

Successful companies tend to have clear processes and tools for idea generation. They have structures in place to capture and channel ideas throughout the organization.

4. New growth businesses:

Delivering shareholder value requires a concerted effort to identify new growth opportunities ahead of the competition. High growth companies tend to go beyond "what is" and focus on "what could be" scenarios.

5. Innovation culture assessment:

A critical component of an effective innovation strategy is for a C-level executive to understand an organization's ability to adapt to changing market dynamics and customer expectations.

"I think we will see some of the trends around inflation reversing a little bit; inflation won't be as bad."

An interview with Mr. John Loewen, Chief Executive Officer of Loewen & Partners, a privately-owned corporate finance firm serving business owners needing access to sophisticated corporate financial services.

» **Arcus:** What is your viewpoint on the North American economy in 2010?

Mr. Loewen: Right now, private equity is attracted to Canadian businesses. We were the only country in the G7 not to bail out our finance sector and Davos rated Canada as the "most sound" economy. What is the opportunity for business owners? We sit between two super powers, America and China (the G2), and we have the advantage of oil, natural resources, water, food, technology and cultural sensitivity. Commercially, China is increasingly an important trading partner we need to understand and engage. Business owners can continue to run trade South, but increasingly, to the East. We have Private Equity funds tremendously keen to partner with entrepreneurs and share the risk of growing their companies to these markets. This is a strong position for our entrepreneurs, but they are going to need to grow their size to take advantage of this economy over the next few years.

Not only is our banking structure one of the most stable in the world, but also I believe the commodities cycle will pick up, supporting our economy and businesses.

While the consumer market is coming back tentatively, results will be spotty and erratic.

» **Arcus:** Should senior executives be concerned about the deficit and inflation?

Mr. Loewen: Inflation has been a massive concern. On the positive side, fears of an inflationary trend in the US, given the increase in money supply over the past year, appear to be over-done. Recent statistics show the velocity of money has not been as inflated as anticipated. Money supply has been driving the right end of the money spectrum, not the entire money spectrum.

Given the frugality of the current world economy, any inflation would impact badly.

» **Arcus:** What's your view on global currencies going into 2010/2011?

Mr. Loewen: There are two big trends. Firstly, the US dollar is going to weaken, perhaps at a slower rate, leading to the second trend that commodities will begin to pick up again. There is enough underlying demand that we will see commodities move, which is good for Canada.

The U.S. is among the world's most competitive economies; their competitive position for their exports will be helped by a much cheaper dollar. The U.S. has always been an economy with impressive resilience.

"If you look on a macro level, at the world economy, I don't think we've seen the end of the troubled times."

It is still the world leader in productivity, and there is the chance of the U.S. economy delivering far-stronger post-stimulus GDP growth than expected in 2010. There is the possibility of even reaching annual growth of 5.0% or better over the next two years, compared with consensus forecasts of 2.5% to 3.5%.

» **Arcus:** What do you see driving equity in 2010?

Mr. Loewen: There's so much dry powder in private equity funds looking to be invested with business owner partnerships. 2009 was the year that people didn't spend money but 2010 will be when investments started again. Having recently sat on a couple of private equity panels with private equity fund managers, it's staggering how many of them said, "We haven't done a deal in two years." It's not just a case of not having done a deal in the last twelve months - they hadn't done deals since the beginning of 2008.

Opinion is that the multiples were too high (which they were). The private equity fund managers said, "We don't want to pay up." Over 2009, the world came apart which de-stabilized valuations, and delayed or deferred deals. This lack of investments from many funds is already changing though, and 2010 looks to be the year of recovery and growth. Business owners will need to look long term and see if they want to grow their companies with a private equity partner or take the risk of waiting for a few years to sell out an maybe leave a great deal of value on the table for the buyer.

We've now had six months of relative stability. As we get more into sustainable growth, the current recovery and economic times will result in money being spent again. The fund managers have to spend because they cannot sit on their hands and charge their investors two percent fees with no new investments.

» **Arcus:** What are you hearing from CEOs of private and public companies regarding their top concerns?

Mr. Loewen: Liquidity is a major concern. It's not just access to capital, but the changing nature of capital in that as companies go off-side of a covenant, the bank's response is sharp and immediate, usually involving a refinancing.

Second, the new big deal-makers have been the bridge guys. They are doing more business than anyone I know out there. There are so many good companies going off-side because of financial volatility, and the banks say, "Pay us now." Bridge capital can help through these economic times.

» **Arcus:** This is indicative of a shift in the market?

Mr. Loewen: It did with the liquidity crisis. Many companies have really had to scramble as the banks called their loans.

Interestingly enough, on the other end of the spectrum are those companies with very good balance sheets, that are not caught in the financial crisis, which have had unprecedented access to cheap debt money, because our Canadian banks have full coffers and they've got to lend it to somebody.

"Liquidity is a big concern. It's not just the access to capital, it's the changing nature of capital."

I was just talking with a client yesterday, part of an acquisition they're doing, they're getting offered 2 1/2% to 3% money from the bank, as much as they want, because they've got a long term relationship with the business and they're doing well.

▪ **Arcus:** Would you say there's a recalibration of risks for the long term that's driving this?

Mr. Loewen: Yes. There's a dichotomy of risk in the market today. Talented owners running businesses with long-term relationships with their banks have access to some of the cheapest capital we've seen; certainly from a debt standpoint. Those companies without a history and looking for bank relationships simply can't get them.

The other risk that CEOs and business owners are facing is still the underlined volatility of the financial economy itself. Markets are changing, we are seeing stability again, but the black swan theory has happened. That's not just having its impact on the financial side. It's very much having its impact on the psyche of the business community. People have to learn to adjust to losing a chunk of their business, down to seventy percent of their market.

A company we were looking to do a deal with early this year, perhaps eleven months ago, was a twenty million dollar business selling electronic components to suppliers in the oil and gas market. They were looking to sell their business since it was owned by two guys who were getting on in age, and between January and March their business declined by seventy to eighty percent in revenues. They had to cut their work force by a similar amount. When you see a business that's been in existence for twenty years that gets that sort of impact, that's some pretty big volatility. It's a scary adjustment for many business owners. That's got a lingering impact on all business owners.

Owners looking to sell could reduce their risk by bringing in private equity partners and selling a minority stake a few years earlier. Prices for companies will continue to decline, particularly for those who are below \$20 million in revenue. With private equity partners brought in before selling, owners get some chips off the table, gain partners with deep pockets and good rolodexes and increase their chances of growing their revenues. Most owners would agree it would be better selling a \$100 million than a \$15 million revenue company. With good private equity partners, owners can have a better chance of retiring rich.

Entrepreneurs and their private equity partners are also talking about where are the opportunities. It's a fascinating market out there because there are lots of good opportunities to pick up distressed assets. Look at companies, and you start thinking "Do I go aggressive at this point in the market or go conservative?" On of our current clients, a construction company, looked at a competitor in Europe who was in financial distress. The company is literally against the wall, bankers are banging on the door, and there's an opportunity to pick them up for basically nothing.

People are, I think, also nervous about being too aggressive given the overall economic uncertainty, but more and more we're now

starting to see the companies who have the strong cash flows and the ability to do so really stepping up and looking at acquisitions, looking at entering new markets.

» **Arcus:** So there's been re-pricing of risk, and there are a lot of bargains out there?

Mr. Loewen: Increasingly so. There are companies that have been hammered that you can go pick up, at much cheaper prices. You come back to the financial markets and there are two areas that do well. One we talked about, which was the bridge loans, they've been an alluring trade this year. The second are distressed buyers. Guys who can pick up distressed companies at the right prices, are making strong profits.

» **Arcus:** On the operation side, do you hear other kinds of challenges that you haven't heard before? One of the things we hear quite often is acquisition and retention of top talent is a top concern they have today.

Mr. Loewen: The current market conditions have freed up some very good people who are more open to the idea of working for companies partnered with private equity. We have seen mainly CFOs, and there have been extraordinarily talented people being downsized by Head Offices located outside of Canada. It's eased up, no question. Go back a year ago, and it's different from today: the pool has expanded. There are more good people, simply because of the shakeups in the last twelve months and these dynamic people are interested in private equity companies.

» **Arcus:** Referring specifically to your organization, are there examples that you think fit in the realm of innovation or the way you've done innovative deals or how you've overcome the challenges of the past one or two years?

Mr. Loewen: Let me say - I'm not sure this is innovation or change. We have established a working relationship with a large mid-market US firm. That has been a fundamental change for us as we can improve our service to our clients who are owners of mid-sized businesses.

If you look at our private equity investment banking space for the Canadian market, you've basically got a number of what's called midi-market shops. This new working relationship now enables us to look at diverse deals such as Canadian businesses that may not get capital in the local Canadian market, or fish farming operations in Belize to carbon trading companies in London, England. There has been a marked change in how we look at and deal with our client base and the international base.

» **Arcus:** What are the other challenges a company like yours faces?

Mr. Loewen: The biggest single challenge we always have is finding good clients. By good clients I mean finding the owners of solid, private companies who are ambitious. They may be requiring capital for growth or are looking to do an acquisition, looking to do re-

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financing, or interested in selling within the next ten years. They may not be aware of how to bring in a private equity fund to work with them to grow their revenues.

A lot of business owners are out there are struggling for capital, and they do not realize there is a far wider range of financial options open to them. Any business with a track record of revenues over \$20 million will be of interest to a wide range of private equity partners. Every deal has always got an element of difficulty to it, but at the same time finding a company, the really good companies, the kind of company you put your own money into, that's the key.

That's probably the most interesting part of the business as well. What I always love doing is getting to know the clients and getting to know what their needs and aspirations are. It's never just about the money. You can get money or capital from many sources. It's about finding a partner, a financing partner for the company, so eventually two plus two is six, or eight, to allow the company to grow. We're lucky here in that we do have a solid background, in our Canadian marketplace, of good family businesses that are looking to grow to the next level. Our business owners are innovative operators who do well on the world stage. ■

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