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The Grand Finale – Exit Strategies for a Successful Startup

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After years of hard work, a successful startup is ready to enter the final phase of the lifecycle of a business - the exit. Businesses in this position typically go down two paths, going public or opting to sell the company. Cassels has partnered with Zeifmans, a full-service tax, accounting and business consulting firm, to author this article to discuss the considerations of different exits.

Going Public

Deciding whether to list a company's shares on the public markets is one of the most important decisions in a company's lifecycle. The process is both time-consuming and costly, involving significant regulatory scrutiny, but offers a myriad of benefits to the stakeholders of a company. Going public opens doors to new funding that wouldn't have been available otherwise, and makes liquidity easier to attain.

There are several methods by which a company can list its shares on the public markets. The two most common are initial public offering (IPO) and reverse takeover (RTO).

- IPO: The company files a prospectus document with the Canadian securities regulators and concurrently applies to list on a stock exchange.
- RTO: The startup completes a business combination with a publicly listed "shell" company structured in a way that the private company's shareholders become the significant majority shareholders of the shell company, which effectively takes over the business of the startup.

While each route is similar in timing and cost, both have benefits and downfalls. An IPO grants a company greater credibility following its listing, having involved a third-party agent or underwriter and the approval of a securities commission, but also leaves the startup more subject to prevailing market conditions in setting and marketing the initial price. Conversely, an RTO generally involves less regulatory scrutiny, but the startup has less control over the process and assumes the risks of the shell company. Other less widely-used methods to go public include a direct listing, a capital pool company (CPC), or a special purpose acquisition vehicle (SPAC).

The above methods can be used to list a company's securities on various Canadian stock markets, including the Toronto Stock Exchange (TSX), the TSX Venture Exchange (TSXV), the Canadian Securities Exchange (CSE), or the NEO Exchange.

Benefits to Public Listings

An important benefit of going public is an increase in capital. Public companies have easier access to capital to pay off remaining debt, increase research and development initiatives, and fund other ventures for future growth or large-scale projects. Public financing generally involves more favourable terms than private equity financing and avoids interest expenses from taking on debt. Existing shareholders are also able to liquidate their positions much more quickly, which may be beneficial for estate planning or for reallocation of assets.

The go-public process, however, can be both costly and time-consuming. Further, once publicly listed, companies are subject to considerable regulatory requirements, increased continuous disclosure requirements (such as the filing of annual and quarterly financial statements), and corporate governance obligations which reduce the company's confidentiality and increase costs. Accordingly, management and the owners of a company must carefully consider whether the company is ready to list publicly.

Public Company Taxation

If a startup benefits from Canada's Scientific Research and Experimental Development (SR&ED) credits, it's important to note that going public (and losing CCPC status), will decrease the startup's tax credit. Qualified CCPCs are eligible for a 35% tax credit, while public companies are eligible for 20% only.

Stock-Based Compensation

Taxation of stock-based compensation is different from regular salary and wages. With careful planning, companies can preserve a more beneficial tax treatment for their existing stock option plans. Under the current Income Tax Act, employees who exercise their stock options will have to pay tax on the difference between the stock's value and the price paid. That being said, eligible employees can claim a deduction equal to 50% of the taxable benefit.

Startups going public should note that once publicly listed, their shares won't qualify for Canada's tax-free capital gain treatment of certain Qualified Small Business Corporations. With proper planning, existing shareholders of a private company which is going public can benefit from the Lifetime Capital Gain Exemption (LCGE), which allows investors selling shares in a qualifying Canadian business and realizing over $900,000 in gains to save a substantial amount in taxes.

Acquisition by Another Company

While opting to go public is seen as a new beginning for startups, an acquisition is, in a way, an ending. Depending on what a founder's end goals are, selling to a private equity fund or strategic purchaser can be a good choice for a company. This option is a one-time transaction that is faster, confidential, and less expensive than going public.

Acquisitions are typically less expensive and much faster than going public. If deciding to exit through the sale of the business, the gating question to consider is whether the transaction will be structured as an asset sale or a share sale – there are tax considerations (described above), legal and practical considerations for each.

Here's a non-exhaustive list of items to consider on a sale of your business:

- Does the sale of the business trigger any competition concerns?
- What approval thresholds are required to consummate a sale of the business?
- Are any consents required from third-parties or governmental bodies?
- Are the company's corporate records up to date?
- Will there be an earn-out to bridge the gap on the valuation and how much involvement will the founder or executive team have in achieving that earn-out post-closing?
- Will the buyer be required to obtain representation and warranty insurance to mitigate your risk with any claim post-closing?

As a seller, it's generally preferable to sell the shares, not assets, to another investor - if planned properly - because the seller could benefit from multiple LCGEs.

In some situations, payments are staggered over a few years. In this case - if appropriate payment guarantees are in place - the seller can also benefit from the Capital Gain Reserves, which decreases the amount of capital gain the seller must report as income that year. This benefit can be claimed up to a maximum of five years, with a minimum claim of 20% made each year. The amount is calculated as a percentage of the seller's capital gain.

If the agreement includes receiving a portion of the investing company's shares as part of the payout, the seller could qualify for a tax-deferred rollover, which would result in postponing a significant portion of the seller's total tax bill.

Understanding Asset/Hybrid Sales

An investor may be more interested in buying a company's assets as opposed to shares. Be cautious in this situation - if the sale isn't structured in the right way, the seller(s) may not qualify for LCGE. In addition, depending on how the assets are taxed, the seller(s) involved may face two levels of taxation before they're able to personally access the sale proceeds in one agreement.

In this situation, it’s sometimes beneficial to combine share and asset sales, allowing for a mutually beneficial structure for the seller and investor. A hybrid sale would have a higher tax base, which would allow the vendor to benefit and use their LCGE while the acquirer can benefit from potential future write off of assets with higher tax basis.

The Final Word

Each startup has unique needs and responsibilities to consider when contemplating an exit. Before jumping into a transaction and popping the champagne, ensure all exit options have been explored.

For a business and tax perspective, contact Zeifmans here, or reach out directly to Ahmad Aslam, Partner at Zeifmans, at aa@zeifmans.ca.

For a legal perspective, reach out to Aly Somani, Co-chair of the High Growth & Venture Capital Group at Cassels, at asomani@cassels.com and Stefan Politano, associate in the Securities Group, at spolitano@cassels.com.

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