

Merchant banks come with risk

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Canada has enjoyed a long and relatively successful history with merchant banks. In the 1970s and '80s they ruled the roost. At its peak, the merchant banking empire controlled by the Edward and Peter branch of the Bronfmans controlled more than a quarter of the TSE 300 by market capitalization.

This empire included conglomerates such as Hees International, Brascan and Edper. Although publicly listed, merchant banking firms were often criticized for being too byzantine and proprietary, even self-dealing. Nonetheless, they were an important feature of an immature, yet evolving Canadian capital market. They were also a driving force in the development and expansion of the markets.

In the private company realm, the track record of merchant banks is tougher to peg. They represent a real pool of capital for small to mid-sized businesses, and should be considered by them as a source for growth capital. There are many legitimate, credible players in this segment.

One caveat is there is no formal definition or set of defined parameters for merchant banks. Essentially, they are unregulated and have no obligation to tell you exactly what they do or what kind of investments they seek.

Most are opportunistic and rely on the personal networks of their partners for investment ideas and deal flow. They don't generally advertise "we are looking for such and such opportunities," as do traditional institutional funds.

Their websites are often little more than an address and telephone number and frequently don't even list partners or professionals, never-mind past investments or investment criteria. When they do, the individuals involved often are people with impressive professional histories, but sometimes their exact relationship and role is unclear.

Before even starting a serious discussion, SMBs approached by a merchant banker should ask themselves these key questions: How much committed capital do they actually represent? Who's money is it? What, if any, documented historical track record is there on the bank?

Many merchant banks charge due diligence or other fees before even committing to making an investment so doing your own due diligence is important. You need to gain a sense of what industries the bank invest in and the types of transactions. This will help determine whether they are a good fit for you. If you can't do this, chances of getting any of their money are substantially reduced.

Aside from financial costs, SMBs often commit substantial time and management resources to the process. This includes meetings, providing follow-on information and various negotiations. This can add to the frustration of having the deal fall through for vague reasons. As a rule, try to avoid paying a dime before a merchant bank cuts a cheque.

Adding to the complexity, the line between principal (an actual capital source) and intermediary (connection to a principal or capital source) often blurs. The lack of transparency creates opportunity for merchant banks to take advantage of the desperation SMBs feel in sourcing risk capital in a tough economy. In more egregious cases, firms brand themselves as merchant banks, indicating they have a "special relationship" with a rich individual or institutional pool of capital. Some are offshore entities that are difficult to nail down. In many cases, the individual you deal with is no more than an intermediary. They often charge fees for the privilege of riding their connections, while delivering nothing special.

The merchant banking label is also used as a marketing tool or pedigree to attract advisory engagements. Heck, we could call Sapien Capital Partners a merchant bank with a clear conscience, but we don't. Our bread and butter is advisory, not the deployment of our capital, or any capital we manage directly or indirectly.

Whoever you talk to should be able to say the same.

The bottom line for SMBs looking into this opaque segment of the capital market --it's "buyer beware."

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<http://www.financialpost.com/entrepreneur/Brad+Cherniak+Merchant+banks+come+with+risk/4084306/story.html#ixzz1AeyubRhy>

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