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Looking For a Growth Or Exit Strategy? Be Alert to Changing Winds In Private Equity

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Increasing numbers of Canadian business owners appear to be looking for opportunities to grow their business or exit them by way of a merger or sale. Business owners who have sailed their companies clear of the financial storms that started in 2008 remark on an eerie calm in the M&A business where there is a lot of money on the sidelines and stories of big deals but no obvious transactions for them on the horizon.

The *Financial Post Crosbie: Mergers & Acquisitions in Canada* report for the first quarter of this year illustrates a surge in the value of M&A deals. The Ernst & Young May 2012 *Global Capital Confidence Barometer* survey also states that almost half of Canadian executives are expecting to pursue an acquisition this year and about one third are expecting to divest, signaling an increase in volume ahead. This volume may be affected further by private company succession planning. There will be more businesses available for sale as boomers with private companies look to retire over the next several years.

Venture capitalists and private equity firms are destined to have a major role in all of this anticipated M&A activity. The recent Canadian Venture Capital and Private Equity Association (CVCA) national conference in Montreal, attended by 1,800 specialists in the field, examined some of the key factors, trends and issues that are affecting both buyers and sellers. There are a number of trends converging in the market which were discussed, suggesting some movement and direction.

While M&A activity has improved since 2008, valuations have not yet returned to 2007 levels. Sellers often overvalue their companies by continuing to use pre-recession valuations while buyers are less anxious to spend their money, creating a gridlock when trying to negotiate a deal. Financial investors thus have a harder time finding suitable companies because of the problem of closing the price gap with sellers.

Many companies have a lot of cash waiting for the right investment opportunity. There are untold millions waiting to find an investment that pays more than bank accounts and the stock markets. Strategic investments by cash rich companies are one of the better opportunities for sellers if they are well placed. Strategic buyers have more latitude to give sellers what they want, including a valuation premium if the investment secures a new market, produces synergies or results in cost savings.

Private equity firms will continue to invest in their own portfolios until the combination of opportunities and prices align once again. It is very much the same as what investors are doing in the commercial real estate markets. Real estate transactions have been one of the driving forces of the economy since the 2008 recession. As properties get more expensive, however, real estate investment trusts and private investors are investing in their own properties rather than chasing new fully priced deals.

New opportunities may be found in making bids for public companies and/or taking public companies private. Investors are turning to depressed financial markets to find undervalued public companies and taking companies private to reduce compliance costs.

In the realm of private company succession planning, over half of Canadian family business owners are not expecting an intra-family next generation transfer and a third are hoping to attract a private equity investor (PwC Capital Markets Flash, January 2012). This transition is already happening. Over a quarter of family businesses plan to embark on a transition within the next five years. Sellers need to understand where they are in the market, what the prices are like and what options they have. The current trends will impact those options.

Even though there are signs of growth in mergers and acquisitions over the past couple of years, the transactions are different and they do not necessarily translate into higher prices. There are some less obvious factors in the market putting downward pressure on prices such as the need by private equity firms to turn over portfolio companies and some more mundane reasons such as company earnings that have not yet recovered to 2007 levels.

In order to best position themselves for a potential sale, sellers should evaluate their options: transitioning through family succession or a management team, bringing in a strategic investor or approaching a strategic buyer. One of the propositions put forward by the organizers of the CVCA conference was that “active management by highly skilled private investors is the secret sauce. These investors jump right into their portfolio companies, working alongside management to truly transform these businesses”.

Companies looking to transition within the next five years should start by cleaning up their books well in advance of a planned transaction. Failure to do so could at best defer closing and at worst uncover surprises that would push investors to walk away from the deal. Private businesses should also make sure they qualify for the capital gains exemption to maximize return on the sale of the business. Certain assets in the balance sheet could disqualify business owners from claiming the capital gains exemption. Complex corporate structures can also deter potential investors and buyers. Simplifying the ownership structure can take time and should be dealt with well in advance of seeking a transaction.

Sellers looking for an exit should also spend less time *in* the business and more time *on* the business by focusing on maximizing value, prioritizing goals and increasing profit margins. Sellers should market their business as a target by determining who needs their business from a competitive, market and strategic partner standpoint. Strategic buyers are willing to pay premiums and premiums can be justified when sellers are offering exposure to new markets, increased market share, economies of scale and the addition of capabilities that leverage much larger existing opportunities for the buyer.

Sellers should also look at new markets for potential buyers. For every dollar on the sidelines in Canada, there are many more in the USA. Foreign interest is also increasing for cash rich investors looking for safe or strategic investments in Canada, especially in the natural resources and real estate sectors.

Perhaps while the venture capital and private equity markets are in the doldrums, owners who want to grow or exit their businesses should check their charts, clean their decks and fix their sails, as both fair winds and gales are in their future. In the meantime,

Day after day, day after day,
We stuck, nor breath nor motion;
As idle as a painted ship
Upon a painted ocean.
-Coleridge-Rime of the Ancient Mariner