



Know Your Buyers

By: Paris Aden, Valitas Capital Partners

Synopsis: Are you thinking about selling your business now or in the future? Know Your Buyers helps business owners consider the types of buyers that are in the market, how those buyers perceive value, and the advantages and disadvantages associated with each. Additionally, a real-life scenario provides practical application.

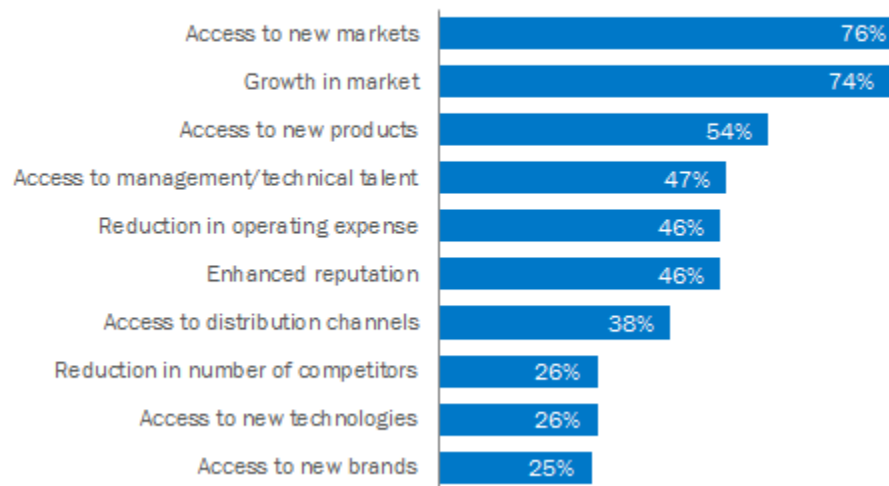
Read on for our views...

Know Your Buyers

Strategic Buyers

Strategic buyers are typically larger corporations that see a fit with some aspect of your business and perceive that synergies may be achieved by combining your business with their own. These buyers often operate in your industry and have a range of motivations for their interest including access to new markets, increasing market share, and acquiring strategic management resources, expertise, or new technologies.

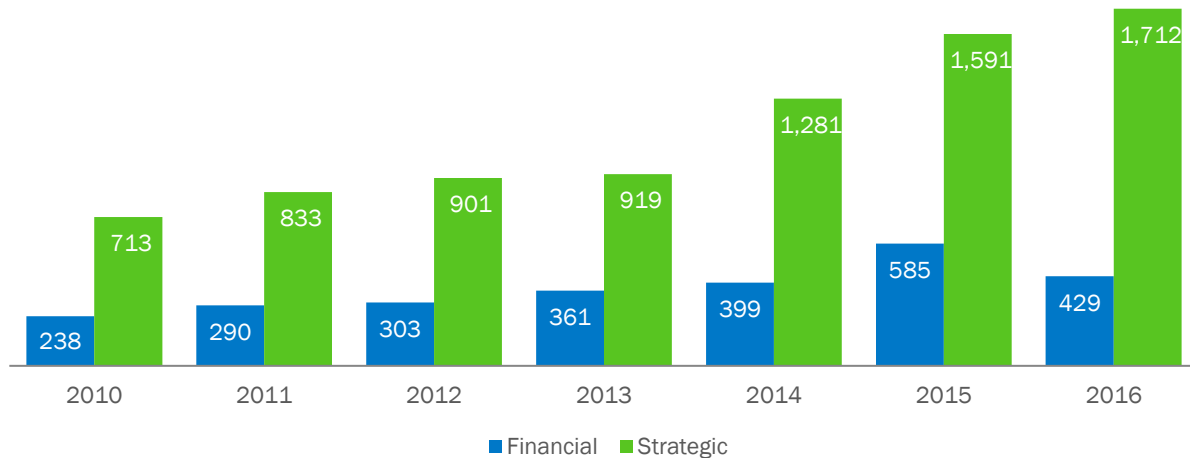
Strategic Buyers: Motivations



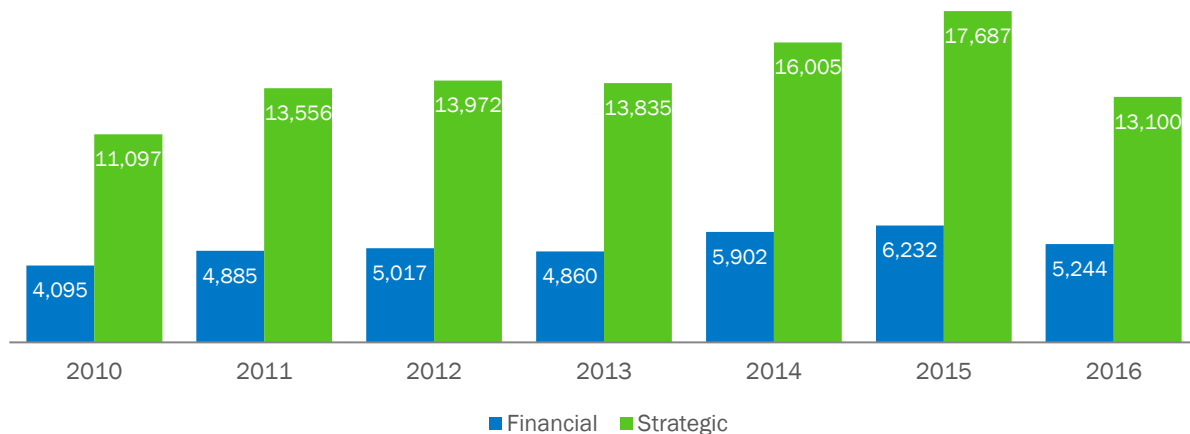
Source: PWC

Strategic buyers have become increasingly active in the M&A market, accounting for 80% of global M&A deal value in 2016. These buyers are often willing to pay higher prices because of their expectation of value creation through synergies. In addition, with corporate cash balances at ten year highs - S&P 500 and TSX 300 corporate cash and short-term investments were sitting at an estimated US\$1.54 trillion in 2016 – there is no shortage of funding for their acquisition programs.

Global Value of M&A by Buyer/Investor (US\$B)



Global Volume of M&A by Buyer/Investor (# of deals)



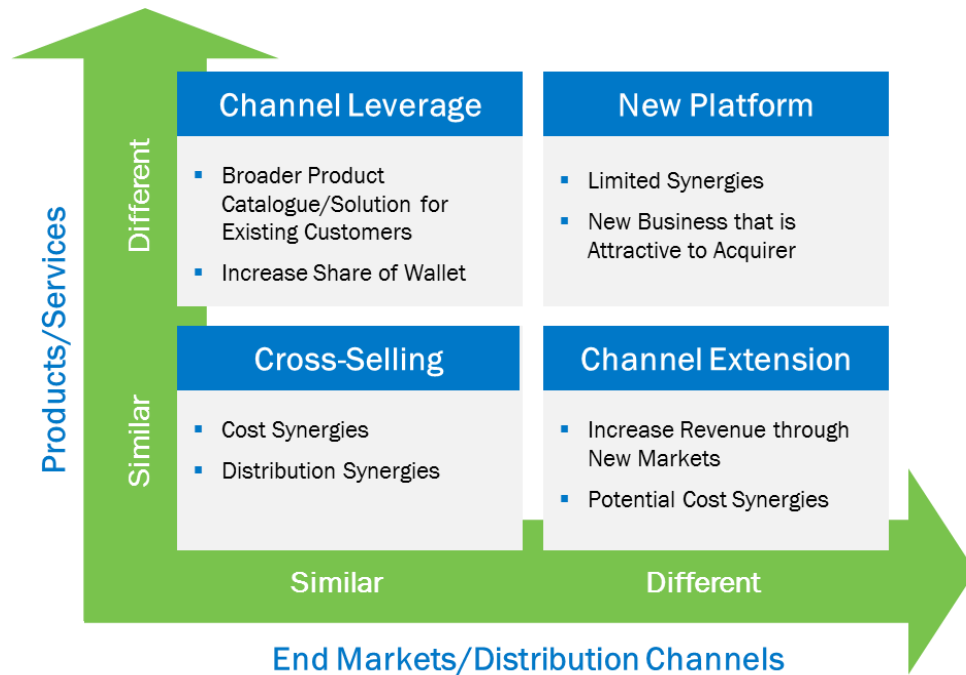
Value Creation through Synergies

As we've noted, strategic buyers expect acquisitions to create additional value, assuming synergies are achieved. For example, if a strategic buyer offers a business owner 10x EBITDA for their business, but doubles the EBITDA through synergies, the acquirer's effective valuation would be 5x EBITDA.

Synergies are most commonly realized in the following two forms:

- **Cost Synergies:** There may be the potential for dramatic margin improvement in your revenues through economies of scale and/or reducing operating expenses; and

- Distribution Synergies: (i) selling your products or services through an acquirer distribution channels; (ii) using your distribution channels to distribute the acquirer's offering; or (iii) a combination of both, can have a significant impact on the EBITDA your business generates post-acquisition.



In addition, inventory and accounts receivable reductions can release cash, effectively reducing the purchase price.

Approach

While often offering the highest valuations because of potential synergies, there may be some drawbacks to dealing with strategic buyers:

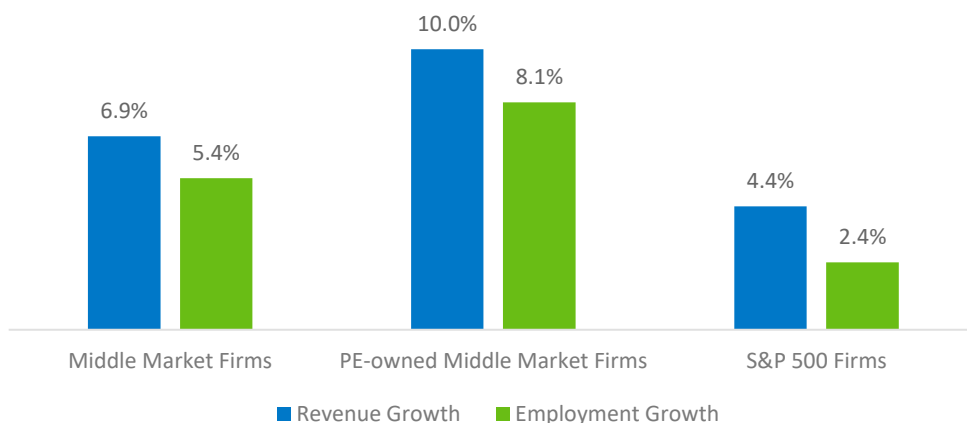
- They are typically slower than financial acquirers
- Some can lack M&A sophistication, which increases execution risk
- There is a greater risk of leaks, temptation to damage a competitor in the marketplace, lack of experience with handling sensitive information
- Potential channel conflicts could undermine expected distribution synergies
- They tend to prefer a 100% purchase
- Post-closing, there is a possibility of closing facilities, displacing people, disrupting business continuity, diluting your brand and legacy

Financial Buyers

Our capital markets are currently characterized by the strong interest of financial buyers that want to invest in private companies. These financial buyers include private equity firms, hedge funds, venture capital firms, some business conglomerates, investment firms belonging to wealthy families, family offices, as well as some ultra-high net worth individuals.

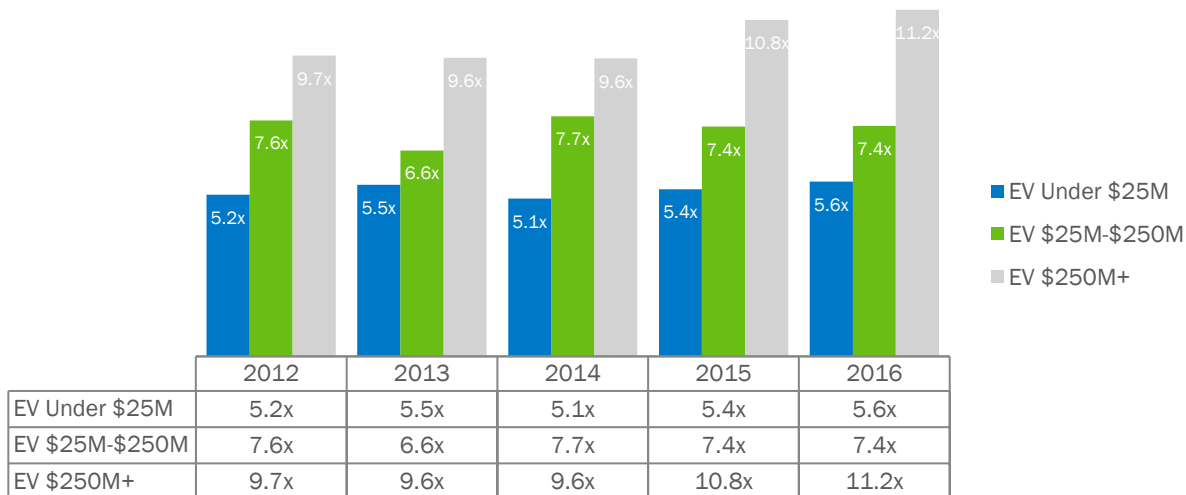
For these acquirers, buying a robust, stand-alone company is motivated by the expectation that they can generate strong equity returns, creating added value using a combination of debt and enhanced financial performance. This can entail improving an underperforming business, expanding it organically, or making a purchase of a platform company to initiate a broader program of add-on acquisitions in an industry where economies of scale are important.

Revenue and Employment Growth: 2016

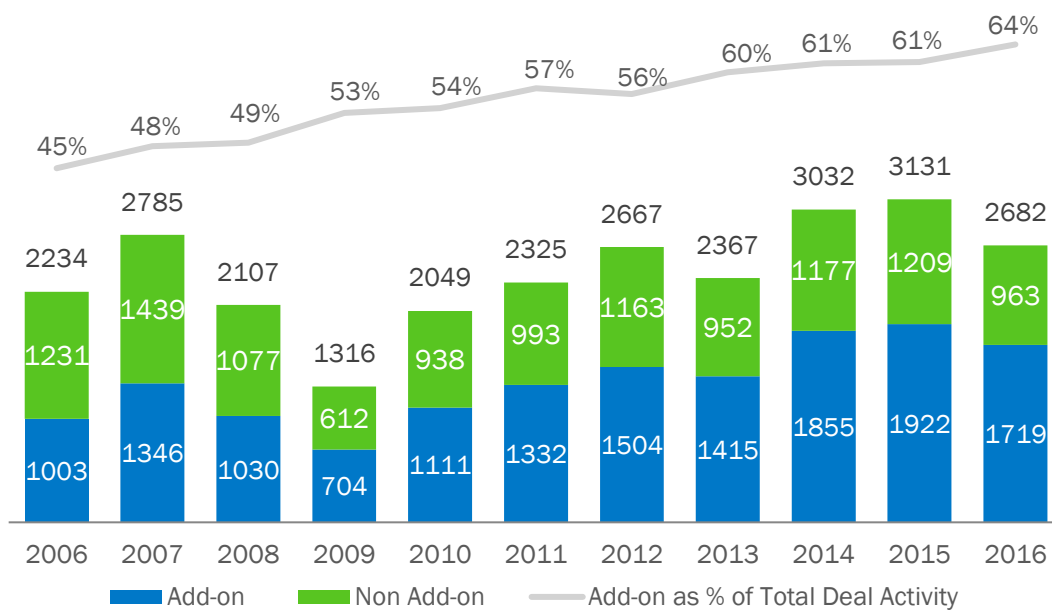


In fact, add-on strategies are growing in popularity among financial buyers who are targeting smaller firms to mitigate high valuations associated with large acquisitions and increasing competition from strategic buyers. An add-on strategy enables financial buyers to tap the value creation potential typically reserved for strategic (corporate) buyers.

Global Median Enterprise Value/EBITDA Multiples



US Private Equity: Add-on vs Non Add-on Deal Activity



Why does this matter to you? Financial buyers have become increasingly prominent in the M&A market, particularly in the US. Currently, there is approximately US\$906 billion in private equity “dry powder” – that is uninvested equity capital looking for a home, much of it with a time limit to be invested. When availability of debt is factored in as a funding source for this activity, this amount more than doubles to over US\$1.8 trillion.

In Canada, we can expect private equity investors to become increasingly active, particularly US funds looking to less mature markets to gain an edge. It is estimated that buyout capital under management in the U.S. represents approximately 5% of GDP, while in Canada it's only about 1%. There has also been a persistent 20% Canadian buyout discount relative to valuations paid on US buyouts. While this discount has been eroding, we expect this to escalate as more US private equity funds pursue investment opportunities in Canada.

Value Perception

Financial buyers target returns over their planned holding period, and typically expect to realize two to five times their initial equity investment. The acquisition valuations they pay vary significantly by industry, geography, and size of transaction. Common characteristics include:

- High financial leverage - Using higher levels of debt to finance acquisitions increases returns on equity investments and increases risk profiles. The target company will be leveraged with debt proceeds used to pay for part of the acquisition price; the current market level is 50-55% debt;
- Control investments - This is usually the case, although minority investments are becoming more common;
- Exit - Typically in three to seven years; and
- Management retention - This is important, and includes significant performance incentives.

Approach

Financial buyers are generally fast-moving and sophisticated. This impacts the sales process and potential outcomes:

- They know how to handle sensitive information;
- They are skilled at operating within sale processes and are more likely to table an attractive price, followed by an aggressive "due-diligence grind," reducing value;
- They often require unique structural features and strong contractual protection;
- Valuations and execution risk are closely tied to credit markets, particularly in the US; and
- They usually require that management stay in the business for more than a year and maintain meaningful equity exposure of at least 20%.

Christine and Murray: A Short Case Study

Christine and Murray own thriving commercial bakeries.

Both spent decades building their businesses from corner shops to the factories that house their current operations today.

Both generate healthy revenue and cashflow, at a level that might make their competitors envious.



Both are still working long, tough hours...maybe longer and tougher than they'd like (particularly in Murray's case).

And while both have adult kids, the kids have gone in different directions, and have no interest in the commercial bakery business.

Those are their similarities, and here are some critical differences...

Murray is 72 years old. He's tired of the long hours, and wants freedom to spend winters in the Florida sunshine, take up golf, and enjoy time with his grandkids. He's ready to realize the value from what he's built over the past decades and have someone else take over the business.

Christine just turned 60. This milestone birthday has triggered some thinking about how she wants to spend the next decade. Further thinking has been provoked by her long-time business partner, who recently announced that she wants to sell her 30% stake in Christine's bakery.

What will generate the most successful outcomes for Murray and Christine?

Murray

Murray is ready to sell. Unequivocally. He wants the best price that he can get for his business today, and is hoping to step out completely.

A strategic buyer is likely the best option for Murray. This type of buyer will typically want to acquire 100% of the business, and offer the highest valuation because of potential synergies.

Competitive tension created through multiple bidders will generate the best price for Murray. To achieve this, he would be wise to retain an M&A advisor to manage the transaction process, as strategic buyers may have less M&A sophistication and a higher probability of leaking information. The right advisor will manage execution and confidentiality issues, and minimize Murray's exposure to these risks.

Christine

Christine isn't ready to retire just yet. She wants to exit in a few years' time, but sees further growth opportunities in her business that she'd like to exploit first. Things are complicated however, as she needs to find the capital to acquire her partner's 30% interest in the bakery, as well as to invest in future growth.

A financial buyer will be the best option for Christine. While this type of buyer would likely offer a lower valuation for her business than a strategic, the terms of an arrangement with a financial buyer will be more attractive to Christine. Management retention is important to a financial buyer, who will want Christine to retain an equity interest in her business. The financial buyer typically has a three to seven year investment horizon. At the end of that period, 100% of the business will be sold, most likely to a strategic buyer. Christine will benefit from the value creation in the business through her retained interest, and will be able to retire on a timeline that she is hoping for.

As in Murray's case, Christine should consider retaining an M&A advisor to create competitive tension in the sale process, to negotiate the terms of the transaction, and to manage the process.



The outcomes:

Murray

After entertaining multiple offers, Murray sold his business to a multinational bakery that wanted a platform to enter the Canadian market. He's currently living his dream and enjoying his grandkids...and he's seen huge improvement in his golf game.

Christine

Christine, supported by her M&A advisor, negotiated an attractive agreement with a financial buyer (a private equity fund). The buyer acquired 80% of the bakery, including the share of Christine's business partner. Christine retained a 20% interest, and continued to run the business for the next five years. During that period, the financial buyer provided capital for Christine to develop a new line of specialty breads that boosted the bakery's top and bottom lines. When it was time to exit, Christine sold her remaining 20% (alongside the financial buyer) for more than her initial transaction with the fund.

The Takeaway...

If you are considering a sale of your business, keep in mind that the best business transition process is one that accesses the optimal buyer universe and considers which potential acquirers are most likely to see value in your business, balanced against your non-monetary objectives.

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least \$100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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About the Author



Paris Aden, Partner

Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding \$80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.