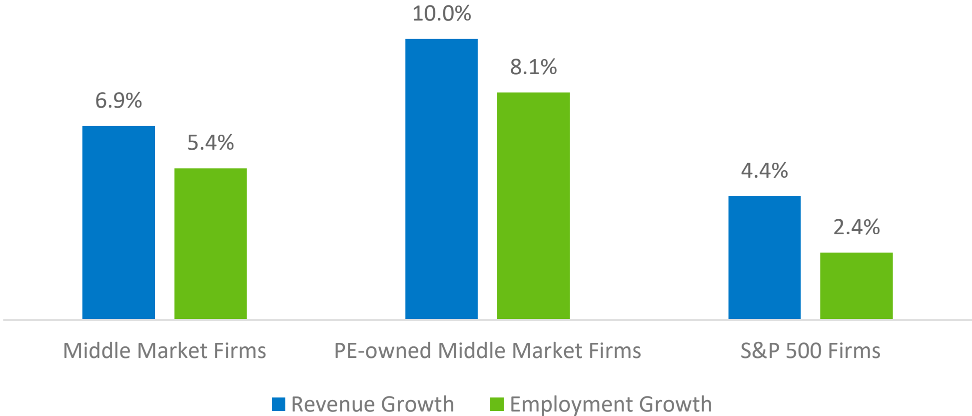
Know your Buyers is a three-part series by Valitas Capital Partners for business owners. It is designed to help owners consider the types of buyers that are in the market, how those buyers perceive value, and the advantages and disadvantages associated with each.

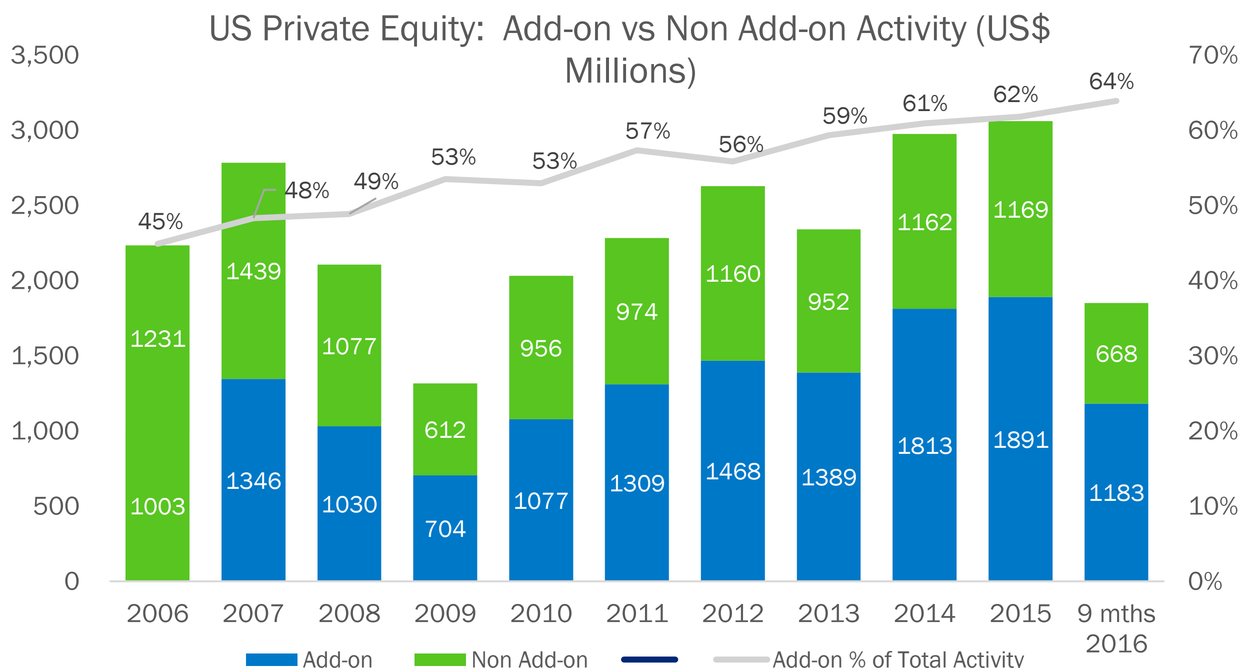
In this instalment of the series, Valitas discusses financial buyers. In May, we will explore strategic buyers and, in June, Valitas will present different business scenarios and how the type of buyer impacts marketing and the outcome in each case.

Today our capital markets are 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 enhancing 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.



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 buyers.



Why does this matter to you? Financial buyers have become increasingly prominent in the M&A market, particularly in the U.S.. It is currently estimated that there is approximately US$750 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 after which it must be returned to the LP investors. When availability of debt is factored in as a funding source for this activity, this amount more than doubles to over US$1.5 trillion.

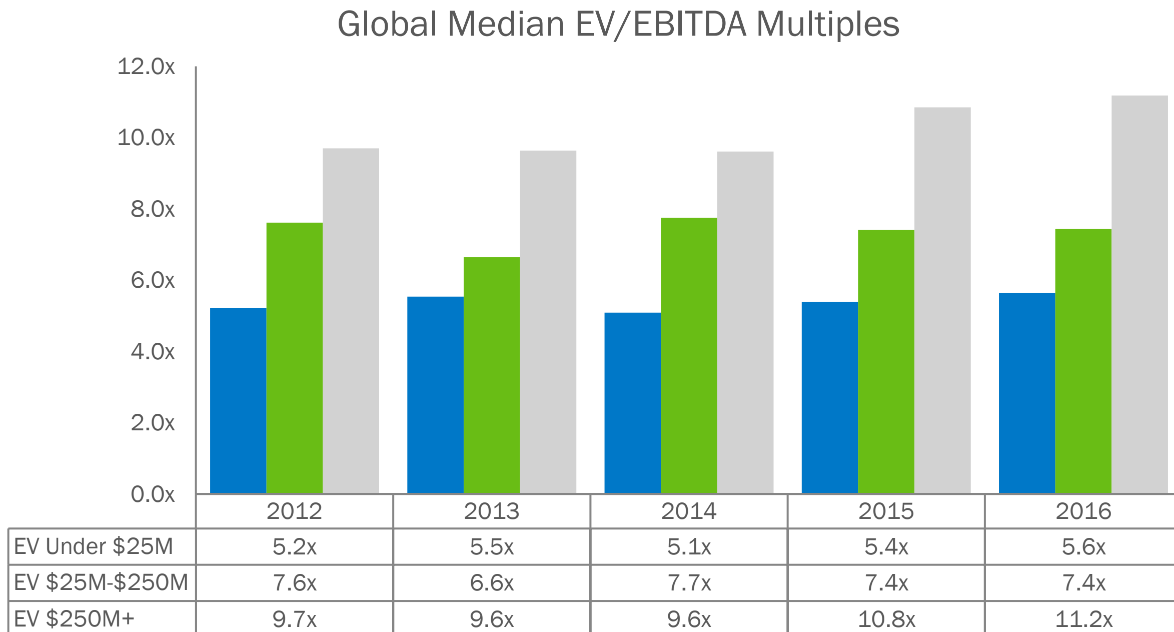
In Canada, we can expect private equity investors to become increasingly active, particularly U.S. funds looking to less mature markets to gain an edge. It is estimated that buyout capital under management in the U.S. represents approximately 5% of GDP, while in Canada it's only about 1%. There has also been a persistent 20% Canadian buyout discount versus the valuations paid on U.S. buyouts. While this discount has been eroding, we expect this gap to close more quickly as more U.S. private equity funds look to invest 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. Hence, 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 proceeds used to pay for part (could be substantial) of the acquisition price – the current market level is 50-55% debt;
- Usually make control investments. Minority investments are becoming more common and have significant negative controls;
- Most exit in three to seven years; and

- Management retention is important, with significant performance incentives.



	2012	2013	2014	2015	2016
EV Under $25M	5.2x	5.5x	5.1x	5.4x	5.6x
EV $25M-$250M	7.6x	6.6x	7.7x	7.4x	7.4x
EV $250M+	9.7x	9.6x	9.6x	10.8x	11.2x

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 also 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% as the starting point.

The best business transition process is one that accesses the optimal buyer universe and carefully determines which potential acquirers are most likely to see value in your business, balanced against your non-monetary objectives.

Valitas knows financial buyers. We communicate regularly with more than 400 firms around the world that are seeking investments in Canadian companies. As former private equity investors ourselves, we are adept at working with business owners in a way that effectively demonstrates the value story a financial buyer will pay for.