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CAPITAL PARTNERS

Understanding Your Liquidity Options

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Synopsis: It's uncommon for a business to be opportunity constrained. Often, the issue isn't having profitable projects to invest in, but choosing which to fund. We call this being capital constrained. Equally as important is choosing how to fund those projects. The cheapest and most expedient option would be to use cash on hand, but this limits the pace of investments possible. When you need to bring in outside capital, should you choose equity or debt?

Read on for our views…

The Expert Panel

If your business cannot generate liquidity for shareholders, it has no value. This article reviews *Understanding Your Liquidity Options*, one of the main sessions at the Business Transitions Forum in Toronto, which was moderated by our founding partner, Paris Aden. Meet the experts on the panel:

Figure 1: Panel Experts

Meet Your Panel

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Liquidity means “readily exchangeable for cash.” Its evil twin, *illiquidity*, means “not readily exchangeable for cash without a *substantial loss of value*.” To picture illiquidity, imagine the NASA crawler, the largest self-powered vehicle in the world. Custom built to move Apollo rockets to the launching pad, the crawler was operated by a team of nearly 30 engineers, technicians and drivers. Although the crawler is valuable, it would be hard to quickly find a willing buyer not named NASA.

Most businesses are like that – custom-built and illiquid. As an owner, you may look at the assets of your business and wonder how readily convertible they are to cash. All too often, the equity in the business is trapped.

While it is an over-simplification, your business is similar to another familiar illiquid asset – a home. If you own a $1 million home, you don’t necessarily need to sell the home to generate liquidity. Of course, you can re-mortgage the home to generate funds if there is sufficient equity and income to support it. Your business is similar, but there are more options and much more complexity.

Having a solid grasp of your business’ capital structure and your liquidity alternatives is critical. Seek advice from experts if you aren’t comfortable.

This chart shows the continuum of liquidity alternatives:

Figure 2: Shareholder Liquidity Alternatives

Dan Lioutas[i] of Grant Thornton describes the above liquidity alternatives as a "progression from the least amount of liquidity to the greatest amount…Operating a business provides no liquidity aside from paying yourself a dividend or a bonus, but you have absolute control of your business. As you move along the spectrum, the liquidity generated goes up, your control over the business goes down.

Are you big enough to access the full range of options?

"It is a bit of moving target. You need at least $2-3 million in EBITDA to access the full complement of alternatives, and at this deal size you are dealing with the smaller lenders and investors." Paris Aden of Valitas Capital Partners explains. "The next level is $5 million EBITDA, and the next $10 million. The advantage at those levels is that there is significant competition among the bigger players resulting in greater flexibility, better terms and lower cost of capital."

While David Hastie[ii] of First West Capital agrees that bigger companies attract more attention, he stresses that not all growth is good growth; "Bigger isn't always better, better is better."

Are you big enough to access the full range of options?

Karen Killeen[iii] of Springboard Management Advisors counsels owners to think carefully about the *consequences* of their liquidity alternatives. These are some of the questions she asks:

- Going forward, how will the owner, management team's and employee's influence over operations and strategic direction be impacted by the chosen liquidity path?
- Do you understand the new investors' desired direction and focus - is it aligned with the current focus of your business? Can you and your team adapt to that desired direction? Could there be a conflict? Finding the right partner is important.
- Personal impact - What do you want from liquidity event - beyond price, are you ready to walk or do you want to stay on? Is it important to continue your legacy?

- If you don't want to stay on, is your management team competent enough to step into your place? If they aren't, be prepared that you will be expected to hang around for a while until that changes. Plan upfront and be ready.

The Liquidity Alternatives

Operate the Business

The way you get liquidity from an operating business is to pay yourself out of earnings. Operating a business is risky, however, and the failure rate is high. Smart operators do two things well:

Diversify: Uninformed owners assume that their business is their best investment because it generates a high rate of return. While a business can have a high return, it also carries high risk. You do not want to be 75 years old and lose everything. Sadly, this is all too common.

Diversify your portfolio by securing your personal wealth outside the business. Execute a sound liquidity alternative and hire a good financial planner. Ask about individual pension plans, insurance and the cost of retirement.

Get "Sale-Ready": We have seen that illiquidity results in "a substantial loss of value." NASA crawlers are not sale-ready. Sale readiness increases liquidity. It is all about minimizing that substantial loss of value.

A significant issue is the transferability of the business: What can you transfer if you leave? A business that depends heavily on the owner's ongoing involvement cannot readily sell. Delegation equals value and increases sale readiness.

To understand your liquidity alternatives get a valuation from a transaction expert, ensure your records and reporting are ready for transaction due diligence, and put value creation processes in place. These steps will substantially increase the liquidity and value of the business. It also provides your family with a lot more security. The last thing a grieving widow needs is an appointment with the banker to explain that the business loans are now due and payable, in full.

Leverage the Balance Sheet

This is a strategy of using borrowed money and distributing proceeds to shareholders as dividends or by redeeming shares. The essence of entrepreneurship is to identify business opportunities. In the land of leverage the classic business formula of buy low, sell high becomes, borrow low, invest high.

Leveraging the balance sheet is an idiom that refers to any borrowing -- mortgages, letter of credit, factoring, or cash-flow financing. This borrowing is recorded on the balance sheet increasing liabilities. Conversely, the payment of dividends or repurchase of shares is reflected as a decrease in equity.

> *"Selling to a strategic buyer is permanent. With leveraging, however, you can iterate that as many times as your creditworthiness will allow."*
>
> Paris Aden[iv], Valitas Capital Partners

You can use the borrowed money to invest in the business or you can use it as a method of accessing money from the business without selling. David Hastie uses the term Margarita Money to emphasize the value of delegation. Lenders get very nervous about lending an owner several million

dollars for personal purposes unless they know the business can run properly without the owner. They worry the owner may decide to move to an island and drink margaritas while the business falls apart.

Another practice that lenders disapprove of is using the operating line of credit to pay big personal dividends. An operating LOC is for funding working capital. If an owner wants to take a large sum out of the business, then a specific loan should be arranged for that purpose as it has different underwriting criteria.

The advantage of leverage is that it provides liquidity without diluting ownership. In fact, private equity firms use debt to increase equity returns. We'll explain this further in the Private Equity Control Investment section below. The cost of debt is usually deductible and much cheaper than equity.

The lending process has a positive value creation side effect. David Hastie explains. "The due diligence that the lender undertakes is a good practice run for any future buyer due diligence. There is no risk, and it often uncovers problems that owners were not aware of."

David also points to the importance of strong financial reporting: "Getting your internal reporting and controls cleaned up will benefit the business day-to-day and, more importantly, down the line. The business should ask the accountant to prepare the financial statements to a Review Engagement or, preferably, Audit Level (are they believable, plausible?)."

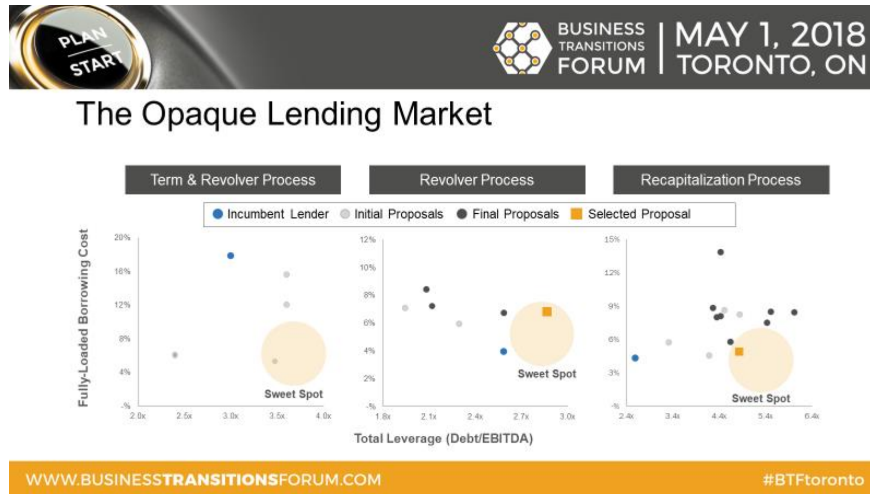
Debt is available from a variety of sources such as private investors, strategic partners (e.g., vendors or customers), family offices, specialty lenders, funds, credit funds, and banks. A wide array of commercial terms are available: short term vs. long term, secured vs. unsecured, guarantees vs. no guarantees, mezzanine, multi-tranche, special purpose vehicle borrowing, etc.

The disadvantages of borrowing include the burden of repaying the loan, restrictive covenants, burdens on prospective cash flow and insolvency risk.

An increasingly viable option for Canadian businesses are the U.S. private debt funds. Because of the vast amounts of money available south of the border and a limited number of opportunities, many of these financial institutions are looking for opportunities outside the U.S.

Many Canadian owners think that a few big banks are their only option. This isn't so; there is an opaque lending market with 150+ lenders to mid-sized Canadian companies. Opaque means there is very little publicly available information on rates, terms, etc. so you need the experience to deal with them. Interestingly this creates an opportunity:

Figure 3: The Opaque Lending Market



This slide shows the astonishing results from 3 actual debt canvasses executed by Valitas Capital Partners. The vertical axis is cost, and the horizontal access is funding committed. Each lender had the same information, and they knew they were competing with other lenders. Note that in each case the funding proposals are all over the graph.

Minority Equity Investment

In a tech start-up, equity and control are forms of currency used to acquire talent and resources. Very few mind-boggling tech start-up founders have 51%. Before Bill Gates set up his foundation and diversified, he only had 15% of Microsoft shares. That was enough to keep him at the top of the charts for 18 of the last 23 years. This year Jeff Bezos is worth almost $140 billion as of this writing, with only 16% ownership of Amazon.

> *Intelligently diluting your equity for capital can create your own mind-boggling success story.*

But why would an investor want a minority non-control position? These types of investors tend to be passive partners who can assist the business to grow, and are looking for superior returns. Contrary to popular press characterizations, not all private equity funds are corporate raiders bent on firing staff and taking assets off-shore.

Minority investing by private equity funds used to be rare. Today, more private equity funds are seeking out owners of profitable companies who want to maintain operating control of their businesses and want an equity partner to help them take them to the next level. This may be the fastest-growing segment of the private equity market. The private equity firm provides the liquidity. The owners continue to provide expertise and profit. Warren Buffet explained in 1996:

> *"Why, then, should we behave differently with our minority positions in wonderful businesses? ...you simply want to acquire, at a sensible price, a business with excellent economics and able, honest management. Thereafter, you need only monitor whether these qualities are being preserved."*

Assuming your business has excellent economics and able, honest management you can attract this kind of investor whether it be to take money off the table or to fund a strategic opportunity. Because of the rapidly-growing market for this kind of investment, you can be choosy and find the right partner. Once again expert advice and a competitive process will pay off.

Private Equity Control Investment

We know why an owner would give up a minority stake, but why would you give up a majority of your equity and hand control over to a private equity firm? One reason is the *double-dip*. Assuming you have excellent economics and able, honest management *plus* an intelligent collaborative private equity firm, you can do very well.

> *The classic private equity investment has a 5 year hold period and targets a 200% increase in equity value.*

Private equity investors are the masters of leverage. They leverage the balance sheet of the businesses they acquire to reduce the equity cheque required.

The reason you can double dip is that private equity investors typically require that some equity ownership be retained by the active founders and management to align incentives. The double-dip refers to the value realized by the founders and management when the private equity fund sells the business, also referred to as the “second bite of the apple”. The table below outlines a simplistic example:

Table 1: Company Value Realized Over Time

C$ Millions	5-Year Holding Period	
	Initial PE Sale	PE Exit Sale
A. Company Value	$30	$90
Founder/Management Equity %	100%	30%
B. Founder/Management Equity % Sold	70%	30%
Remaining Equity %	30%	0%
Total Proceeds (A x B)	**$21**	**$27**

In this example, you received $48 million by partnering with the PE fund instead of $30 million today, which is $18 million for five more years in the saddle. Many owners find this an exhilarating period where the all their business dreams come true, and the real value is unleashed. “Our companies don’t worry about cash,” Warren Buffett explains. “I worry about cash. They don’t have to have it on their own. If they have no cash and there’s a good idea, they’ll get it from me that day.”

Private Equity investors can be demanding and some owners do not have the energy required. If the owner has properly delegated the responsibility of running the business, then the management team can do the hard work to build the value required by the Private Equity investor. Many managers welcome an opportunity to work hard for five-years to get a large payout.

As we mentioned earlier, Private Equity investors often use leverage to increase the equity return of their investments. Leverage allows Private Equity investors to invest less equity in the beginning by

financing part of the purchase of the business with debt. As the business grows, the initial debt put on the business stays at the same level (usually is paid down) while all the growth accrues to the equity value. Essentially, you get the same growth for a cheaper price, and therefore higher returns.

Below is an example comparing a leveraged PE investment compared to a non-leveraged investment:

Table 2: Leveraged versus Non-leveraged PE Investment

C$ Millions	Two Cases	
	No Leverage	50% Leverage
Company Purchase Value	$100	$100
Debt	-	50
A. **Equity Cheque**	**100**	**50**
Company Growth	100%	100%
Company Sale Value	200	200
Less: Debt	-	50
B. **Equity Sale**	**$200**	**$150**
Equity Growth % ((B - A)/A)	**100%**	**200%**

In the no leverage scenario, the Private Equity firm contributes $100 to purchase the company and initially own 100%. They then grow the business to twice its original size over their holding period. In the leveraged example, the growth pattern is the same however the Private Equity investor only contributes 50% of the initial purchase value. While they only invested 50% of the purchase value in the beginning, the equity holders are entitled to all of the subsequent growth. So, even though the absolute gain in enterprise value is the same in both scenarios, the return on equity is significantly higher for the leveraged firm.

Sometimes the management team is looking for a private equity control investor to finance a large management buyout. Dan Lioutas explains how he arranges financing for a management buyout: “What we do is map out a five-year plan like a private equity firm would and then look at all the financing options starting with the least expensive. The reason to look at a private equity control investment is they have a more sophisticated view of the capital structure than managers do, and strong relationships with lenders. The banks tend to be aggressive on deals where a private equity investor is involved.”

Strategic Sale

The starting point for assessing the stand-alone value of a business starts with determining its expected cash flow generation on a stand-alone basis and assessing the present value of its expected cash flow.

A strategic purchaser has another level of value it can unlock. A strategic purchaser can create synergies in addition to the stand-alone value. A synergy is any effect that increases the value of a

merged firm above the combined value of the two firms separately. Synergies make the deal more valuable and allow the strategic purchasers to pay more – at least in theory.

A strategic purchaser's value is intrinsic value + synergy value.

Synergies come in many forms; the common ones are cost reductions, new markets, new products, intellectual property, management expertise, new territories, licenses and many more. Synergies can have a dark side, especially cost reductions like eliminating duplicate departments. The owner's long-term loyal employees could suddenly be terminated. Sometimes entire companies are closed down because the purchaser only wanted a patent or customer list.

This concern about the dark side of synergies and loyalty to long-term employees often steers owners away from this option.

However, strategic buyers only pay sellers for expected synergies if they think it is required to present a compelling option versus their next best alternative. In other words, strategic buyers pay for synergies when they are competing with other bidders.

Conclusion

Without liquidity, your business has no value. If you have at least $2 million EBITDA in a business with excellent economics and an able, honest management team that can run it, then you have some interesting alternatives. You would be well served to seek expert advice as you weigh your options and embark on your chosen path.

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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