Deloitte.

Lessons from Private Equity
How to increase the value of private companies in B.C.

Vancouver Private Company Services
2011 Edition

“Someone’s sitting in the shade today because someone planted a tree a long time ago.”

Warren Buffett

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Foreward

Despite a slow economic recovery over the last couple of years, liquidity in the market has been increasing, and we are seeing a surge in the Private Equity sector. These professional investors are being reinvigorated by the relatively lower valuations and excess uncommitted capital at hand. Regardless, whether the economy is up or down, top Private Equity firms operate with their investment companies to produce a strong return on investment on a consistent basis.

Given a defined exit period, top Private Equity (PE) firms have a disciplined framework of strategies and tactics that allow them to build up the enterprise value of an investee company, usually over a five- to seven-year time period, and exit with a target Internal Rate of Return (IRR) of 25%+. As a business owner it is critical to create value by applying a PE type of discipline over a certain timeline without forgoing the long-term health of the company, even if you plan on leaving your business to your family.

Who are Private Equity investors?

Private Equity investors are professionals who raise capital and invest in private companies. Well-known for their ability to provide leadership support, advise on operational efficiencies, and fund and drive growth, PE investors bring with them a disciplined framework and a plethora of business acumen that often lends itself to business success. Simply put, PE investors focus on working with management teams to make good companies great.

Although that's more easily said than done, PE investors have the ability to realize an IRR on invested capital in the range of 20% to 30%. Many target companies are those that have demonstrated impressive historical growth that, for whatever reason, has plateaued. PE investment firms have a track record of transforming strong, stable companies into expansionary businesses. Their ability to aid management in moving into a new phase of business growth is uncanny, and has spurred Deloitte to ask the question, "How do they do this?"

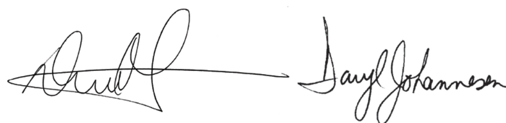
What are the lessons learned from Private Equity?

We have interviewed BC's leading PE firms to learn about the techniques they employ to achieve business success. We believe that these principles and techniques are relevant to all of our private company clients, and we hope to share these lessons learned with you.

This report summarizes our interviews with BC's top PE firms and identifies five key lessons learned. We believe that these lessons can be employed by many of our private company clients to produce improvements in operating and financial performance, and to develop repeatable and sustainable processes that will make their companies more valuable. For some clients it may be appropriate to employ one or two of the lessons; for others, a future partnership with a PE firm may provide significant growth potential.

Given that driving shareholder value is the number one priority for private company owners, we believe that this Private Equity study provides an important perspective. We trust you will find this report insightful and relevant and we look forward to further serving your business needs.

Sincerely,



David Lam, CA, CBV, CF
Mid-market M&A Leader

Daryl Johannesen, CA
Private Company Services Leader

Private Equity background

Different types of Private Equity

As is true for any industry, Private Equity (PE) comprises various sub-segment niches. The objective is always similar in the sense that PE firms will try to create operating and financial efficiencies and increase shareholder value; however, the strategy and risk profile is different for each segment. Provided below is a brief overview of the three main vehicles for PE investing.

Traditional Private Equity – Separated into two key classes (buyout and growth funds), traditional PE funds target mature companies with a history of stable earnings, with the goal of enhancing the target companies so that they can grow and be sold for a premium relative to the investment purchase price. Buyout firms will typically utilize a greater proportion of leverage and purchase control of the company so that they have a greater influence on the strategic direction of the company. Growth funds utilize less debt and do not require control in all their investments. Investments from growth funds are typically used when target companies require an injection of capital to allow the company to reach the next stage of its business cycle. Buyout funds will more commonly purchase control from a vendor who is in the midst of a succession plan (i.e., planning to exit), whereas growth funds will more often partner with the vendor to achieve mutual gains. Below is a breakdown of a few different types of funds that operate in the realm of traditional Private Equity:

- ***High Net Worth*** – These funds are backed by one or more high net worth individuals. They are able to leverage current and past investments as well as relationships to advance the success of new ventures.
- ***Infrastructure Funds*** – These funds are specialized to long-term capital-intensive projects such as roadways, tunnels and bridges. With the advance of public private partnerships in recent years, infrastructure funds have become more common.
- ***Pension Funds*** – These large institutional funds invest in various sectors to provide pension benefits for their members. They invest in Private Equity so that they can provide diversity to their fund and influence the progress of their investment.

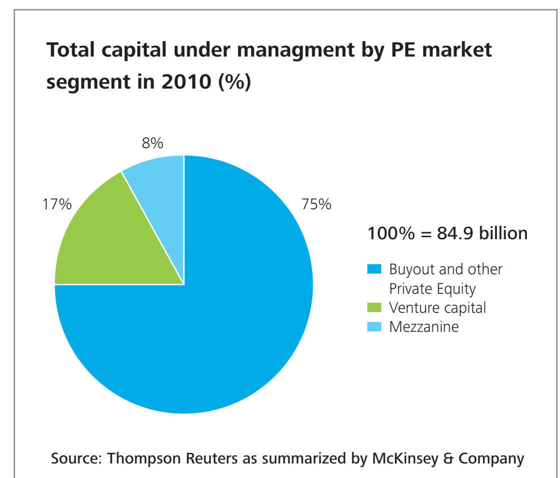
Venture Capital – Predominantly composed of start-ups and early-stage companies, venture capitalists engage in investments that provide growth capital to prepare companies for a more mature stage of the business cycle. Venture capitalists invest in ventures that are high-risk and have a high-return, and are most commonly known for investing in high technology, biotechnology and software companies. Public venture capital targets similar types of companies, providing needed capital to execute growth plans and build the business over a minimum of 3 to 5 year time horizon to create a sustainable enterprise.

Mezzanine Funds – Mezzanine capital provides financing for Private Equity transactions with subordinated debt and/or preferred shares. Sometimes, the financing is convertible into common shares after a vesting period, which gives the financiers the opportunity to hold equity in a company at a later point. Mezzanine funds mitigate risk exposure because subordinate debt and preferred shares receive priority on the assets of the firm ahead of common shares. Mezzanine funds typically operate under a growth strategy similar to growth funds for traditional Private Equity.

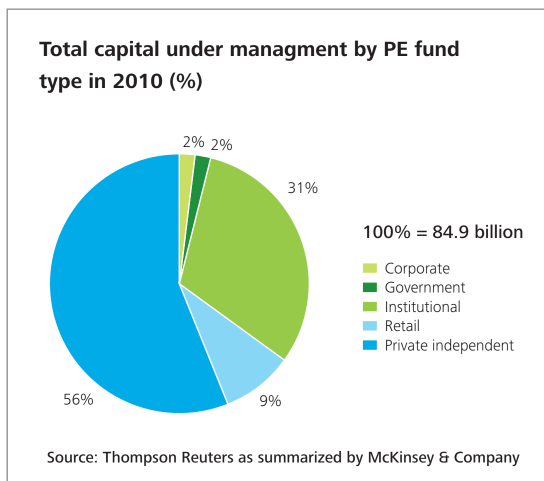
The PE market in BC is largely composed of a mix of buyout funds and growth funds partnered with high net-worth investors. BC has always been dominated by mid-sized businesses. This provides buyout firms with plenty of middle-market targets, and generates less interest from large institutional funds.

The graphs highlight the overall PE landscape in 2010 Canada:

Total capital under managment by PE market segment in 2010 (%)



Source: Thompson Reuters as summarized by McKinsey & Company



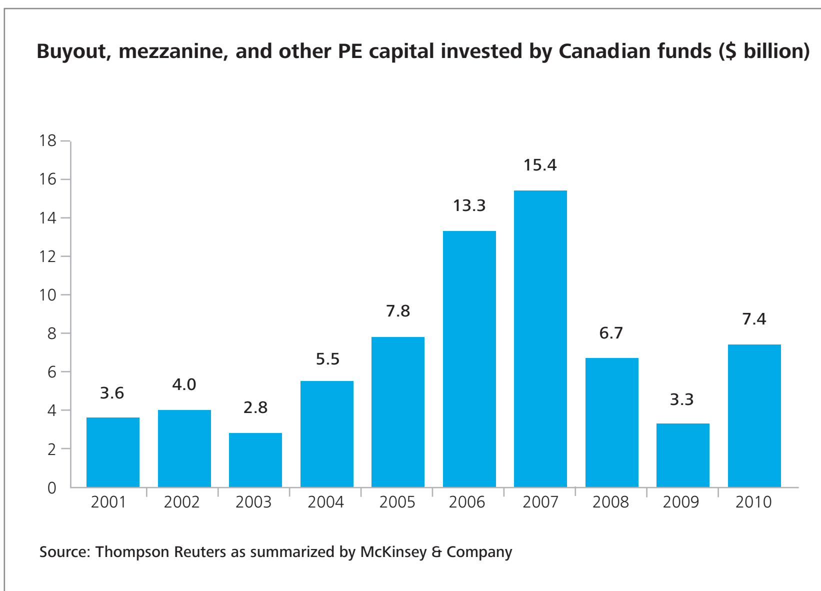
Evolving landscape

Along with the steep advance of stock markets in the early 1980s, Private Equity (PE) also began to gain momentum. The relative increased volume of ebbs and flows created opportunity for PE firms to capitalize on turnarounds and fast-growing companies, largely with the use of pure financial engineering tactics. PE firms found that an optimal capital structure and an efficient tax regime combined with some strategic guidance offered strong returns in a relatively fragmented market. Over the years, consistently attractive results have created further interests in the PE model, which in turn created more competition in the PE space. As PE firms invest in foreign companies, and as strategic acquirers are more able to transact across borders, there is further increased competition for PE firms within the growing trend of globalization. The perceived increase in strategic investors resulted in increased acquisition prices, which has the ability to limit a PE firm's IRR.

In recent years, PE firms have adapted to the competitive forces by employing a 'buy and operate' model. Financial engineering is still very important, particularly for buyout firms, but in recent years the ability to provide operational expertise and strategic planning is much more relied upon. A Morgan Stanley study[1] demonstrated that "company outperformance" was the main driver of value in nearly two-thirds of PE deals. The reliance on financial leverage and market/sector appreciation was found to be a primary driver in only one-third of deals. Since the global economic crisis, this is amplified, as the ability to obtain leverage has been more difficult. Therefore, PE firms need to ensure they provide excellent operational oversight to achieve their targeted IRR, to capitalize on their strategic and operational experiences, and to spend considerable time working with their partner management teams to increase the company's value. Understanding the areas where operating and process improvements can be made, the ways to aid management with strategic planning and targeting, and the extent to which the industry is fragmented are all essential. Our interviews with the top PE firms in BC, which are discussed further in this document, have revealed the methods of increasing value.

Recent trends in Private Equity[2]

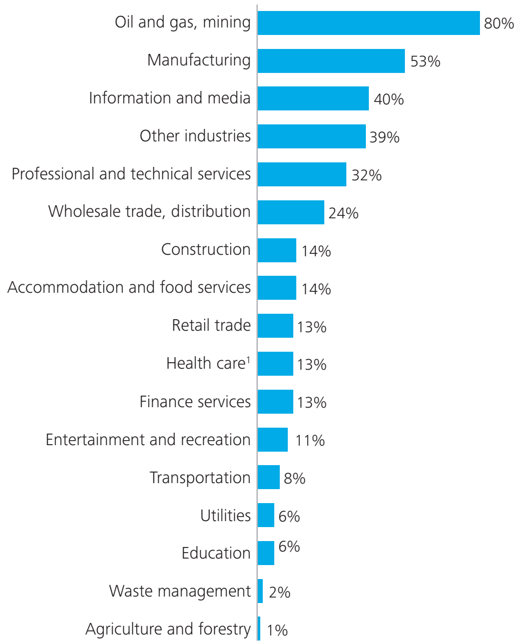
Not unscathed by the global financial crisis, PE firms witnessed a nearly 90% reduction in fund-raised capital between 2007 and 2009 across Canada and the United States. Not surprisingly, this also translated into a large decline in the amount of capital invested. As depicted in the graph below, the amount of capital invested by Canadian funds declined nearly 80% between 2007 and 2009.



The graphic on the next page illustrates that the majority of PE deals occur in energy and resource services, in manufacturing, and in the information and media sector. This is driven by the size of the respective sectors as well as the opportunities to increase value within a five- to seven-year time frame.

[1] As summarized in "Operational Improvement: The Key to Value Creation in Private Equity," Morgan Stanley, July 2009

[2] Private Equity Canada 2010, McKinsey & Company



Source: Thompson Reuters as summarized by McKinsey & Company

[1] Per the Canadiann Oxford dictionary

Despite the remaining economic woes, recovering macro indicators coupled with pools of dormant capital from the prior year spurred PE firms to invest in numerous opportunities. Canadian PE firms increased investment by approximately 120% between 2009 and 2010. This improved market activity is largely attributed to middle-market companies, which is in contrast to the pre-recession upticks that comprised mostly large-cap deals. Further, the appreciating Canadian currency provided ample opportunities for cross-border investments. It is estimated that 70% of all Canadian buyout deals in 2010 were for non-resident businesses.

It appears that the uptick generated from market activity will at least be sustainable through 2011. A recent report published by Mergermarket[3] indicated that North America witnessed 357 Private Equity buyouts in the first half of 2011, which marked a 10% increase in volume compared to the same period last year. Further, Mergermarket estimates that this resurgence in volume translates to an approximate 59% increase in value. The second half of 2011 is expected to be slightly slower for Canadian activity compared to the first half because of changing macroeconomic conditions. Nonetheless, market activity is expected to increase compared to 2010.

What Deloitte has noticed in the marketplace

Deloitte's transaction experience corroborates the foregoing discussion. We saw 2009 as a year of hesitancy for investors, allowing for a collection of capital to build. Although volumes have increased since then, the market activity is still well below the pre recession levels, causing more competition for high-quality deals at the middle-market level. Increased competition has resulted in opportunistic Private Equity investors pursuing smaller deals overall, and seems to have changed some of the transaction strategy for the time being. The chart below highlights the noticeable differences in Private Equity strategy that Deloitte has been privy to between the current period and pre-recession levels.

	Prior to 2008	Current
Transaction terms	Outbidding strategic	More conservative
Valuation	6x to 9x Earnings Before Interest, Tax, Depreciation, Amoritization (EBITDA)	4x to 6x EBITDA
% Investment	Majority (70% to 80%)	More willing to take minority position
Leverage	70% to 80%	40% to 60%
Participate in auctions	High willingness	Moderate willingness

[3] Deal Drivers North America 2011 Half Year Edition, Mergermarket in association with Merrill Datasite

"There is a direct correlation between the purchase price for a business and the quality and reliability of the reporting system. Quality reporting provides more confidence to the purchaser and reduces perceived risk."

Joe Lucke
Tricor Pacific Capital

Lessons from BC's top Private Equity firms

Based on our interviews with BC's Private Equity (PE) firms and our extensive transaction experience in the private company space, we have noticed reoccurring themes of successful businesses that are owned by these firms. Intrigued by the business model, we interviewed BC's top PE firms to understand the defining characteristics. The following are summaries of the five key lessons that Deloitte took away from the various interviews.

Lesson 1:

Confirm/redefine your corporate strategy

One of the very first things that PE firms will do post-investment is either confirm or redefine the corporate strategy of the investee. What does 'great' look like? They will do a complete market, customer and competitor analysis to get a thorough understanding of the competitive context in which the company operates today and where it will operate in five years. Oftentimes, the investee company has a viable strategic plan with sufficient growth opportunities. However, as Praveen Varshney, Director of Varshney Capital Corp. explains, "Sometimes the plan is tailored and biased to the strengths of the existing management team – we help management prosper in areas that they are less familiar with. This often results in substantial growth." Mr. Varshney recalled a past investment in Coastal Contacts, where the president of the company offered a pioneering service, excellent distribution with a growing brand recognition. To drive growth beyond the initial plan, Varshney Capital helped expand the company's focus to ensure that a global marketing strategy of being recognized in the top spots of various search engines around the world and an affiliate marketing program were essential aspects of the strategic plan. Coastal's management team successfully executed exceptional sales growth with annual sales increasing from $2.5 million to $160 million over the period of a few years.

A critical part of the strategy is to understand where the revenue and EBITDA need to be in five years to generate a return on invested capital of two to three times or more. Moreover, they will identify, agree on and implement three to five key initiatives that are practical and achievable under a defined time frame to realize the required return on investment (ROI). In particular, top PE firms will consider segments with the best growth potential (top-line improvement), segments with ability to improve margins (bottom-line improvement), and segments that require enhanced customer service (overall improvement and creation of goodwill). Darren Latoski, CEO of Western One Equity, explained that his goal is often not to 'reinvent the wheel'. Most times, he prefers to reinforce a strong existing strategy. "This is exactly the case with a recently acquired company, Britco," says Mr. Latoski. "To hit our revenue targets. it's clear that we need to add facilities in Alberta; however, we also need to be conscious of the operational impact. We support management's goal of adding facilities, but our challenge is for management to first streamline the throughput of existing facilities. By doing so, implementing a successful facility is much more likely to be value added. Challenging management's strategy gives both parties the opportunity to identify shortcomings and ensures the plan will be successful amongst partners." Chris Tsoromocos of Stern Partners firmly underscored the need to demonstrate growth in the strategy: "Most business owners will understand that equity value is typically generated from growth. You need to have a very clear path to realistically growth your company's top line. Flat revenue businesses will often see valuation discounts applied."

The recent economic environment is testament to the fact that strategic plans need to be monitored and adjusted regularly. Tyler Smyrski from Yellow Point notes, "You'd be surprised by how beneficial a strategic planning session is. You get the opportunity to discuss all of the successes and failures, which basically leads to innovative thinking. We engage in a revised strategic planning session at least annually for all of our portfolio companies. The plan doesn't always change, but when it does, it's well worthwhile and can keep you ahead of the market." Furthermore, David Eisler, Managing Director at Banyan Capital Partners, told Deloitte that encouraging different perspectives in strategy planning is integral. Mr. Eisler encourages a two-day annual strategy meeting between the directors, management and sometimes industry professionals in a non-board-meeting setting for each investee company. "By incorporating different perspectives, the strategy will be more robust and will not reflect individual biases."

> "Most business owners will understand that equity value is typically generated from growth. You need to have a very clear path to realistically grow your company's top line. Flat revenue businesses will often see valuation discounts applied."
>
> Chris Tsoromocos
> Stern Partners

Lesson 2:

View your company as a platform

It is important to view your company as a platform for subsequent tuck-in acquisitions to improve growth. PE firms understand that acquisitions are an effective way to grow valuation metrics such as EBITDA and to accelerate market penetration and increase the valuation multiple. As a business owner, it is imperative to have an acquisition strategy with infrastructure (i.e., financial systems, strong business processes, information technology, etc.) that is robust enough to support acquisitions. It is also imperative to internally develop Mergers and Acquisition integration capabilities to ensure that the company can maximize and extract synergies from the acquisition targets. A company with a valid acquisition strategy and the ability to grow via acquisitions will have a higher perceived value. Although not every business model is suited for acquisitions, the acquisition core competency of PE investors can be an invaluable service to their investee companies. Terry Holland, President and CEO of Krystal Financial Corp., notes that "Acquisitions are not a core competency of many business owners – we're able to facilitate the process, organize an efficient capital structure with lenders, and negotiate the terms of the deal, which allows the management team to focus on growing the business. You need to be conscious of the ability to add shareholder value through debt financing during growth cycles."

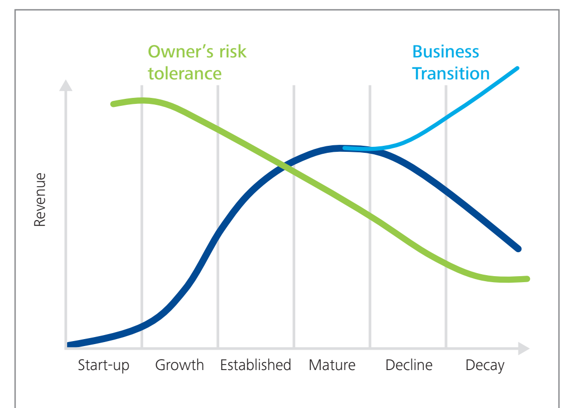
"If you look beyond organic growth opportunities and ensure that you have the skills necessary to execute on an acquisition strategy, the returns can be quite attractive."

Michael Berkson
Fulcrum Capital

Furthermore, Joe Lucke, Director at Tricor Pacific, emphasizes the value that PE firms can provide, with their relative impartiality: "Consolidating is always an issue in practice because competitors struggle to trust each other enough to complete a deal. Sometimes, rightfully so, entrepreneurs are wary of their competitors' motivation. When we're involved, this is less of an issue because we don't share the same history with the competitors and we're perceived as being more neutral."

Michael Berkson, Partner at Fulcrum Capital (formerly HSBC Capital), was able to share an ongoing success story with Deloitte whereby the natural path of an investee was to expand geographically through acquisitions. "We are currently involved with a company that had a great reputation in Western Canada and an experienced and committed management team but, despite their desire to grow, this group had never raised capital or dealt with the myriad of issues involved in integrating a new business. Our investment created a partnership that allowed the existing team to remain focused primarily on operations while leveraging our experience to close on the identified acquisitions. Together we created and executed on a long-term strategy for the business, ultimately resulting in the completion of three successful acquisitions that have expanded the company's geographic footprint across Canada. If you look beyond organic growth opportunities and ensure that you have the skills necessary to execute on an acquisition strategy the returns can be quite attractive.

While PE firms will utilize appropriate amounts of debt to maximize IRR and grow the business efficiently during all business cycles, business owners are more reluctant to leverage. The graph below highlights a conundrum that privately owned companies commonly face.



Business owners will often grow a business to a stage of maturity that naturally makes it an excellent candidate for leverage and expansion; however, this coincides with a period of their life when they have built up equity and wealth and, as a result, feel more conservative and are less willing to assume further debt. Consequently, the business owner cannot make the changes that are required for the business to continue to grow. Entrepreneurs should clearly understand the ability to increase their equity value through debt financing during growth cycles, bearing in mind the proper capital structure for their business. Because PE firms are able to remove themselves from this bias, they are able to use leverage to their benefit. Terry Holland commented: "By financing a company with the proper capital structure, we're able to improve IRR even during a period of business decline. Just recently, we were able to exit from an investment where the enterprise value declined, but the equity value had actually improved because of the capital structure in place."

Lesson 3:

Develop and monitor appropriate KPIs

Most business owners do not know the value of their company, let alone what drives value. Therefore, to assist an owner to make the right economic and strategic decisions, it is important for them to clearly understand the key value drivers for their company at an operational and tactical level.

This all starts with Key Performance Indicators (KPIs). Quality data and interpretation of data allow for quality decision-making. Developing KPIs that tie back to the execution of the three to five key initiatives is essential to the valuation of the company. Analyzing KPIs can fill the gap between business value and business operations by linking standard economic drivers with business inputs, outputs and management. In this way, KPIs help companies organize, discuss and prioritize improvement opportunities that can deliver high value in terms of their impact on the following elements: revenue growth, operating margin, asset efficiency and market expectations. Because these four elements are essentially what determine the value of a business, business owners should spend considerable time identifying exactly what aspects of their operations affect these elements, and which operational levers are available to impact financial performance.

PE firms are always gleaning KPIs to assist with their planning and their regular monitoring. Randy Garg, Managing Partner at Beedie Capital Partners, noted, "I wouldn't say KPIs can be taken from some playbook and generalized across companies – they need to be crafted and measured specifically for each type of business. In the case of one of our portfolio companies, Nettwerk Music Group, we try to measure, on a monthly basis, the number of new signings as well as leverage on the existing library, amongst other indicators. This exercise shows everyone, on a very granular and regular basis, where management needs to focus its efforts and be more aggressive and proactive, as opposed to being reactive in this fast moving industry."

Notwithstanding the above discussion, KPIs are not always easy to identify. Based on our interviews, we found that many PE firms do not have a solid grasp of the KPIs for as long as six months after investing. Without giving oneself proper time to analyze value drivers, hasty decision-making lends itself to skewed goals. Curtis Johansson from CAI made the following comment on this topic: "For example, utilizing revenue as a KPI without giving proper regard to margins can have an adverse impact on value as it may encourage management to focus on revenue growth but not necessarily profitable revenue growth. Ensuring that KPIs align with the agreed upon strategy is imperative." Engaging in strategic discussions with an executive team and having an impartial board of directors will help identify new and existing levers that arise with new opportunities and growth, giving entrepreneurs a better opportunity to identify and closely track the proper KPIs for their business.

"Perhaps the most difficult aspect of KPIs is ensuring that the entire upper management team associates themselves with the KPIs. The worst case scenario is one where management considers the KPIs to be a reporting requirement imposed on them by the board and/or investor, but not something they actively measure and manage, as opposed to considering the metrics as a tool that will enable them to more effectively manage the business." says Mr. Johansson. PE firms work with management to develop KPIs, but ultimately the management team needs to clearly understand how detailed operating metrics impact financial performance, valuation metrics, and individual compensation and growth. The KPIs should be clearly defined with management, along with targets. By linking upper management's compensation to KPIs, two objectives are fulfilled: first, they ensure that management is genuinely interested in KPIs, and second, they provide management with the ability to grow with the business, keeping them motivated and keeping employee turnover low. Further, as we alluded to in Lesson 1, entrepreneurs need to be open to the fact that key initiatives and five-year plans may need to be modified. By regularly interpreting operating results and KPIs, one can identify necessary changes on a timely basis and can better adjust to changing business environments.

Yuri Fulmer, President at FDC Capital, is a long-time entrepreneur. Before becoming a full-time private investor, Mr. Fulmer owned and operated a successful chain of MR MIKES Steakhouse restaurants, which he eventually sold to a Vancouver-based Private Equity company. Mr. Fulmer states, "After the sale I continued to operate the restaurants for a period of time. I knew the KPIs in my head, but I never really thought about measuring and analyzing them. Private Equity brought a disciplined, regular reporting and reconfiguration of KPIs. With this experience, I've learned that KPIs are twofold: they will help you grow your business and they will help you sell your business."

"I've learned that KPIs are twofold: they will help you grow your business and they will help you sell your business."

Yuri Fulmer
FDC Capital

Lesson 4:

Develop a high-performance culture

There are three distinct steps to ensuring a high-performance culture:

1. Conduct an honest assessment of the strengths and weaknesses of the current management team.
2. Provide key employees with creative incentives and equity plans tied to the key initiatives and the KPIs.
3. Fill gaps with strategic executive hires at the management team and board levels.

Identifying the relative strengths of an existing management team is challenging for any company. Fortunately, PE firms are able to delve into many past experiences to aid and coach management with this process. A common theme that we have found is that entrepreneurs are very good at what they do, but as they grow a relatively simple business into a complex organization, they become bogged down with detailed work that hinders them from growing their business further. PE firms recognize this before they even invest, and they apply their best efforts to pair each member of the management team with their relative strengths. Beedie Capital told us that professional personality assessments are especially useful in identifying strengths and weaknesses. By having management focus on their strengths, they are much more likely to assume greater responsibility. Leveraging down in this fashion ensures that the success of the business's success is not attributable solely to one or two individuals. In order to maximize ROI, it is imperative that the management team takes responsibility for and ownership of business growth. By delegating operating decisions to management, shareholders free up more time for strategic planning, their business becomes more attractive to investors and lenders, and the business model transforms into an independent and sustainable entity.

A key differentiator between many business owners and PE firms is the hesitancy of business owners to sell equity to management, which Deloitte also notices during the annual rollout of Deloitte's 50 Best Managed Companies program. Albeit understandable, the consensus from our PE interviews is that diluting one's equity position for increased motivation, an improved 'partnership' mindset and greater growth potential is worthwhile. According to Praveen Varshney, "Stock options can be a great compensation tool to attract and retain staff and to reduce employee turnover." And according to another PE firm, "We know private company owners do not like diluting their equity, and yes, having minority shareholders complicates ownership. However, equity ownership is one of the best ways to align interest and help drive the company forward. Also, potential upside of equity is a motivator, but so is the potential loss of capital. That is why WE will not give equity, or allow them to earn in. We want them to put their own capital on the line."Corroborating the applicability of these strategies, we reviewed a study that was recently published by Stanford University.[4] The study suggests that the reduced agency costs that stem from the Private Equity compensation model may improve profitability. Interestingly, the authors found that CEOs at PE-owned companies received almost double the equity, 10% lower salary and increased variable cash compensation compared to their counterparts at comparable public companies.

> "Culture eats strategy for breakfast."
>
> Peter Drucker

Another local private equity firm helped us understand the extent to which creative incentive schemes can add value to your business. "We had a manufacturing business where safety procedures were an issue. By implementing a nominal bonus that was tied to safety procedures, we found a significant improvement in safety. Fewer employees were injured and less downtime was necessary. The benefit this business received far outweighed the cost." The message is clear – if incentive schemes can change the way people view their own personal safety, it can certainly motivate people to improve all other business operations.

Another common finding is that existing CEOs wear too many hats. By filling the gaps with strategic executive hires at the management and board levels, PE firms are able to facilitate the greatest efficiency from management. Private companies sometimes have a large divide in experience between the founder/CEO and the rest of the management team. PE firms use their extensive network to provide CEOs with VPs that will reduce the work burden and will help grow the company. The CFO role is one that requires improvement, according to almost all of the PE firms we spoke with. This is because an experienced CFO will ensure that the main operators are available to engage in valuable strategic planning, rather than needlessly spending time on financial reporting. Also, the quality of the financial reporting system impacts the extent to which KPIs can be measured. Joe Lucke highlights the importance of financial reporting: "There is a direct correlation between the purchase price for a business and the quality and reliability of a business's reporting system. Quality reporting provides more confidence to the purchaser and reduces perceived risk."

[4] Managerial Incentives and Value Creation: Evidence From Private Equity, Phillip Leslie and Paul Oyer, Graduate School of Business, Stanford University, November 2009

> "It is actually best to seek financing (debt or equity) when you don't need it, as you can negotiate from a position of strength, which ultimately results in beneficial terms."
>
> Praveen Varshney
> Varshney Capital

Lesson 5:

Cash is king

Whether the objective is to secure debt financing, sell your business or pay yourself a dividend, one thing is certain: cash flow is the single most important factor, without contest. A cash flow mindset is critical because business value is ultimately determined by cash flows. Many operators view the first step in enhancing business value as improving revenues and earnings. This is incredibly important; however, strong, positive cash flow will perpetuate positive earnings and growth potential. The best practice is to consider earnings and cash flow jointly. Aside from growing EBITDA, there are two critical areas that private company owners need to focus on in order to increase operating cash flows: efficient management of working capital and capital expenditures.

It is not uncommon to see top-line growth coupled with increasing working capital. Without oversight, this can translate into decreased cash flow as a percentage of revenue. Another PE firm explains, "We continually see small and medium-sized business owners being quite lax with working capital. We see them repeatedly allowing late payments on their receivables because they've grown comfortable with the customers and, similarly, we see them paying suppliers early because that's the precedent they've set from years of dealings. By reducing your collection period from 30 days to 27 days, your AR balance falls by 10% – the extra cash produces an incentive to quit granting breaks."

The concept of managing cash flow is so important that some PE firms will offer short-term bonus incentives that are tied to the quality of the balance sheet and cash flow KPIs. A similar methodology should be applied to capital expenditures as well. Capital expenditures need to be consistent with the company's strategic plan, should be well researched and should provide long-term value.

Owners should consider alternative measures such as return on assets, capital efficiency ratios and discounted payback periods as KPIs to monitor regularly. The goal is always to enhance the balance sheet. This means monetizing redundant or unproductive assets or business units, and converting traditional assets into sources of financing. Michael Berkson, Partner at Fulcrum Capital (formerly HSBC Capital), illustrated this concept with the classic 'lease vs. buy' decision when it comes to a company's facilities; "Without a strategic reason to own the property that a company operates out of, there is usually very little economic benefit in directly owning this type of non-operating asset. If you use the funds that would be required to purchase this asset and, instead, re-invest it into operations returns should be much higher. In addition, when you ultimately look to sell the business prospective purchasers are unlikely to pay market value for non-operating assets and, therefore, you are not maximizing value." Business owners who adopt a similar approach will be able to improve their balance sheet, impress lenders and perhaps extract more dividends in the long run.

To emphasize the importance of cash flow, Terry Holland provided details about an issue that one of his investee companies faced during the economic crisis. Annual sales declined from $30 million to $12 million and the company found itself in breach of debt covenants. Mr. Holland noted, "Although we missed our earnings covenants for the year, our lenders were able to relax the covenant issue because we had demonstrated excellent cash flow. All of our cash covenants were in good shape." Curtis Johansson had a similar story, where an investee had annual revenue decline from approximately $100 million to approximately $50 million, but was still able to manage covenants and reduce its debt balance by maintaining disciplined cash flow techniques. In both cases, each party is proud to say that their business has improved substantially since then, and cash flow discipline was essential to the recovery in both circumstances. As one would expect, our PE interviews found that there seems to be a strong correlation between improved cash flow and the sophistication of the reporting framework of a business. Private company owners can benefit from investing money – and, more importantly, investing time – into a reporting framework that is compatible with proactive decision-making.

Cash flows relating to the financing activities such as interest payments also have a material impact on the company's cash flows. Praveen Varshney notes that "It is actually best to seek financing (debt or equity) when you don't need it, as you can negotiate from a position of strength, which ultimately results in beneficial terms. The extra cash or line of credit comes in handy when the rainy day comes because they always do!"

Optimizing cash flow is certainly a goal of all business owners, but many firms can still improve by imitating the discipline that PE firms employ. Yuri Fulmer was impressed by his stint when he was employed by a PE firm after selling his MR MIKES enterprise. He says, "I learned more about the balance sheet side of business than I ever learned before, and I noticed an improvement in our cash positions too." The fact that Mr. Fulmer says this after selling an already successful company speaks volumes.

Concluding remarks

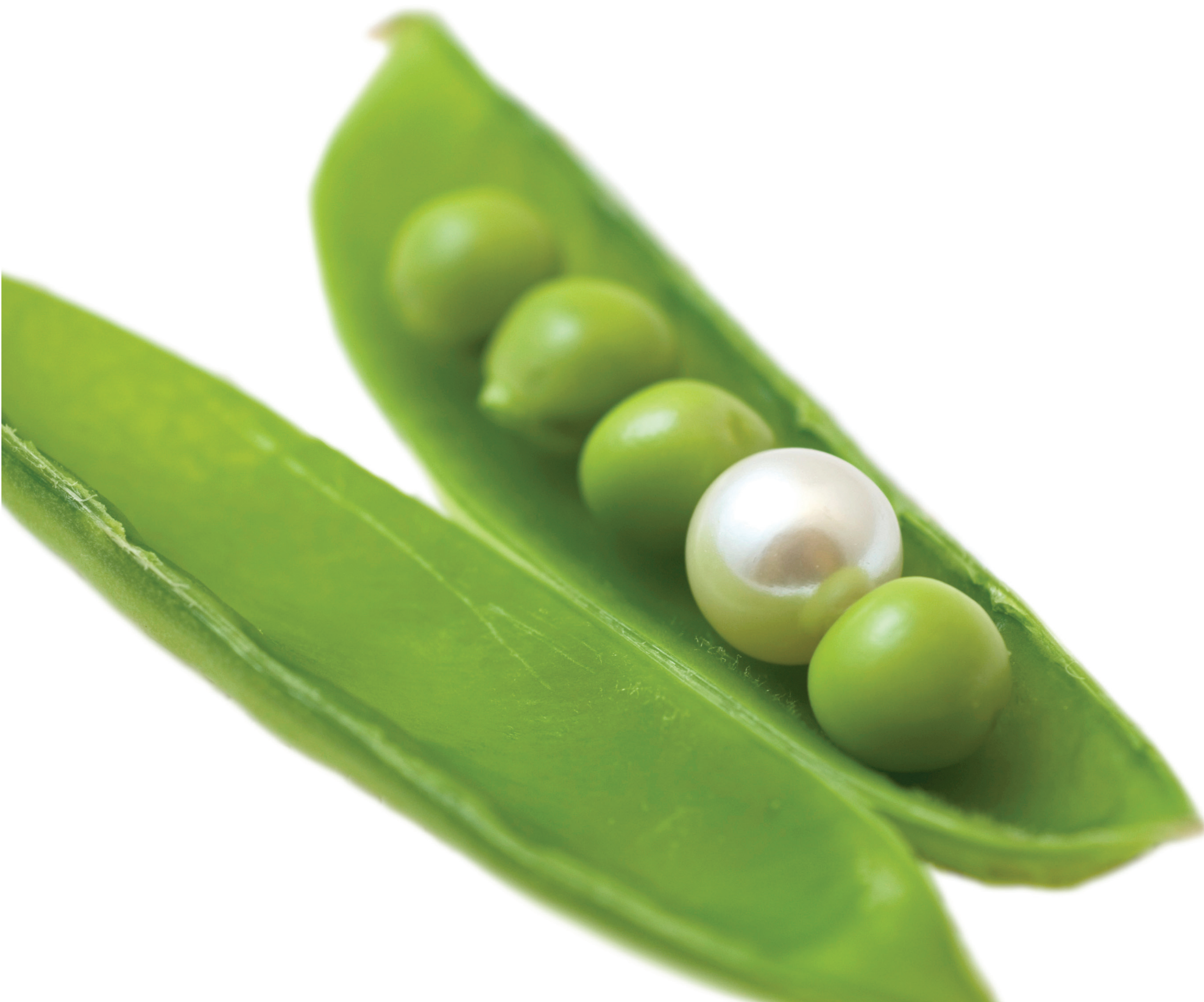
“As a business owner it is critical to create value by applying a PE type of discipline over a certain timeline.”

Daryl Johannesen
Private Company Services Leader

It is easy to say that business value is important, but not so easy to make the right decisions every day about strategies and priorities – such as where to spend time and resources, how best to get things done, how to win in the competitive marketplace and, ultimately, how to drive shareholder value.

While the economic recovery has yet to build real momentum and more challenging times are still ahead of us, there are also real opportunities for substantial growth for private companies in BC through smart and disciplined execution.

Private Equity firms are not smarter than business owners; however, their framework and strategy to build value, due to their defined ownership time frame, should be better understood by business owners. By understanding and following some or all of the lessons from Private Equity firms, private company owners can drive greater value.



Lessons in summary:

Lesson 1:

Confirm/redefine your corporate strategy

- Challenge your strategy. What does 'great' look like? Do you have a management team or board of directors to properly challenge your thesis?
- Know where the revenue and EBITDA have to be in five years to generate a return on invested capital of three times or more.
- Identify, agree on and implement three to five key initiatives that are practical and achievable under a defined time frame to achieve the required ROI.

Lesson 2:

View your company as a platform

- View the company as a platform and develop an acquisition strategy plan. Accelerate growth through accretive tuck-in acquisitions to accelerate market penetration and multiple arbitrages.
- Develop integration capabilities to ensure that the team can maximize and extract synergies from the acquisitions.
- Leverage up – always bear in mind the proper capital structure for your business. Be conscious of the ability to add shareholder value through debt financing during growth cycles.
- Leverage down – ensure that the business's success is not attributable solely to one or two shareholders. In order to maximize ROI, it is vital that the management team takes responsibility and ownership of business growth.

Lesson 3:

Develop and monitor appropriate KPIs

- Develop appropriate operating Key Performance Indicators (KPIs) that tie back to the execution of the key initiatives.
- Ensure that the organization and management team clearly understand how detailed operating metrics impact financial performance, valuation metrics, individual compensation and personal growth.
- Understand what operational levers are available to improve financial performance. Strategic discussions with an executive team and an impartial board of directors will help identify new and existing levers that arise with new opportunities and growth.

Lesson 4:

Develop a high-performance culture

- Conduct an honest assessment of the strengths and weaknesses of the current management team.
- Provide key employees with creative incentives and equity plans tied to the key initiatives and the KPIs.
- Fill gaps with strategic executive hires at the management team and board levels.

Lesson 5:

Cash is king

- Cash flow mindset: business value is ultimately determined by cash flows.
- Manage working capital aggressively.
- Discipline capital expenditures: apply a similar methodology to capital expenditures. Ensure that major expenditures are consistent with the plan, that they are well researched and that they will add long-term value.
- Enhance the balance sheet: be disciplined about the financial position of the company.

Appendix A – Participant companies

Banyan Capital Partners

Banyan Capital Partners, a Canadian-based Private Equity firm with offices in Toronto and Vancouver, invests in and buys middle-market companies located in Canada and the northern United States.

With more than 100 years of Private Equity, investment banking and operating experience collectively, Banyan has developed a strong franchise and has invested directly in 15 diverse companies generating over $1.5 billion of annual revenue. Banyan's portfolio companies include leading healthcare, manufacturing, distribution, utility and oilfield service businesses operating across North and South America.

Banyan has over $200 million of capital under management. Their investor base includes two of Canada's largest pension funds, one of the largest financial institutions in the United States, a multi-billion dollar Japanese trading company, and Connor, Clark & Lunn Financial Group, one of Canada's largest independent money management firms.

Beedie Capital Partners

Beedie Capital Partners is the recently established in-house capital arm of the Beedie Development Group, the largest industrial landlord in British Columbia, with a 65+ year history of growth and success. Based in Vancouver, Beedie Capital manages the group's non-real-estate-related investment interests and invests directly into companies in the form of debt and/or equity (typically as minority investors), preferably in Western Canada and the Pacific Northwest. Beedie Capital looks for growth and expansion financing opportunities in companies that are achieving $10-100 million in revenues, across a variety of industries.

CAI

Founded in 1989, CAI is a Private Equity firm specializing in buyouts, restructurings, acquisitions, recapitalizations and other corporate growth initiatives. CAI's broad operational and financial expertise and its ready access to capital position this firm as a valued partner for proven, motivated management teams. CAI acquires significant ownership positions in North American companies and fully utilizes the firm's extensive experience and resources to achieve strategic objectives. CAI has invested, or placed with co-investors, over $1.3 billion in equity or equity-related investments to help fund growth and corporate transition in companies throughout North America.

FDC Capital Partners

FDC Capital Partners is a Vancouver-based boutique private equity firm focused on early stage investments, the creation of operating partnerships, and buyouts of privately held companies in the lower middle market. FDC prefers powerful ideas and passionate people: which is reflected in a portfolio that includes among others, a food service businesses and an early stage, internet-based purveyor of comprehensive electronic gift card solutions. FDC looks for opportunities that other firms might pass over. Due to it's extensive operational background, FDC will consider investing in companies that may need a new direction, re-branding, or new management.

Fulcrum Capital

HSBC Capital (Canada) has a successful investment track record achieved over the past 18 years through four private equity funds plus mezzanine and bridge lending. In September 2011, the management of HSBC Capital agreed to a deal with HSBC Bank to acquire HSBC's Canadian private equity and mezzanine finance business. The spinout is expected to be completed before the end of the year. Upon closing, the group will operate as Fulcrum Capital Partners ("Fulcrum") from their offices in Vancouver and Toronto.

The Fulcrum team is poised to continue HSBC Capital's strong performance through continued focus on the Canadian mid-market with flexible investments typically ranging from $5-25 million in sectors spanning business services, distribution and retail, manufacturing, consumer products, real estate and beyond. Fulcrum will manage two private equity funds with $300 million in committed capital and a mezzanine finance business with in excess of $400 million in committed capital."

Headwater Equity Partners

Headwater Equity Partners was established to address the succession challenges faced by many companies in the lower mid market today. It specializes in helping companies manage succession through well-aligned management buyouts. Headwater also provides growth capital to management teams that have a strong vision for their businesses and are seeking value added investors to help them achieve it.

Headwater is focused on making private investments primarily in Western Canada. The principals have over twenty years experience making private equity investments

to support succession, growth financing, corporate spin-outs and acquisitions. They have an excellent track record and strong references from those they have done business with.

Krystal Financial Corp.

Krystal Financial Corp. is a Vancouver-based Private Equity firm focused on lower middle-market companies. Krystal has not only executed numerous buyout transactions where 80% to 100% of a business from a founder/owner was purchased, but has also been an investor in businesses that are seeking to bring on a partner to help them grow and/or strengthen the business. Krystal believes in a partnership philosophy where management, employees and shareholders all participate in the success of the business in a meaningful way. As investment managers, Krystal strives to add value to experienced management teams through participation in strategy, financing and capital budgeting decisions. Notable investments include Foley's Chocolate and No Limits Sportswear.

Stern Partners

Stern Partners is a lead investor in a diverse range of operating companies, including apparel manufacturing and retailing, commercial printing, equipment distribution and servicing, home furnishings retailing, horticultural products manufacturing and distribution, newspaper publishing, packaging, paper manufacturing, real estate and technology. The investee companies are operated and managed independently, generating annual revenues ranging from approximately $15 million to over $200 million, and collectively employ about 3,000 people. By deploying its own capital to each investment, Stern Partners can align objectives with all stakeholders and have flexibility with investment structures and approaches. Investments are individually structured, and can accommodate external partners or co-investors as warranted. Founded over 20 years ago by Ronald N. Stern, Stern Partners is based in Vancouver, with the head offices of operating businesses and investments located primarily throughout North America.

T&M Group of Companies

The T&M Group has over 30 years of experience investing in, building and realizing success in growing profitable businesses. T&M currently manages a portfolio of businesses across diversified industries that share the common goal of driving success through people, a long-term perspective of value and a passion for excellence. T&M helps management teams increase the long-term value of their businesses through strategic advice, operational expertise, organic and acquisition growth, and financing. Notable investments include Mr. Lube and Boston Pizza.

Tricor Pacific Capital, Inc.

Tricor Pacific Capital is a leading Private Equity firm that invests in profitable, well-managed middle-market companies. Based in Vancouver, with an office in Chicago, Tricor's investment efforts are concentrated in the Western and Midwestern regions of Canada and the U.S., where its reputation, relationships and responsiveness have enabled Tricor to be very effective. With expertise resident in both countries, Tricor has been successful in expanding Canadian businesses into the U.S. market and U.S. businesses into the Canadian market. Notable investments include Golden Boy Foods and Advanced Engineered Products.

Varshney Capital Corp.

Varshney Capital Corp. (VCC) is a Vancouver-based family investment firm with a focus on public venture capital. VCC specializes in using the Canadian stock markets to fund-raise for early-growth-stage companies in a variety of sectors ranging from mining to technology. The firm also invests in real estate ventures. Notable investments include Carmanah Technologies Corp., Mountain Province Diamonds Inc. and International Thunderbird Gaming Corp.

Western One Equity Income Fund

Western One Equity Income Fund is an unincorporated, open-ended trust formed to seek out and acquire predominantly privately owned small and medium-sized businesses located in Western Canada. Industries of focus include infrastructure and construction, logistics and distribution, outsourcing, financial services and manufacturing. Notable investments include Britco Structures and Production Equipment Rentals.

Yellow Point Equity Partners

Yellow Point Equity Partners is a Private Equity investment firm based in Vancouver. Yellow Point specializes in management buyouts and growth investments for middle-market companies based primarily in Western Canada. A significant portion of the personal net worth of Yellow Point's principals is committed to the funds, ensuring that interests are fully aligned with investors and portfolio companies. Notable investments include CBV Collections, MR MIKES Steakhouse and Prism Medical.

“Start to build your business to sell, not build to own, even if you plan on leaving your business to your family. That way, you will focus on drivers of value earlier on.”

David Lam
Deloitte

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