Making a market for micro-cap

Small and medium Canadian enterprises: A private equity opportunity

"Micro-cap typically refers to those companies with an equity value of less than $250 million. Nano-cap is another term that is used to refer to companies with a value of less than $10 million."

A new era

The Canadian economy continues to recover in the wake of the 2008 financial crisis. As credit conditions ease and the prospect of growth tentatively takes hold, the economy faces lingering pressures and an environment that can be described as a 'new normal.' Despite this tenuous hold on sustained recovery, new opportunities are surfacing for key players in the national economy. As the country exits one historical economic era, it is set to enter another, one defined by the largest mass retirement and work force exodus in Canadian history. 2011 represents the first official retirement year of the Golden Boomers, the leading edge of the baby boomer generation. This demographic event, coupled with a confluence of other economic factors, is creating significant and untapped opportunities for two key market participants: private equity (PE) funds and small- and medium-sized enterprises (SMEs).

In Canada today, SMEs comprise a significant portion of the national economy. A recent report from Statistics Canada indicated that small businesses represent approximately 30% of annual GDP in this country.[1] Though Canada is known for its large banks and resource giants, a large part of the economy remains underpinned by over 2.3 million small businesses across the country.[2] Many of these businesses were founded – and continue to be run – by entrepreneurial baby boomers. These mature companies are often stable, well-run and cash-rich income providers for the generation that started them. However as these baby boomers begin to retire, SMEs will undergo a massive collective ownership transfer. Despite this, current evidence suggests that many business owners have yet to develop a succession plan or feasible exit strategy to monetize the equity in their businesses. As such, many successful, cash flow-generating businesses are at the cusp of ownership change without a firm exit strategy.

On the other side of the economic spectrum, the Canadian private equity industry experienced its own set of challenges through the financial crisis. Tighter credit markets and fundraising constraints characterized the industry through the last recession. Prior to the 2008 financial crisis, large transactions and unbridled access to credit markets supported substantial fund returns. Post-recession, an imperative has emerged for private equity firms to re-evaluate their business models. While credit availability has arguably returned to pre-crisis levels, a consequence of the 'new normal' has private equity firms, search funds and other related entities revisiting the 'traditional' success model – finding value in the market – increasing the value of portfolio companies through operational improvements and organic growth, and making prudent use of leverage. With a glut of baby boomer-owned SMEs imminently available, there is an untapped and growing opportunity for Canadian private equity firms to realize significant value at the low end of the micro-cap market.

Characterizing the opportunity

While buyout and other PE market activity in Canada made gains in 2010, the industry struggled to regain its footing following the financial crisis. Although deal volumes and disbursement levels rose in 2010 for the first time in three years, industry performance remains well off its 2007 peak. While growth opportunities remain, there is a growing imperative for PE firms and smaller search funds to seek growth in non-traditional segments.

Indeed, there is a major and unrealized opportunity for investment in Canadian micro-cap businesses – particularly those businesses at the smaller end of this range. This micro-cap opportunity is principally driven by two key factors: market size and upside potential; and the impending collective transfer of ownership by SME business owners.

Untapped market potential

The Canadian marketplace is awash with SMEs. Currently, there are over 2.3 million across the country, representing 99.8% of all Canadian businesses.[3] While some of these can be discounted as too small or unattractive for investment, many are viable candidates for capital deployment.

A significant number of these SMEs are, in fact, mature, long-standing businesses that have been operating for decades. They produce stable, predictable free cash flows and are diligently attended to by the entrepreneurial business owner/CEOs who founded them. It is important to distinguish these baby boomer businesses from start-ups or growth companies seeking early-round financing. Rather, they are income-generating, lifestyle businesses with owners seeking exit strategies that will allow them to liquidate their illiquid holdings. This healthy predictability ensures two key benefits for PE firms targeting SME companies: accurate business valuations and limited volatility risk.

The growth potential of these healthy companies is another key factor. Despite the tepid economic recovery, small business growth rates in Canada continue to rebound. A recent study by Industry Canada indicated that between 2003 and 2006, more than 40% of small businesses in this country experienced an average annual growth rate in excess of 5%[4]; moreover, about 12% of all small businesses experienced an annualized growth rate of greater than 20%.[5] As PE firms increasingly seek to acquire and manage portfolio companies for organic growth, these increases are very encouraging.

Another attractive element of the micro-cap opportunity is the sheer range of industries Canadian SMEs represent. From manufacturing and transportation to professional services and real estate, there is healthy coverage across all industries and sectors. While some countries have sectors dominated by large – and in some cases state-owned – enterprises, this is not invariably the case in Canada. Although some companies loom large in certain industries – financial services and telecommunications, for example – smaller firms still have significant representation in all industries. The benefit is clear: no matter what industry specialization a PE firm or search fund may have, there is an array of viable target businesses available.

Investment upside potential is another crucial pre-requisite to any corporate buyout. While organic and inorganic growth opportunities may be limited in mature sectors dominated by a few large-cap players, there is often significant fragmentation down-market. By acquiring the right SME, a PE firm can capitalize on the upward mobility that exists in unconsolidated markets. As a result, while the total investment may be smaller with a micro-cap entity, the potential upside and investment returns may far exceed those of large companies in heavily consolidated industry environments.

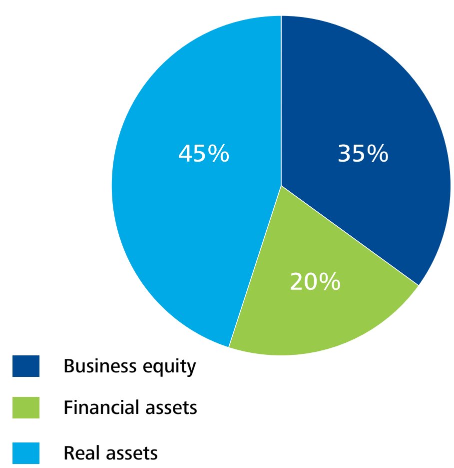
Through whichever lens you evaluate the micro-cap/SME market, the potential for substantial investment returns clearly exists; amplifying this opportunity is another favourable and imminent market characteristic: the collective transfer of ownership of baby boomer-run SMEs.

"Once-in-a-lifetime" transfer of ownership

While SME opportunities have been present for some time, a strong pre-crisis economy largely masked the potential of the micro-cap market. Large-cap deals and easy credit access characterized the period. In addition, the demographic factors driving baby boomer retirement and earnest succession planning had not yet come into focus. As we enter 2011, Canada is arriving at a natural inflection point where baby boomer small business owners will need to consider selling. This will sharply increase the supply of available businesses – a market reality that simply did not exist five or ten years ago. To underline this point, six in ten private companies in Canada will change ownership structures within the next decade, according to a 2010 CICA/RBC Business Monitor Survey.[6] Consequently, the menu of available businesses will surge, and continue to do so for some time. Indeed, the opportunity is real and substantial, with some estimates pegging the total value of business equity in transition as high as $1.2 trillion.[7] Firms that position themselves to take advantage will reap the benefits.

A corollary advantage of baby boomer retirement is the importance business owners will place on "cashing out" and realizing the equity in their businesses. Many small business owners have a significant percentage of their net worth tied up in their companies and will eagerly look to tap these illiquid assets. Consequently, it is likely that many owners of prospective target companies will seek one-time, all-cash deals. The mismatch between buyers and sellers in this market may allow PE funds to execute full buyouts at discounts to market value. Indeed, business owners may be very willing to accept the security and finality of one-time payouts at the expense of receiving full market value for their companies. In effect, this would allow PE firms to create instant value at the point of transaction. These savings could then be re-invested in the business to charge organic growth. In many ways, PE firms would negotiate from a position of strength, increasing the likelihood of realizing instantaneous value in the micro-cap market range. As this collective transfer of ownership begins, the supply of available businesses – and the potential to find value – will increase in tandem.

Business owner net worth

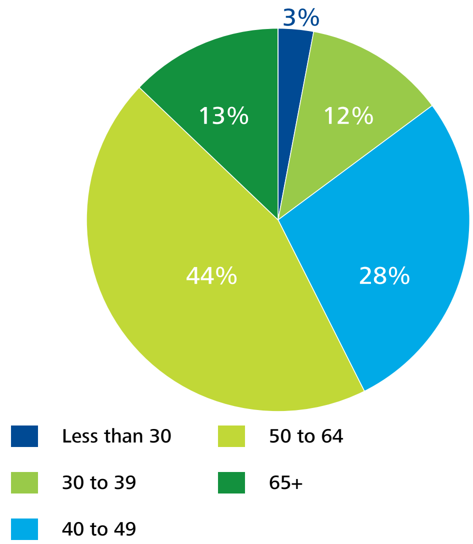


Immediacy of the opportunity

The opportunity to act is now. The oldest of the baby boomer generation will reach 65 years of age this year. While not as definitive for business owners as for employees, it is a directionally important milestone. With more than 60% of SMEs now controlled by an owner aged 50 or older, the number of business owners seeking an exit option is very likely to increase in the near future.[9] In fact, some sources suggest that the baby boomer exodus should already be well underway. A 2005 survey from the Canadian Federation for Independent Business found that 71% of SME business owners planned to exit within ten years (by 2015). While this finding was likely influenced by optimistic economic projections, the sentiment is telling. More recent studies suggest that approximately half of business owners aged 45 or older plan to exit within the next decade.

While the exact timeline of this bubble remains somewhat uncertain, the opportunity is clear: a large number of business owners will be seeking an exit strategy to realize the value of their lives' work.

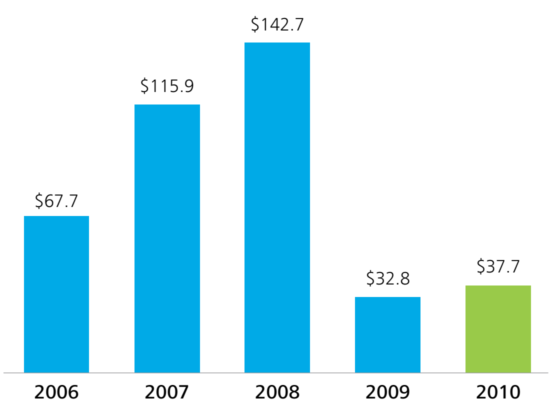
Distribution of SMEs by owner age



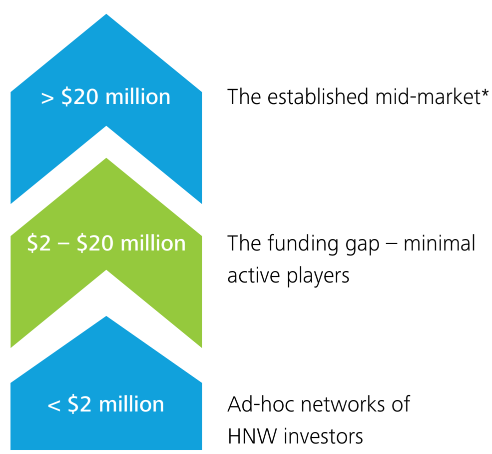
The challenges faced

The Canadian private equity market, as it is structured today, is not organized to exploit the SME opportunity. Despite the average transaction value of private equity deals in Canada shrinking from $143 million CDN in 2007 to $38 million CDN in 2010, there is no evidence to suggest that the industry is moving into the micro-cap segment of the market.[8] However, should the market for larger deals stagnate, firms may not be able to afford overlooking micro-cap buyout opportunities.

Private equity: Average Canadian deal values ($B)



Micro-cap 'deal' thresholds in Canada



There appears to be a funding gap in the market. Colloquially, private equity firms in Canada segment themselves based on the 'size of cheques cut'. Funds that acquire companies worth $20 million or more are plentiful in the market. Companies worth $2 million or less typically can be digested through ad hoc or semi-formal networks of high-net-worth (HNW) investors and private financing groups. The funding gap persists between $2 and $20 million.

Why, if the opportunity is both imminent and sizeable, has the industry not rushed to swallow SMEs? The core obstacles can be grouped into four broad categories: insufficient incentives, a scale bias, capital constraints, and limited exit strategies.

PE firms typically operate under the '2 and 20' model where the fund charges an annual management fee of 2% of the fund's net asset value and, potentially, 20% of the profit generated (the carry) possibly based on a specified hurdle rate or high water mark. In theory, this model should align the interest of the manager and investor where the management fee covers the operations of the fund and the carry delivers the profit. The majority of attractive SMEs are attractive not for their future and presently unrealized growth potential, but rather for their stability and reliable streams of cash flow. In a model where profitability depends on taking a share of comparably outsized returns, the stable annuity stream presented by the mature SME may not be compelling.

Additionally, the economics of independent private equity drive a bias towards larger funds. The infrastructure and human capital required to raise and manage a small fund (e.g., $50 million) does not differ materially from the level required to raise and manage a significantly larger fund ($100 million – $300 million). Similarly, the effort required to close the purchase of a $5 million company is roughly equivalent to the effort required to acquire a $50 million company. Where operating revenue equals net assets multiplied by 2%, there is a clear disincentive to invest in SMEs when the same-sized team can 'do the same amount of work' but generate management fees on a much larger asset base. The answer is not simply for small cap funds to be larger, consisting of a greater number of companies. A larger fund composed exclusively of a greater number of small companies is very likely to constrain the profitability of the fund in the current model because of the incremental burden of evaluating, closing, and managing more portfolio companies. SME-focused funds are, therefore, typically smaller in total size themselves.

Despite these constraints, there are examples of small cap private equity funds that have been modestly profitable at $50 million. Unfortunately, not even the best SME-focused fund can escape capital raising constraints. Many large institutional investors will not make investments of less than $10 million while simultaneously adhering to prescribed concentration limits (e.g., a particular institution will not accept being larger than a given share of any fund). This limits the ability of smaller, SME-focused funds, to raise capital. Furthermore, these same larger institutions have historically been 'sponsors' effectively acting as beacons that smaller institutions could "follow in" for co-investment opportunities. As these investors retreat, so too do smaller institutions unwilling to make direct investments independently. At the other end of the spectrum, raising funds directly from pools of private client wealth requires a level of bespoke service that PE is not organized to efficiently deliver.

Under the current model, private equity is also constrained to the relatively fixed 7-10-year timeframe within which it must deliver returns to limited partners. Producing outsized returns to investors within this time horizon is made more difficult by the lack of viable exit strategies inherent with smaller-sized portfolio companies. Unlike larger businesses, companies at the low-end of the micro-cap range are less attractive to corporate buyers. Likewise, a fund's limited partners are unlikely to seek an exit via an initial public offering. One of the few options available is to aggressively build a platform business through organic and inorganic growth in order to "sell into" the next tier of the secondary PE market. However, this strategy is rife with its own challenges and risks, particularly within the standard time horizon of 7 to 10 years.

Despite the aforementioned challenges, there are anecdotal success stories and various models being tested against these opportunities; however, a proven, consistently-successful solution has yet to emerge.

The opportunity is “too big” to abandon the pursuit of a novel solution

As Canada enters a new economic era – one that will be chiefly defined by the lasting impact of the 2008 financial crisis and the mounting effects of a seismic demographic shift – opportunities will abound for market participants prepared to take advantage of them.

There is a massive and growing investment opportunity represented by small and medium-sized Canadian enterprises seeking exit strategies. Today, the most obvious beneficiary – the private equity industry – is ill-equipped to take advantage of this opportunity.

Nonetheless, the structural issues faced by private equity are not insurmountable. Indeed, the opportunity to reap massive financial benefits from this collective liquidity event compels an innovative approach. This new model may be fundamentally different than the traditional PE approach – and it may come from a non-traditional player.

One thing is clear however, the SME opportunity is real and growing. In many ways, it represents Canadian business' greatest curtain call. The question remains, who will answer that call?

Endnotes

[1] "Key Small Business Statistics." Industry Canada. July, 2010. Web. Accessed 17 March, 2011.
[2] "Key Small Business Statistics." Industry Canada. July, 2010. Web. Accessed 17 March, 2011.
[3] "Key Small Business Statistics." Industry Canada. July, 2010. Web. Accessed 20 March, 2011.
[4] "Key Small Business Statistics – Special Edition: Growth Map of Canadian Firms." Industry Canada. January, 2010. Web. Accessed 23 March, 2011.
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[6] CICA/RBC Business Monitor Survey. 2010.
[7] "Canadian SMEs and Transition Planning Backgrounder." Business Development Bank of Canada. 2005.
[8] "Canada's Buyout and Private Equity Market in 2010." Thomson Reuters. 2010.
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For more information, please contact:

Rob Galaski
Senior Manager, Corporate Strategy
rgalaski@deloitte.ca
416-601-4594

The authors

Rob Galaski
Senior Manager, Corporate Strategy
rgalaski@deloitte.ca
416-601-4594

Andrew Hamer
Senior Consultant, Corporate Strategy
anhamer@deloitte.ca
416-775-7463

Matthew McWhirter
Consultant, Corporate Strategy
mmcwhirter@deloitte.ca
416-775-8642