

Preparing a Company for the Private Equity Investor

Private Equity Group Seminar
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Presentation by:
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Agenda/Introduction

- The PE investor
- Understand the PE investor/partner's objectives
- Understand your capital structure
- Understand the barriers to accessing PE
- Preparing for the dance
- Due diligence – the critical courtship
- Understand your market share and propose your market value
- Compatibility with your PE investor/partner





The Private Equity Investor

- Private Equity is a generic term for the private investment market comprised of VC, buy-out/strategic partner investment and mezzanine financing
- VC funding has continued to decline in Canada to a 14 year low
- PE firms raised billions in 2009 and have an appetite for deals in current environment of lower valuations and still tight credit
- PE investors typically have a stronger value proposition than VC investors (sector expertise, operational experience, powerful networks, access to public markets)
- PE investors can be effective partners for growth capital, acquisition capital, management buyouts, ownership succession, distressed situations, etc.



Advantages of Private Equity

- PE investment offers enhanced future financing opportunities
 - Continued control of business
 - Alignment of interest with owners while providing some liquidity
 - Assistance in increasing owners' personal financial security
 - Access to strategic advice, powerful networks and sector expertise
 - Access to a deeper pool of prospective hires and advisors
 - Assistance in the preparation for an IPO or M&A exit



Private Equity Firms are Looking For..

- Strong management and leadership that is open to change and vision modification
- Established businesses or established experience with defensible market advantages
- Earnings and cash flow
- Asset base to leverage
- Industry sectors with high growth potential
- Exit options



Understand your Capital Structure


- In order to prepare for the PE investor, undertake a capital structure analysis
- Diagnostic analysis of current and projected capital needs for the business
 - “Snapshot” of balance sheet, P&L, cash flows for the last year end and the next 2-3 years
 - Layer over current capital structure
 - Financial track record and future prospects
 - Stress analysis – cash shortfalls, margin violations, covenant defaults
 - Assess adequacy of current capital structure – meet needs of go-forward growth plans and shareholders’ objectives
 - Market conditions





Understand your Capital Structure (Cont'd)

- Include alternative scenarios
- Objective: the right balance
 - Financial flexibility vs. cost of capital
 - Dilutive impact on the shareholders
 - Operational and board controls
 - Ability to fund operations in the medium term without having to again access capital markets
- Assess various capital sources to fill identified needs



Accessing Private Equity – Barriers to New Money

- Too many small shareholders
- Excessively complex share structure
- Pre-existing shareholders' rights (e.g. veto rights, anti-dilution, etc.)
- Secured debt complications in credit arrangements
- Built-in liquidation bombs
- Inadequate management stake
- Weak systems, governance and/or recordkeeping





Barriers: Too Many Shareholders

- Multiple and often competing stakeholder interests
- Makes negotiations unruly, protracted and expensive
- Completion of the deal can be frustrated if there is no structure in place to compel co-operation
- Impairs clean governance structure
- Potential to muddy valuation discussions



Barriers: Unduly Complex Share Structure

- A clean, simple share structure provides essential negotiating and structuring flexibility
- Simple common share structure is the ideal going-in position – investors/buyers prefer it
- Stakeholders with different rights arising from various share classes, options, warrants, phantom equity plans, etc. increase the complexity of negotiations
- Pre-existing preference share positions should be eliminated



Barriers: Pre-Existing Shareholders' Rights

- Pre-Existing Dilution Mechanisms
 - Pre-existing options, warrants, conversion rights and ESOPs dilute investor upside
 - 'Fully-diluted' analysis becomes basis of structuring negotiations
 - All conversion/exchange rights should be crystallized
 - Create the ability to accelerate the vesting of options and warrants
- Pre-existing shareholder vetoes
 - Complicates control analysis and negotiation process
 - Creates 'conflict dynamic' in structuring discussions
 - Frustrates investor's 'control' objectives
 - Will inevitably be eliminated/altered by new investor arrangements



Barriers: Secured Debt Complications

- PE investors will seek liquidation preferences
- Investors increasingly seek their own convertible secured debt position to protect from downside
- Concerns about 'control position' represented by prior secured debt; imposition of operational restrictions
- Pre-existing secured debt adds to funding risk
- Shareholder loans present unique problems including conflicts of interest





Barriers: Built-in Liquidation Bombs

- Concerns raised by shareholder ‘puts’, third party debt maturities, pre-existing priority liquidation rights, shareholder exit plans and triggers in material contracts
- External threats to stability and liquidity introduce ‘wild cards’ and undermine investor’s risk/return analysis
- Issues that create third-party dependency/ exposure must be eliminated



Barriers: Inadequate Management Stake

- Investors want to see their interests aligned with the interests of key management and shareholders
- Investors want to see management has meaningful upside incentive and vested economic interest
- History of dilution undermines confidence
- Cash contributions/historic re-investment of retained earnings reflects leadership commitment and confidence
- Management should be open to transition staging, increase in board scrutiny and for “earn-out” pressure




Shareholders' Arrangements/Agreement

- Unanimous shareholders' agreement ("USA") – important rule book and defence against "rogue" shareholder behaviour
- USA should include drag-along mechanisms so that holders of majority stake can ensure they can deliver 100% of the company if an attractive sale is possible – avoid hostage taking
- PE investors will insist on a new USA to reflect the terms on which it is prepared to provide financial and human resources to the enterprise
- USA will address governance, financing, operational and liquidity issues

Preparing for the Dance – Looking Your Best

- First impressions are powerful and create a mind-set
- Being prepared and organized
 - Builds important impression of a "best-practices" culture
 - Enhances investor's confidence
 - Minimizes management distraction
- Assists in identifying what can/should be disclosed and sources of information to be disclosed
 - 'hard' sources (e.g. paper, public files and other written/digital records)
 - 'oral' sources (e.g. interviews with management, employees and advisors)



Preparing for the Dance – Looking Your Best (Cont'd)

- Knowing your shortcomings because PE Investors will find them in their due diligence
- Assists the company in developing systematic recording and reporting system and proactive game plan for addressing negative issues that could adversely impact valuation
- Helps owners and management better anticipate how the investor will look at the business
- Aids in positioning the business in the best possible light
- Saves time and money once the investors start their due diligence



Due Diligence – The Critical Courtship

- Expensive, time-consuming, distracting to management
- More is not necessarily better – relevant, thoughtful and strategic is the goal
- Engage the assistance of professionals who have extensive transaction experience
 - Quicker, smoother process
 - Keeps you focused
 - Added objectivity





Due Diligence – The Critical Courtship (Cont'd)

- Categories of Review
 - Financial (auditors/accountants)
 - Legal (lawyers)
 - Commercial (management)
 - Strategic (management and advisors)



Due Diligence – The Critical Courtship (Cont'd)

PE Investors' Due Diligence Objectives

- Confirm the truth of relevant facts
- Verify value and ownership of property
- Understand future cash flows, EBITDA, working capital and capital expenditure requirements
- Identify and assess risks, opportunities and threats to the deal
- Avoid legal, commercial and reputational risks
- Assess their synergy assumptions
- Gather information to optimize tax and legal structure for deal
- Enhance their negotiation of a successful transaction and at the lowest possible price





Due Diligence – The Critical Courtship (Cont'd)

- Communicate with all employees to ensure they don't feel threatened
- Identify value inhibitors and possible solutions
- Ensure management team members are engaged and "on plan"
- Organize critical records thoughtfully – electronic data rooms preferred



Due Diligence – The Critical Courtship (Cont'd)

- Key Commercial Relationships and Related Agreements
 - Key relationships with management, suppliers, customers and partners need to be well documented for their full value to be recognized
 - Change of control triggers (loan and security documents, employment contracts, shareholder agreements, leases, etc.)
 - Veto rights or consent and notice requirements
 - Disclosure restrictions
 - Competition issues
 - On-going obligations
 - Termination provisions
 - Create, amend and terminate contracts as needed





Due Diligence – The Critical Courtship (Cont'd)

- Customer/suppliers – formalize relationships
- Employees – contracts/stay agreements, non-compete, non-disclosure and waiver of IP rights
- MIS systems – current
- Identify adequacy of IP protection and privacy issues
 - Mission critical assets secure?
 - Rights granted to third parties?



Due Diligence – The Critical Courtship (Cont'd)

- Financial records and financial statements
 - Need high quality statements, ideally audited
 - Look to quality of earnings
 - Normalize earnings for non-recurring revenues and expenses
 - Identify personal expenses (and related tax exposures)
 - Bridging historical results to projections
 - Identify new business opportunities that are not yet fully reflected in financials
- Insurance coverage up-to-date



Due Diligence – The Critical Courtship (Cont'd)

Leadership and Governance

- Leadership
 - Strong, experienced leadership is essential
 - Their on going engagement critical to investors' confidence in the business
- Board of directors and board committees
 - Independence
 - Industry experience
 - Open to working with PE investor's nominees
- Management contracts
- Management engagement and succession
- Ownership succession expectations and planning
- Internal systems and controls – policies and procedures



Research Your Market Share/Market Value

- Competitive advantage and diverse customer base
 - translate into cash flows
- Prepare the business plan and value proposition
 - Concise, compelling and unique opposite competing plans
 - Executive summary: business proposition, investment requirements, projected sales and profitability, unique selling points and management experience





Research Market Share/Market Value

- Consider author of valuation report – credentials (e.g. accountant, independent valuator)
- Any scope restrictions?
- Failure to understand key business drivers
- Reasonable/relevant key assumptions – reliable financial information/projections
- Goodwill – will pay for corporate goodwill, not personal goodwill



Compatibility in a PE Investor/Partner

- The Company seeks to:
 - Protect its brand
 - Ensure continued growth in the business
 - Safeguard customers and employees
- The stakeholders seek to protect their investment
- Fit is everything, so the company should know what it is looking for



Compatibility in a PE Investor/Partner (Cont'd)

- The company should not over-shop its story
 - Research the PE firms – do they have complementary or competitive investments?
- Chemistry – do they know the company's industry? can add value?
- An ability to align the interests of management and shareholders with those of the PE investor
- An ability to foster growth



Compatibility in a PE Investor/Partner (Cont'd)

- Experience to drive growth, improve operations and management
- Assist the company improve its corporate governance by devising appropriate stock option, compensation and incentive programs
- Access to strategic advice and a wider network
- Assist the company to enjoy the wealth in the business they built, reduce risk and continue to grow the business





Conclusion

- Expend resources and reap the rewards later with higher enterprise valuation and successful collaboration with new PE investor/partner



Questions?



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BIOGRAPHIES



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Lisa Marcuzzi is a partner in the Business Law Section in the firm's Toronto office. She is engaged in a broad corporate/commercial practice with a focus on mergers and acquisitions (cross-border and domestic), private equity, equity/debt financings, and corporate restructurings, as well as general corporate governance related matters.

Lisa has experience working in both the public and private market context. She has acted for companies at various stages of development, including owner-operated businesses, Canadian public companies and multi-national corporations doing business in Canada, providing them with on-going general corporate and commercial advice. Lisa has also worked with a number of private equity firms and venture capitalists, such as investment bankers, private equity funds, labour sponsored investment funds, industry-specific specialty funds and angel investors, and a number of investee companies in many industries, assisting them with structuring rounds of investments/financing with an aim to maximizing liquidity options for the investors. She has also been involved in the formation of a number of private equity funds. Lisa has acted for both purchasers and vendors in asset and share purchases.

Lisa is a contributing editor to the Business Law Reports and was a contributing editor to the O'Brien's Encyclopedia of Forms, Canada Law Book's comprehensive reference source for forms, both legal and precedential, and has presented papers and seminars on various corporate and commercial matters and privacy legislation compliance.

Lisa joined Fasken Martineau in 2004 as a partner, having previously been a partner at another national firm.

Representative Experience

- *Asset Back Commercial Paper market restructuring*
Advised Desjardins Gestion, one of the largest holders of ABCP

Areas of Practice

Corporate / Commercial

Emerging Global Business

Securities and Mergers & Acquisitions

Private Equity

Education

LLB, University of Windsor, 1996

MBA, Finance and Policy
University of Windsor, 1996

BA, Administrative and
Commercial Studies
University of Western
Ontario, 1990

Year of Call

Ontario, 1998

Lisa Marcuzzi

- *EnviroTower completes private placement of preferred shares with XPV Cleantech Fund*
Advised XPV Cleantech Fund Limited Partnership
- *Travelzest acquires The Cruise Professionals for \$13 million*
Advised Travelzest plc
- *Group DKG acquires Precisioneering*
Advised Group DKG Corp.
- *Consortium including Nautilus Renewables invests in North American renewable energy partnership*
Advised Nautilus Renewables LLC
- *Diploma acquires 75% of AMT Vantage Holdings for up to \$30 million*
Advised Diploma PLC
- *Goodyear sells Engineered Products Division to Carlyle Group for US\$1.475 billion*
Advised Goodyear on the Canadian aspects of this transaction
- *Shift Networks closes \$4 million private placement financing*
Advised Loewen, Ondaatje, McCutcheon Limited
- *Travelzest acquires iTravel2000.com for \$51.5 million*
Acted for Travelzest plc in Canada
- *Cansult merges with AECOM's Maunsell operating company to create Cansult Maunsell*
Advised Cansult
- *Park Lawn Company creates income trust*
Advised Park Lawn Company Limited
- *Integral Wealth Management completes non-brokered private placement*
Advised Integral Wealth Management Inc.
- *GMP Capital Trust completes EdgeStone acquisition for \$155.4 million*
Advised GMP Capital Trust

Lisa Marcuzzi

Presentations

- Preparing a Company for the Private Equity Investor, Private Equity Group Seminar, March 2, 2010
- Protecting the Client in Exit Strategies, Private Equity Transactions program, Osgoode Professional Development, January 15-16, 2009
- Protecting the Client in Exit Strategies, Private Equity Transactions program, Osgoode Professional Development, October 24-25, 2007
- Counselling the Emerging Business, Ontario Bar Association, October 27, 2006



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Craig Brown is a partner and Chairman of the firm's Private Equity Group and an active member of several other practice groups including Securities and Mergers & Acquisitions and Investment Funds.

Areas of Practice

Emerging Global Business

Securities and Mergers & Acquisitions

Private Equity

Investment Products & Wealth Management

Corporate / Commercial

Education

BA, Economics
University of Western Ontario, 1979

LLB, Jointly with the University of Western Ontario
University of Windsor, 1983

Year of Call

Bermuda, 1995

Ontario, 1985

Craig carries on an active transaction-oriented practice with a special focus on advising high-growth Canadian mid market companies with a global outlook, as well as several of the leading investment dealers, merchant banks and private equity funds that provide financing to them. His expertise is in the areas of mergers and acquisitions and corporate finance in both the public and private market contexts. In addition to having extensive experience representing both issuers and agents/underwriters active in the Canadian financial markets, Craig also has experience acting for such clients active in the U.K. financial markets, particularly in connection with private and public financings and both primary and secondary listings on the Alternative Investment Market (AIM). Craig also works extensively with investment fund managers in the structuring and launching of new investment fund products, negotiating with third party service providers, and regularly advising with respect to unit holder communications, governance issues and regulatory compliance.

Prior to joining the firm in April, 2002, Craig was co chair of the technology group of another major Toronto law firm.

In 1994, Craig joined a leading Bermuda law firm where he practised as a corporate finance and hedge fund lawyer for two years before joining a Bermuda based investment fund management and administration company where he was President until 1998 when he returned to practise law in Toronto.

Craig is a director of several private and public companies and not for profit charitable organizations including Invest Toronto Corporation which was created by Toronto City Council in 2009 to engage the private sector in promoting the city internationally as an investment opportunity.

M. Craig G. Brown

Representative Experience

- *Starfield Resources closes \$2.3 million private placement offering*
Advised Starfield Resources Inc.
- *Toro FX sold to Grey Horse Corporation*
Advised Toro FX Inc.
- *Starfield Resources closes \$20 million private placement offering*
Advised Starfields Resources Inc.
- *Olympus Pacific Minerals completes \$25 million prospectus offering*
Advised the syndicate led by Loewen, Ondaatje, McCutcheon Limited and including M Partners Inc.
- *Wesdome Gold Mines completes \$11.5 million offering of senior unsubordinated convertible debentures*
Advised Loewen, Ondaatje, McCutcheon Limited and Pollitt & Co. Inc., the agents for Wesdome
- *ZoomMed closes \$6 million private placement*
Advised Loewen, Ondaatje, McCutcheon Limited
- *Starfield closes \$15.1 million private placement offering*
Advised Starfield Resources Inc.
- *Starfield Resources closes \$1.7 million private placement*
Advised Starfield Resources
- *Murgor Resources completes \$6 million private placement*
Advised Loewen, Ondaatje, McCutcheon Limited, lead agent for the private placement
- *GMP Capital Trust completes EdgeStone acquisition for \$155.4 million*
Advised GMP Capital Trust
- *Starfield Resources closes \$16.6 million private placement*
Advised Starfield Resources Inc.
- *Open Energy acquires Solar Roofing Systems for \$18.5 million*
Advised the shareholders of Solar Roofing Systems Inc.
- *Commercial Solutions raises \$15 million in private placement financing*
Advised the syndicate of underwriters led by Paradigm Capital Inc.

M. Craig G. Brown

- *First Trust/Highland Capital Floating Rate Income Fund II completes \$85 million IPO and First Trust/Highland Capital Senior Loan Trust closes related \$85 million revolving credit facility*
Advised First Trust/Highland Capital Floating Rate Income Fund II
- *First Trust/Highland Capital Floating Rate Income Fund completes \$185 million IPO and closes related \$185 million revolving credit facility*
Advised First Trust/Highland Capital Floating Rate Income Fund
- *Azure Dynamics closes \$10.7 million financing*
Advised Azure Dynamics Corporation

Publications

- "Canada's Foreign Investors Face New Scrutiny", Legal Eye, September 2009
- "Implications of Recent Amendments to the Competition Act and Investment Canada Act on Investments in the Canadian Mining Industry", Global Mining Bulletin, June 2009
- "Underwriters' liability for the contents of a prospectus and their due diligence defence: The Danier decision prompts a review and confirms the importance of U.S. guidance", Securities and Mergers & Acquisitions Bulletin by George C. Glover, Jr., M. Craig G. Brown, Richard Steinberg and Geoff A. Clarke, October 2004
- "Taking Advantage of the New Capital Gains Deferral Opportunity", Emerging Global Business Bulletin by Craig Brown and Allan Beach, October 2002

Memberships and Affiliations

- Secretary, Board of Directors of The Indus Entrepreneurs Toronto association (TiE Toronto)
- Member, Law Society of Upper Canada
- Member, Bermuda Bar Association
- Member, Canadian Bar Association

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Toronto

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