Applied Private Equity and Venture Capital

Course 1

Nicolas Renaud

Hello World!

- No stupid questions only stupid answers…
- Please focus on understanding not learning and even less grades
- Be nice I am not a professional teacher, but at least you can be sure I apply what I teach

1 **Nicolas Renaud:**
- – French (from France)
- – Currently working for Novacap (Private Equity)
- – Previously Vice President at Canaccord Genuity (M&A)
- – Previously manager at Novacap (Private Equity)
- – M&A at Morgan Stanley (London, UK)

2
- **Target for the course:**
  - – **Tools to analyze** a company (financially)
  - – **Introduction** of what is important in a transaction
  - – **Introduction** to business plan analysis

3
- **What you won't learn:**
  - – Public company valuation

4
- **How we do that:**
  - – Lectures
  - – Speakers
  - – Practical case

Admin

- Course plan only indicative and highly likely to be modified as we progress (especially sessions orders)
- Books are optional

Session	Activity
Sat 12/09	Basic financial concepts, PE/VC market overview, source of financing, financing lifecycle, value vs price, WACC **Note this course will be only half a day, the other half day will be recouped later**
Sat 26/09	DCF, standalone model, LBO model, basic forecasting, valuation methods
Sat 03/10	Modeling and Excel, the false god + Process Considerations
Sat 24/10	Mid-Term Introduction to company analysis
Sat 7/11	Company analysis and forecasting
Sat 21/11	Advanced issues (WC adjustments, negotiation, financing terms, legal workshop, Governance)
Sat 5/12	Advanced issues (WC adjustments, negotiation, financing terms, legal workshop, Governance)
TBD	Final Exam

Things you can read if you want:

Tim Koller – Valuation – Wiley Publishers 2010
Aswath Damodoran – Investment Valuation 3rd Edition
George Soros – Alchemy of Finance

Admin (cont'd)

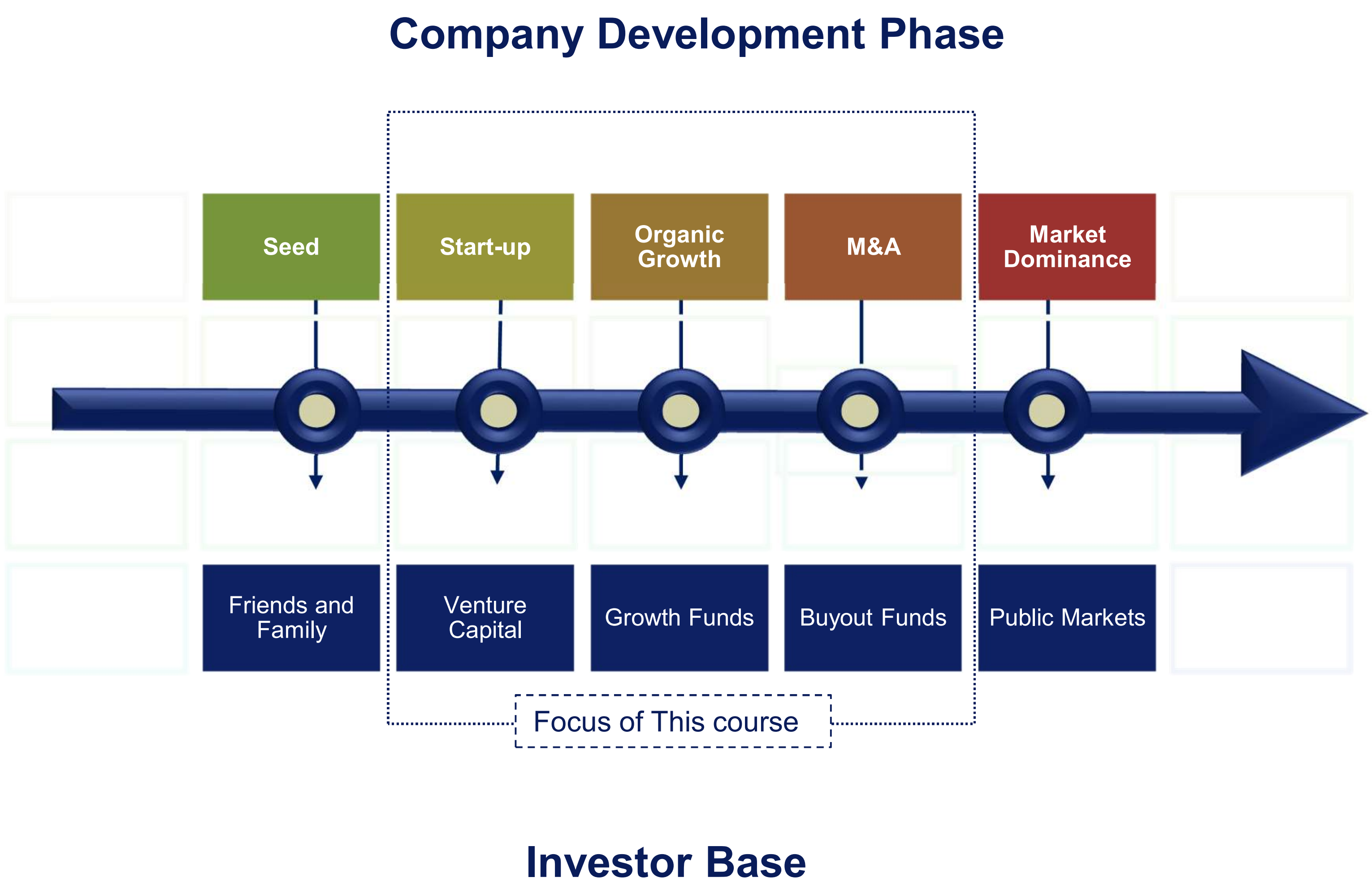
- Group work will be ranked instead of scored from A+ to B-
  - This will then be translated to a grade (see course outline)

Letter	Number		
A+	90	-	100
A	85	-	89
A-	80	-	84
B+	77	-	79
B	73	-	76
B-	70	-	72
C	60	-	69
F	0	-	59

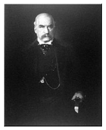
The best job if you can't kick or sing…

Retail Banking	Wealth Management	Wholesale Banking	Investment Banking / Private Equity	Markets / Funds
•**Products** •Loans/mortgages •Credit cards	•**Services** •Tax planning •Asset allocation	•**Products** •Corporate financing •Project lending •Syndication •CDOs, CLOs	•**Services** •IPOs •M&A advisory •LBOs/MBOs	•**Products** •Sales & trading •Equity research •Hedge funds
•**Key skills** •Skills?	•**Key skills** •Relationship •Trust •Network	•**Key skills** •Strong analytics •Risk assessment •Structuring	•**Key skills** •Exceptional analytics •Hard work •Top of the crop	•**Key skills** •Market sense •Reactivity •Exceptional skills
•**Salary**: $ •**Good-Bad spread**: -- •**Luck factor**: 0 •**Hard to find**: --- •**Job security**: ++++	•**Salary**: $$ to $$$$$ •**Good-Bad spread**: +++ •**Luck factor**: + •**Hard to find**: - to +++ •**Job security**: +++	•**Salary**: $$$ •**Good-Bad spread**: + •**Luck factor**: ++ •**Hard to find**: ++ •**Job security**: ++	•**Salary**: $$$$ •**Good-Bad spread**: ++ •**Luck factor**: + •**Hard to find**: ++++ •**Job security**: +	•**Salary**: $$$ to $$$$$$ •**Good-Bad spread**: +++++ •**Luck factor**: +++ •**Hard to find**: ++++ •**Job security**: ---

Financial Lifecycle of a Company



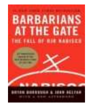
History of the Private Equity Industry



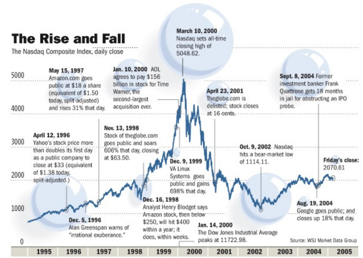
1901- J. Pierpont Morgan completes first buyout in history with the acquisition of Carnegie Steel

1955- Malcolm McLean completes first leveraged buyout by acquiring Pan-Atlantic Steamship Company

KKR



1989- Boom culminates with largest LBO in history at the time of RJR Nabisco by KKR due to its poor outcome



Venture capital boom and the Internet Bubble

Private equity takes off and crashes again with the bursting of the internet bubble

The Credit Crunch

Financial crisis crushes PE firms that relied on heavy leverage and favored those that focus on adding operational value rather than solely through financial engineering

1901-1945 | 1946-1954 | 1955-1981 | 1982-1989 | 1990-1994 | 1995-2003 | 2004-2007 | 2008-present

1946- First two private equity funds are founded: J.H Whitney & Company and American Research and Development Corporation

J.H. WHITNEY & CO.
J.H. WHITNEY CAPITAL PARTNERS, LLC

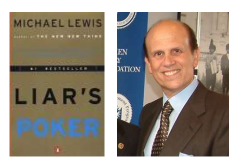
1981- Foundation of Novacap

novacap

1982- Well-publicized and successful LBO of Gibson Greetings launches LBO boom

Gibson

1990- Bankruptcy of Drexel Burnham Lambert leads to a collapse in the junk bond market



"Golden Age"

Low interest rates and increasing regulation brings golden age for private equity as 13 of the largest 15 LBOs in history are realized

CHRYSLER
KINDER MORGAN
GMAC
First Data.
freescale semiconductor
Equity Office

What is a Private Equity Fund?

Private equity is capital invested in the direct ownership of businesses that are not traded on public stock exchanges.

Co-invest

Limited Partnerships (LPs)

Fund of Funds

GPs

Universe of Potential Targets for Private Equity Funding

FUND

Usually have a target,
most funds don't go to pharma, weapons, etc...

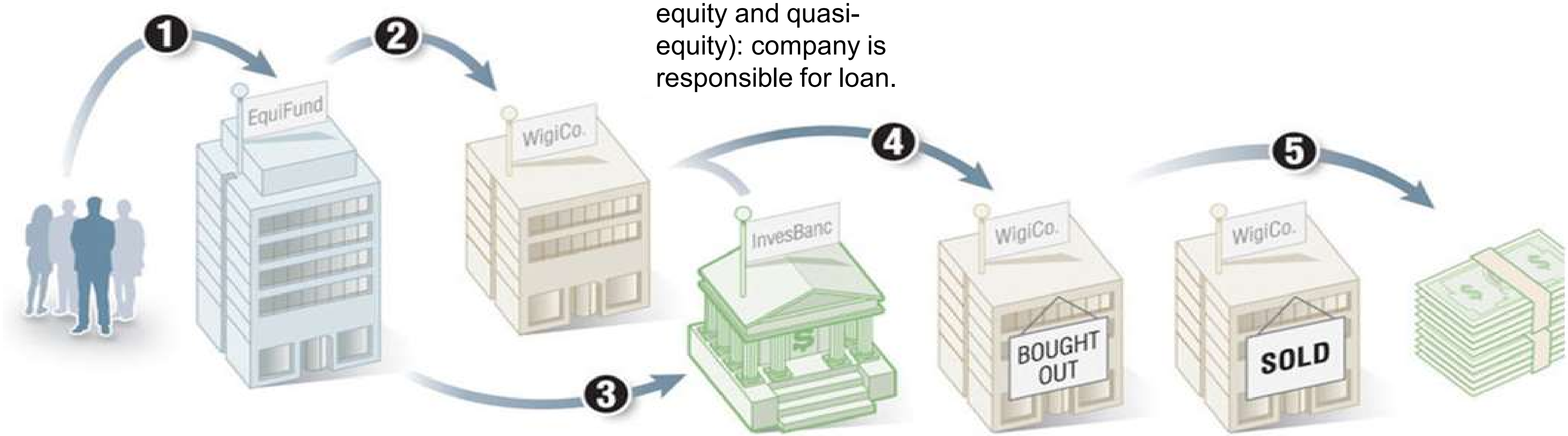
Direct

- Private equity investors are typically organized into a pool of funds as LPs.
- The pool is operated by a general partner (GP) who charges management fees to the LPs.
- The pool of funds has a finite life (10-12 years), during which the GP acquires businesses, increases their value, sells them at a profit and returns the capital to the LP of investors

How Private Equity Firms Work

Steps in a Typical PE firm's leverage buyout of a company:

Fundraising	Deal Sourcing	Deal Structuring	Company Management	Exit
1. PE firm creates buyout fund that gets commitments of capital from investors (such as pension funds, endowments, foundations, banks, high net worth individuals	2. Firm finds target company for its buyout fund to acquire	3. Firm obtains loan from several commercial or investment banks to finance purchase of company; fund typically puts in fraction of the money needed for deal (50% in Canada of equity and quasi-equity): company is responsible for loan.	4. Buyout fund holds company for 3-5 years (8-10 years for Novacap); tries to increase company's value via operational or financial changes so fund can make a profit when company is sold	5. Fund exits investment by an IPO stock offering or selling the company to another PE firm or to a strategic player; any profits are returned to fund, shared by investors and the firm



Source: U.S. Government Accountability Office, Private Equity Growth Council Graphic: Judy Treible, Robert Dorrell © 2012 MCT

Typical Transactions

Secure shareholders' capital and grow the business:

The entrepreneur wants to secure part of his capital and pursue growth of the company → **Novacap** buys a stake in the equity and collaborates with the company to foster its growth

Consolidation / Acquisition of competitors:

The company wants to become a leading player in its industry by consolidating its market → **Novacap** can provide the capital and play an important role in the industry consolidation strategy

100% sale of the company:

Shareholders want to sell their company outright → **Novacap** buys the company in partnership with management

Typical Transactions

Turnaround:

The company has demonstrated its viability but requires capital to implement its restructuring plan	→	**Novacap** can actively assist in the turnaround and provide the required capital

Spin-off of a division:

The parent company seeks to sell one or more of its divisions	→	**Novacap** can move quickly and discreetly to facilitate the divestiture

Privatization of a public company:

A public company seeks to privatize	→	**Novacap** can work with management/shareholders to privatize the company and pursue its growth

What is Private Equity?

Private equity firms have been in the headlines because of their fundraising prowess and because of the companies being purchased.

- Having more capital, private equity funds have increased the size of their acquisitions. Many of their recent targets have been well-known public companies:

Equity Office Privatized in Feb 2007 for **$39.0B**. Acquired by: Blackstone	Burger King Privatized in Feb 2007 for **$3.3B**. Acquired by: 3G Capital	Toys"R"Us Privatized in Sep 2010 for **$6.6B**. Acquired by: KKR, Vornado Realty Trust, BainCapital	freescale semiconductor Privatized in Sep 2006 for **$16.5B**. Acquired by: Permira, TPG, AIG Investments	GMAC Privatized in Apr 2006 for **$7.4B**. Acquired by: Aozora Bank, Cerberus, citi
HCA Hospital Corporation of America Privatized in Jul 2006 for **$22.0B**. Acquired by: KKR, BainCapital, Merrill Lynch Global Private Equity	Kinder Morgan Privatized in May 2006 for **$30.3B**. Acquired by: Goldman Sachs, Riverstone, The Carlyle Group, AIG Investments	Harrah's Entertainment, Inc. Privatized in Dec 2006 for **$16.7B**. Acquired by: Apollo, TPG	Alliance Boots Privatized in Apr 2007 for **£9.0B**. Acquired by: KKR, Private Equity	Biomet Privatized in Dec 2006 for **$10.8B**. Acquired by: Blackstone, TPG, KKR, Goldman Sachs
Chrysler Privatized in May 2007 for **$7.4B**. Acquired by: Cerberus	First Data Privatized in Apr 2007 for **$26.3B**. Acquired by: KKR	TXU energy Privatized in Feb 2007 for **$31.9B**. Acquired by: TPG, Black Canyon Capital, KKR	BRP Privatized in Aug 2003 for **$1.1B**. Acquired by: BainCapital, Caisse de dépôt et placement du Québec	Hilton Privatized in Jul 2007 for **$27.7B**. Acquired by: Blackstone

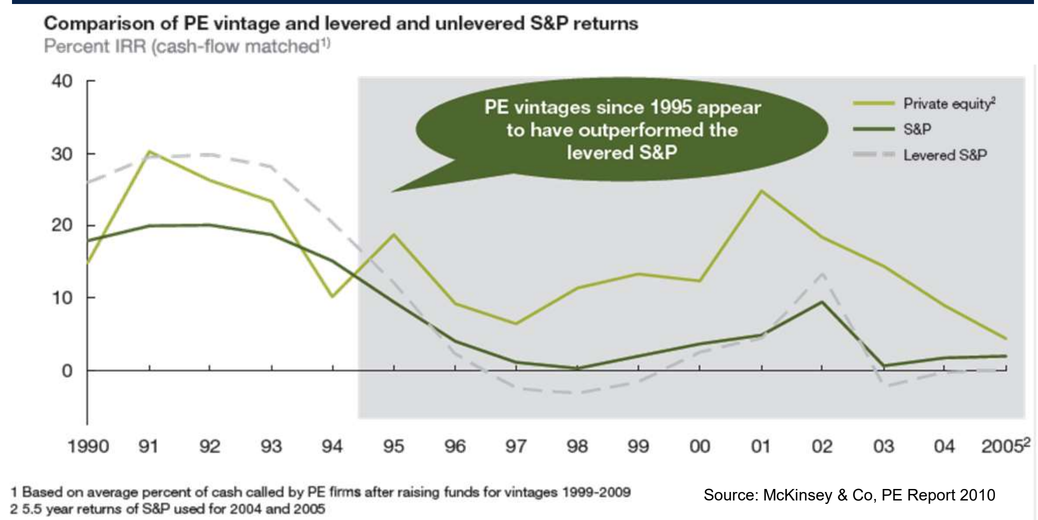
Why Invest in Private Equity?

The primary motivation to invest in private equity is to achieve returns above what the traditional asset classes of public equity (stocks) and debt (bonds) have provided.

- The longer-term data for private equity shows returns significantly higher than those of publicly traded stocks (S&P).
- Over the twenty years to the end of 2006, private equity has provided excess returns of 3.7% (annualized) over public equity, as measured by the NASDAQ Composite Equity Index.
- This is a substantial premium and is clearly a prime reason for the increasing interest from institutional investors.

Source: PH&N, Private equity returns are net of underlying fees and expenses. Total return shown for public market indices, except NASDAQ. Source: CVCA - Canada's Venture Capital & Private Equity Association, "Why Canadian Institutional Investors Should Participate in Global Private Equity: 'Finding the Key' Report Implementation" (May 1, 2007). Accessed on November 14, 2007. http://www.cvca.ca/files/Downloads/CVCA_Institutional_Presentation_-_May_2007.

Historical Returns

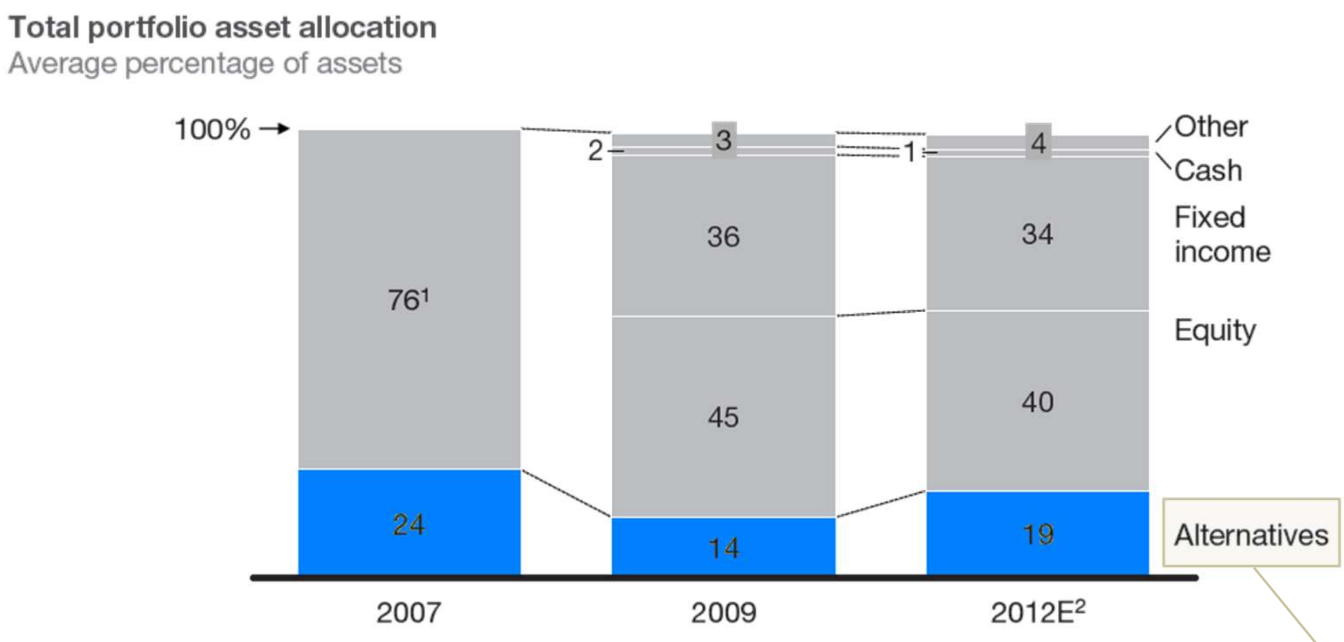


Source: McKinsey & Co, PE Report 2010

Private Equity (to Dec 31, 2006)	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr
All Venture	16.4	9.1	1.0	20.3	21.5	16.6
All Buyout	24.5	14.6	10.4	8.5	11.1	12.9
All Private Equity	23.3	12.7	7.5	11.0	13.8	13.9
Public Equity Indexes						
S&P 500 Index (US$)	15.8	10.5	6.2	8.4	10.6	11.7
S&P/TSX Composite Index (US$)*	17.0	22.9	20.4	11.8	11.2	11.0
NASDAQ Composite Index (US$)	9.6	6.4	4.4	6.5	9.9	10.2

Investors’ Typical Allocation to Private Equity

Investors’ Expectations for Their Own Capital Allocation



1 Includes equity, fixed income, cash, and other
2 Expected next 2-3 years
Note: Results based on simple average of firms’ responses

SOURCE: 2010 McKinsey Global Survey on Alternative Investing

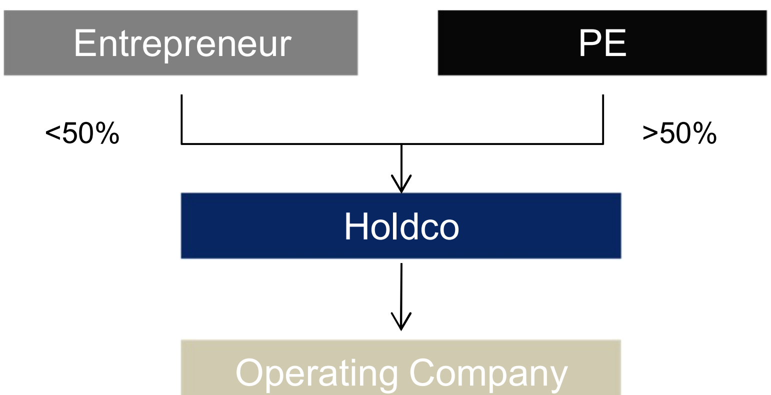
Asset class where PE falls in

Buyout Principles

Structure

A buyout is a transaction where a controlling share of a company's equity is sold from an entrepreneur to a private equity investor

- The transaction is based on issued and outstanding shares
- The entrepreneur sells between 50% to 100% of his equity stake
- The new shareholder becomes a business partner through same financial instrument as the entrepreneur.



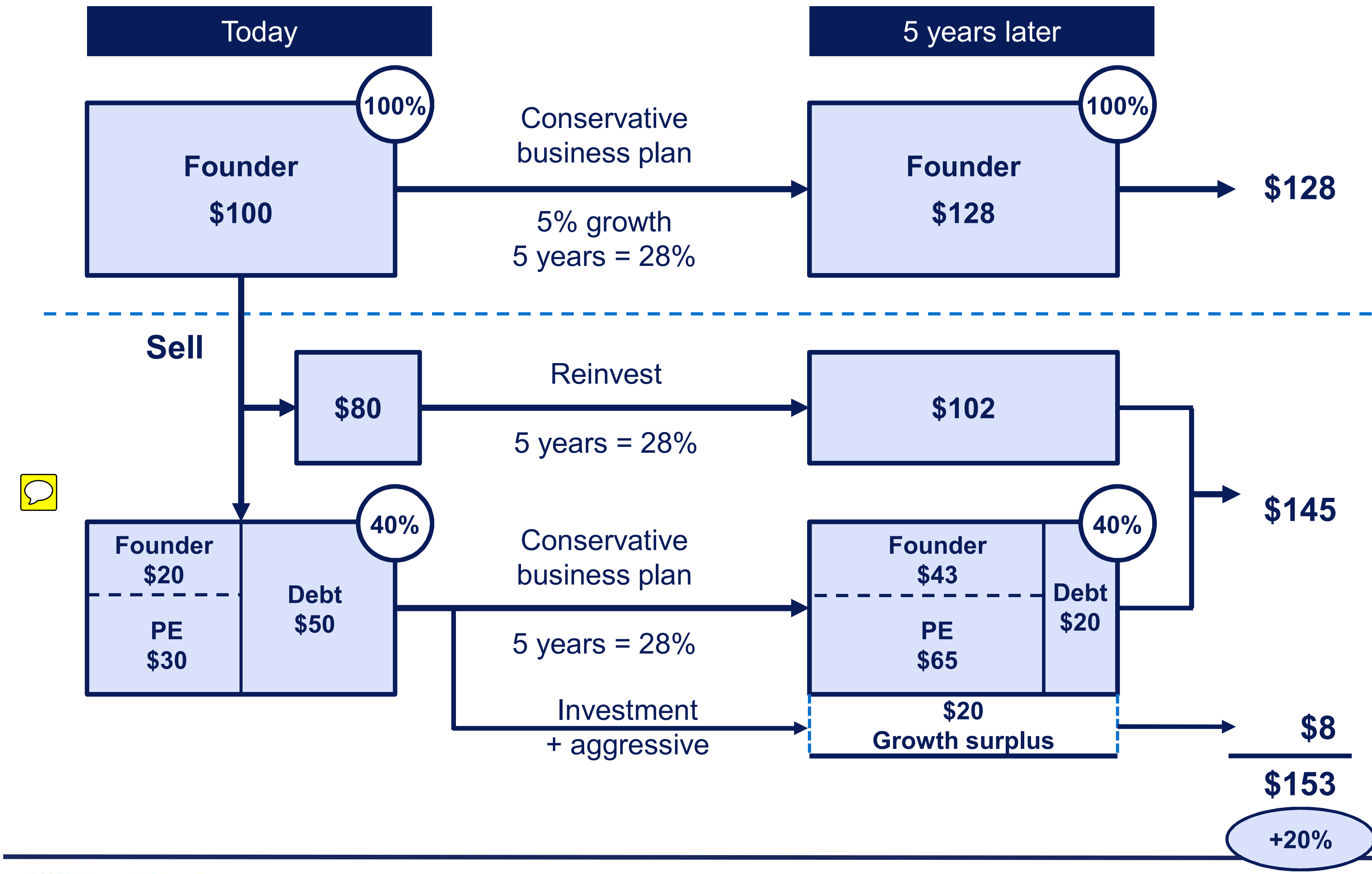
Strategic Partnership

A buyout transaction has two main objectives:

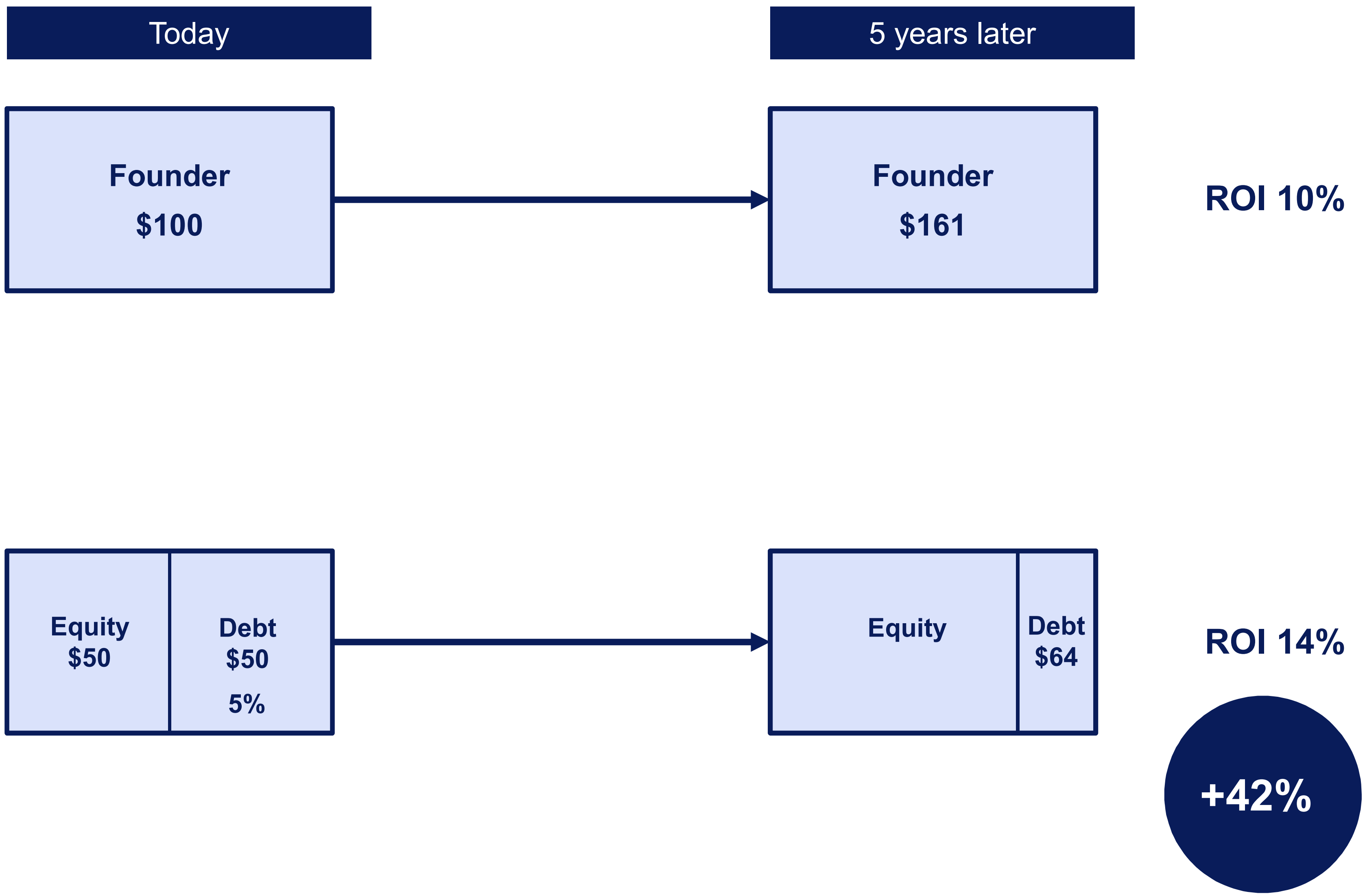
1. **Provide liquidity to selling shareholders**
2. **Create a partnership to foster growth**

- Optimization of capital structure to support growth
- Increase of capital and resources
- Entrepreneur's risk / return equilibrium

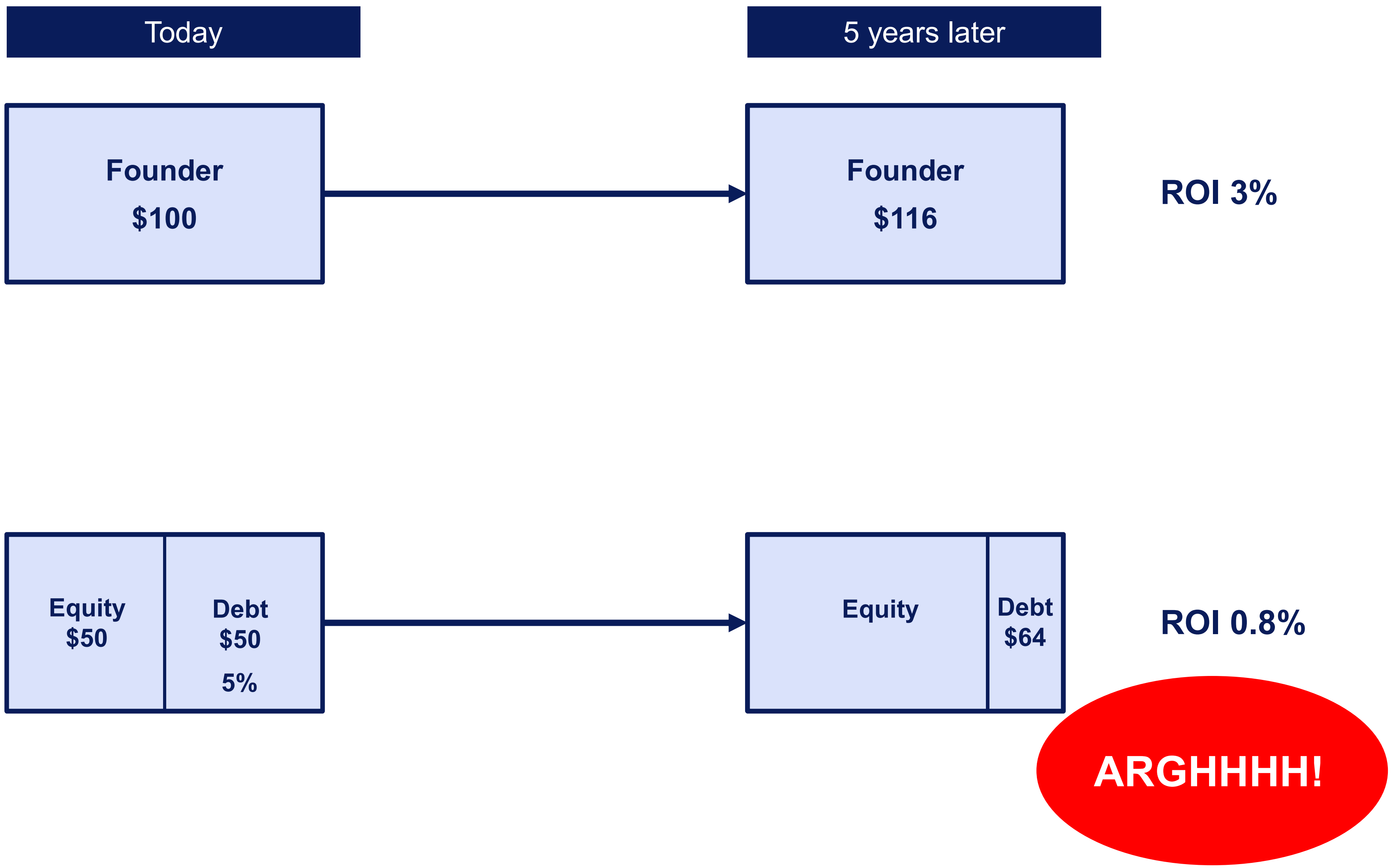
The LBO – Seller Point of View



The LBO – Fund Point of View -> Leverage



Leverage (Cont'd)



Caracteristics of a good deal?

Deal Life Cycle

Deal Alert	Preliminary Due Diligence	Confirmatory Due Diligence	Closing
1 week	**4-6 weeks**	**4-6 weeks**	**2-3 weeks**
▪ Receive Confidential Information Memorandum CIM – or direct solicitation ▪ Prepare deal alert presentation ▪ Investment committee decides on pricing	▪ Preliminary due diligence – Dataroom (usually online) ▪ Process limited to selected parties ▪ Investment committee decides on pricing	▪ Full-blast due diligence ▪ Coordination with outside advisors (legal, operational, tax, etc.) ▪ Due diligence report ▪ Site visits, final negotiations	▪ Final closing documentation
IOI (indication of Interest)	**LOI (Letter of Intent)**	**Start legal drafting documentation** (SPA or APA, Reps & Warranties, Schedules, Employment Agreement, Shareholders Agreement, etc.)	

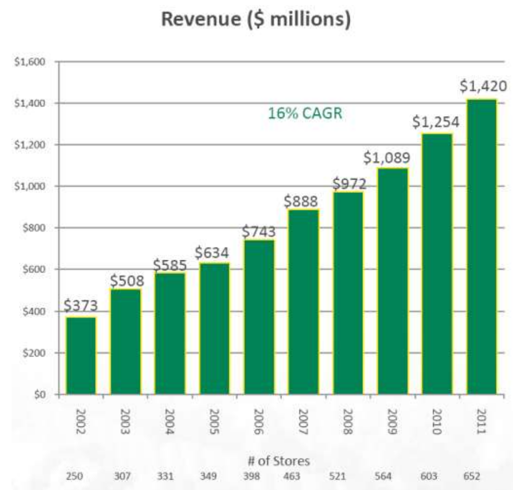
PE Investment Case Studies

DOLLARAMA

Transaction Acquired in November 2004 by Bain Capital. Rossy family and management retained approximately 20% of the equity post-transaction

Thesis The company was founded in 1992 following a progressive conversion of former Rossy stores in Dollarama stores. A majority position was sold to Bain Capital in order to pursue an aggressive growth and development plan.

Value-add Development of a focused business model, aggressive store openings, real estate optimization, improvement of IT management, $1+ concept/growth of in-store SKUs



BainCapital PRIVATE EQUITY

2004

High growth potential but limited resources

Market:	Eastern Canada
Revenues:	$500M
Concept:	Single price point ($1 SKUs)
Profitability:	Good
Market Share:	#1

2002 › 2003 › … › 2010 › 2011

- Store openings in Western Canada
- Accelerated growth to 50 store openings/year
- New distribution center in Montreal for all food products
- Introduction of 3 new price points in order to offer a wider range of products and limit impact of price inflation
- Success full IPO (IPO at $17.50 in Oct 2009, currently trading at $55.50) and full monetization

2011

5x the size of largest competitor, dominant position

Market:	National
Revenues:	$1.6B
Concept:	Multiple price points
Profitability:	High
Market Share:	Dominant

kdc
Knowlton Development Corporation

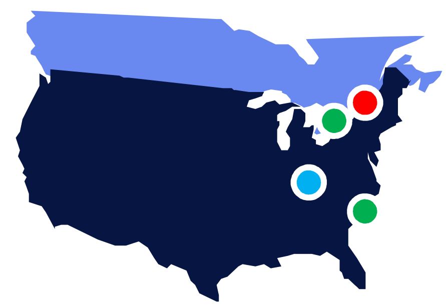
PE Investment Case Studies

ORGANIC GROWTH AND DEVELOPMENT STRATEGY

Transaction Novacap acquired the company along with management in 2002.

Thesis The business strategy is to become the largest contract manufacturer of personal products in North America through a combination of organic growth and acquisitions.

Novacap's Value-add The company is redefining the manufacturing of personal care products by offering turnkey solutions from formulation to product positioning.



Initial Factory · Acquisitions · New Factory

novacap

2002	2002 – 2003 – … – 2008 – 2009 – 2011	2011
Regional Manufacturer		North American leader in formulation/fabrication

2002 – Regional Manufacturer

Market:	Canada
Revenues:	$60M
Avg. Client:	Small
Profitability:	Medium
Production Runs:	Low

2002 – 2003 – … – 2008 – 2009 – 2011

- Business development with Fortune 500 customers;
- Acquisition of Body Blue (ON) in May 2006 / Acquisition of Tri Tech Laboratories (VA) in December 2006;
- Joint-venture with a European partner in order to penetrate the North American hair colour market; and
- Creation of a dedicated group focused on new product and formulation development.

2011 – North American leader in formulation/fabrication

Market:	Canada, USA
Revenues:	$400M
Avg. Client:	Important
Profitability:	High
Production Runs:	High

And Now for Something Completely Different…

Basic Financial Concepts

2 Axioms of finance

- Every financial concepts revolve around only 2 principles:
  - No free lunch
  - Rationality of actors

1 **<u>Efficiency of market – "no free lunch":</u>**

– No possible return without taking a risk

2 **<u>People are rationale:</u>**

– Maximization of **utility**

Time value of money

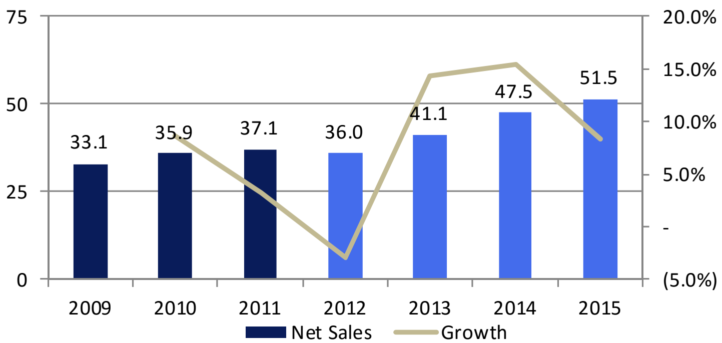
Entreprise Value

Rapid Reminders:

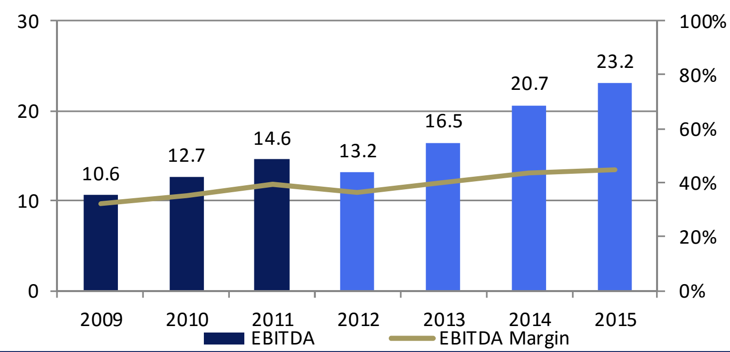
1. **P&L**
2. **Balance Sheet**
3. **Cash Flow Statement**
4. **Consolidation**
5. **Acquisition accounting**
6. **Entreprise Value**
7. **Working Capital**
8. **IRR and VAN**

P&L Overview

Evolution of Sales



Evolution of EBITDA



Summary P&L

As of December-31	Historical			Projected				CAGR	
$ M	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**09 - 11**	**11 - 15**
Revenue	**33.1**	**35.9**	**37.1**	**36.0**	**41.1**	**47.5**	**51.5**	**5.9%**	**8.6%**
Growth		*8.6%*	*3.2%*	*(2.9%)*	*14.3%*	*15.5%*	*8.3%*		
COGS	(13.6)	(13.8)	(13.3)	(13.8)	(15.3)	(17.2)	(18.2)		
Gross Profit	**19.5**	**22.1**	**23.7**	**22.2**	**25.8**	**30.3**	**33.2**	**10.3%**	**10.8%**
Gross Margin	*59.0%*	*61.6%*	*64.0%*	*61.7%*	*62.7%*	*63.9%*	*64.6%*		
SG&A	(4.4)	(4.8)	(4.3)	(4.5)	(4.6)	(4.9)	(5.2)	(1.3%)	4.9%
Overhead Costs	(4.5)	(4.5)	(4.5)	(4.5)	(4.6)	(4.8)	(4.9)		
EBITDA	**10.6**	**12.8**	**15.0**	**13.2**	**16.5**	**20.7**	**23.2**	**18.6%**	**11.6%**
Adjustments vs Special Purpose Financials	-	(0.1)	(0.4)	-	-	-	-		
EBITDA adj.	**10.6**	**12.7**	**14.6**	**13.2**	**16.5**	**20.7**	**23.2**	**17.2%**	**12.3%**
EBITDA Margin (excl new inv.)	*32.2%*	*35.5%*	*39.4%*	*36.6%*	*40.1%*	*43.5%*	*45.0%*		
Net income adj.	**10.6**	**12.7**	**14.6**	**3.9**	**4.4**	**6.6**	**8.0**	**17%**	**(14%)**
Capex	**2.3**	**5.5**	**1.4**	**3.3**	**6.6**	**4.6**	**5.1**	**(21%)**	**38%**

Summary Balance Sheet

- Balance sheet is always divided between short and long term
- Balance sheet present a Photography of the company

Summary Balance Sheet

$ '000 - As at 31 Dec 2011

Assets		**Liabilities**	
Accounts Receivables, Net	2,405	AP & Accrueds	1,635
Prepaids & Other Current Assets	397	Accrued Capital Expenditures	116
		Other Current Liabilities	625
Total Current Assets	**2,802**	**Total Current Liabilities**	**2,377**
Property & Equipment, Net	60,639	Other LT Liabilities	13,236
Other Assets	416	Advances from Parent	482
		Shareholders' Equity	47,763
Total	**63,858**		**63,858**

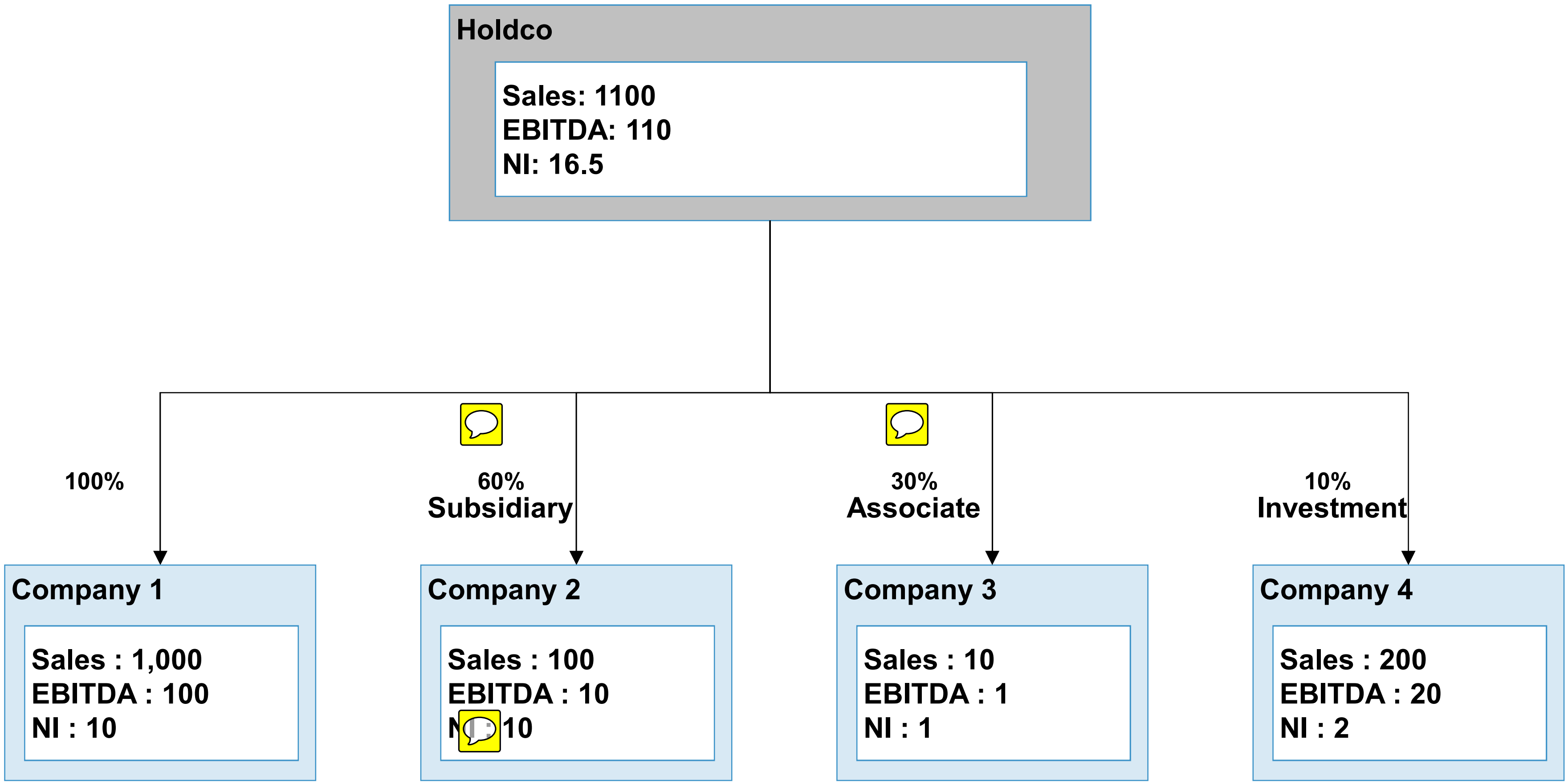
Note: under Canadian GAAP and IFRS, GW does not amortize

Cash Flow Statement

CASH FLOW STATEMENT	
(in US$'000)	**2012F**
Net income	3,667
Depreciation and amortization	5,519
Capitalized Interest	-
Working Cap Requirements	27
Operating Cash Flow	**9,213**
Sale of Fixed Assets	-
Capital expenditures	(3,292)
Investing Cash Flow	**(3,292)**
Purchase of Performance Shares	-
Repayment of new senior debt	(1,267)
Repayment of new subordinated debt	-
Capex Financing (net)	300
Financing Cash Flow	**(967)**
Total cash flow	**63**

Consolidation

- Please see any good accounting book



Note: for all, assumes full amortization

Acquisition accounting

- Please see any good accounting book
- Assumes acquisition for EV of 250 financed by 100 of debt and 150 of equity

Company

Cash: 10
Debt: 50
Equity: 100

Repayment of Debt
-50

Company

Cash: -40
Debt: 0
Equity: 100

Issuance of Debt and Equity
+100 debt
+150 equity

Company

Cash: 210
Debt: 100
Equity: 250

Payment of purchase price
-210

Company

Cash: 0
GW: 110
Debt: 100
Equity: 150

Note: under Canadian GAAP, acquisition costs are no longer capitalised

Enterprise Value

Entreprise Value

- Net Debt
(all debts – Operating cash & cash equivalents)

- Off balance sheet items
(unfunded pension liabilities, leasing obligations etc)

- Minority interests

+ Investment in associate (at market value)

= EQUITY

Exercise

Which bank loan is best :

$1.0 M , capital payments of $200 k for 5 years and interest of 5% calculated on opening balance

$1.0 M , no capital payments until term and interest of 5.3% calculated on opening balance

Quick Questions:

Define WC

Define GW

If risk free rate go up how are valuation affected?

The Different Financing Sources Available

- In Canada / Us true Mezzanine is not available due to absence of Mother – Daughter fiscal integration
- The goal of the entrepreneur is to lower as best as he can his cost of capital
- Main strategy involve delaying as much as possible capital raising to optimise leverage
- Some variation include:
  - **PIK**
  - Revolver
  - Convertible
  - Mandatory convertible
  - Hybrid
  - Bullet
  - Sukuk

1 **Equity**

- Most expensive type of capital
- The only one available at the beginning and the cushion for debt investors

2 **Subordinated Debt**

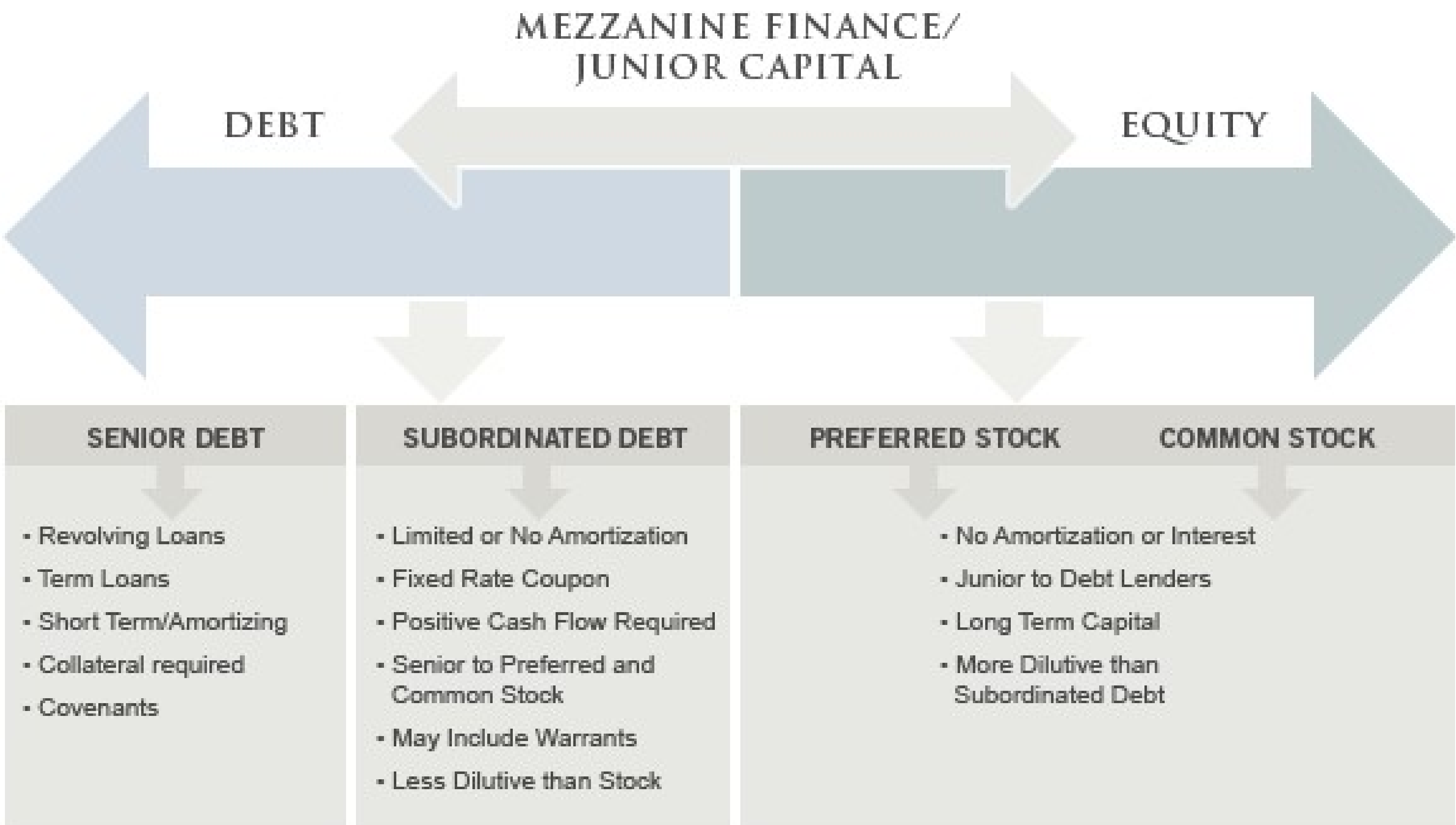
- **13% - 18%+ fairly expensive type of capital**
- Similar to equity but with a tax shield effect
- Used primarily for tax reasons, to increase leverage, to avoid diluting entrepreneur

3 **Senior debt / bonds:**

- Cheapest source of capital
- Bank financing, subject to strict covenants
- Usually amortizing term loan, can be a Bullet or very fashionable currently reducing revolving facility
- Typically require a minimum equity cushion of 40%

4 **Subventions**

The different Financing Sources Available



What is Value

- Value exclusively comes from economic profit
- Value is not price

1 **Companies create value by investing capital at rate of returns that exceed they cost of capital**

– Spread between cost of capital and ROIC

– Invested capital is CAPEX + WC

2 **Economic profit is the true measure of a company value:**

– **(ROIC-cost of capital) * capital deployed**

– The goal is to maximize capital economic profit

3 **Value of a company is the present value of economic profit:**

– + invested capital of course

4 **This is very different than price:**

– Demand meets offer

– Sum of different expectations

– No equilibrium in markets + future based pricing

Cash Flow?

- Income is not the primary goal per-se cash is the real factor

Net Income Overview

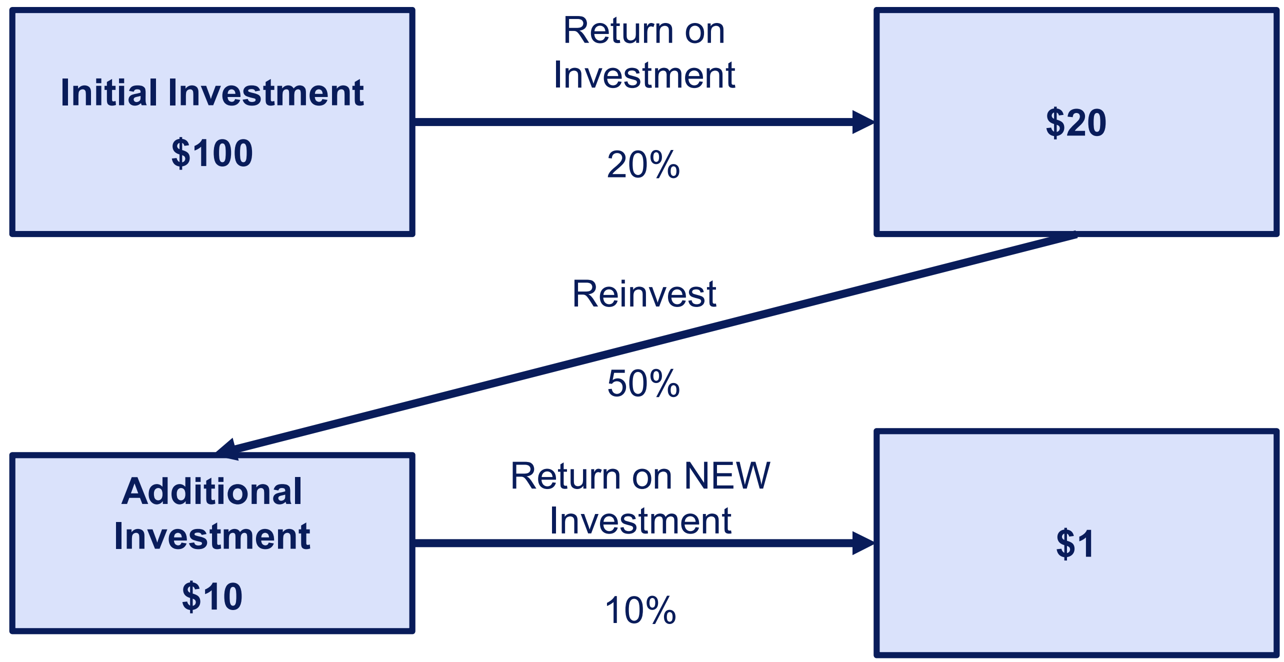
	2012	2013	2014	2015	2016
Company 1	100	112	125	140	157
Company 2	100	109	119	130	141

Cash Flow Aproach

	2012	2013	2014	2015	2016
Company 1 earnings	100	112	125	140	157
Net investment	25	28	31	35	39
Earnings - Investmnet	**75**	**84**	**94**	**105**	**118**
Company 2	100	109	119	130	141
Net investment	12	13	14	16	17
Earnings - Investmnet	**88**	**96**	**105**	**114**	**124**

Cash Flow vs. ROIC

- If return on investment is constant, growth is essentially a factor of RONIC and investment rate



GROWTH = RONIC * Inv. Rate

Cash Flow vs. ROIC (Cont'd)

Cash Flow Aproach					
	2012	**2013**	**2014**	**2015**	**2016**
Company 1 earnings	100	112	125	140	157
Net investment	25	28	31	35	39
Earnings - Investmnet	**75**	**84**	**94**	**105**	**118**
Implied RONIC	***48%***	***48%***	***48%***	***48%***	***48%***
Company 2	100	109	119	130	141
Net investment	12	13	14	16	17
Earnings - Investmnet	**88**	**96**	**105**	**114**	**124**
Implied RONIC	***75%***	***75%***	***75%***	***75%***	***75%***

Note: Returns favor higher reinvestment

Cash Flow Aproach	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Company 1 earnings	100	105	110	116	122	128	134	141	148	155	163
Net investment	25	26	28	29	30	32	34	35	37	39	41
Earnings - Investmnet	**75**	**79**	**83**	**87**	**91**	**96**	**101**	**106**	**111**	**116**	**122**
RONIC	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***
Company 2	100	102	105	107	110	113	115	118	121	124	127
Net investment	12	12	13	13	13	14	14	14	15	15	15
Earnings - Investmnet	**88**	**90**	**92**	**94**	**97**	**99**	**101**	**104**	**106**	**109**	**112**
RONIC	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***	***20%***

Free Cash Flow Formula

- To measure the cash provided by the company it is important to remember that you want it free of the capital structure of the company

EBITDA

–

Reinvestment into the business

–

Tax

Free Cash Flow Formula

EBITDA	• Closest measure to operational performance • least subject to manipulation
-	
Reinvestment into the business	• Capex • Working cap
-	
Tax	• Don t forget Depreciation tax shield

$$(1-\tau)\ \mathrm{EBITDA} + \tau\ \mathrm{D\&A} - \mathrm{CAPEX} - \Delta \mathrm{WC}$$

Discount Rate: WACC

- The WACC is the best way to reflect for the structure of capital in the discount rate

Free Cashflow	⇨	DEBT	EQUITY
Discount rate	⇨	Return on capital to debt holders	Return on capital to Equity holders

$$\text{WACC} = \frac{D}{D+E}(1-\tau)\,k_d + \frac{E}{D+E}\,k_e$$

Discount Rate - Risk

- Risk is a measure of uncertainty
- As private equity investors we are not concerned about systemic risk but only about company specific risk

In finance, risk is a measure of the probability and magnitude of a difference between actual returns and expected returns

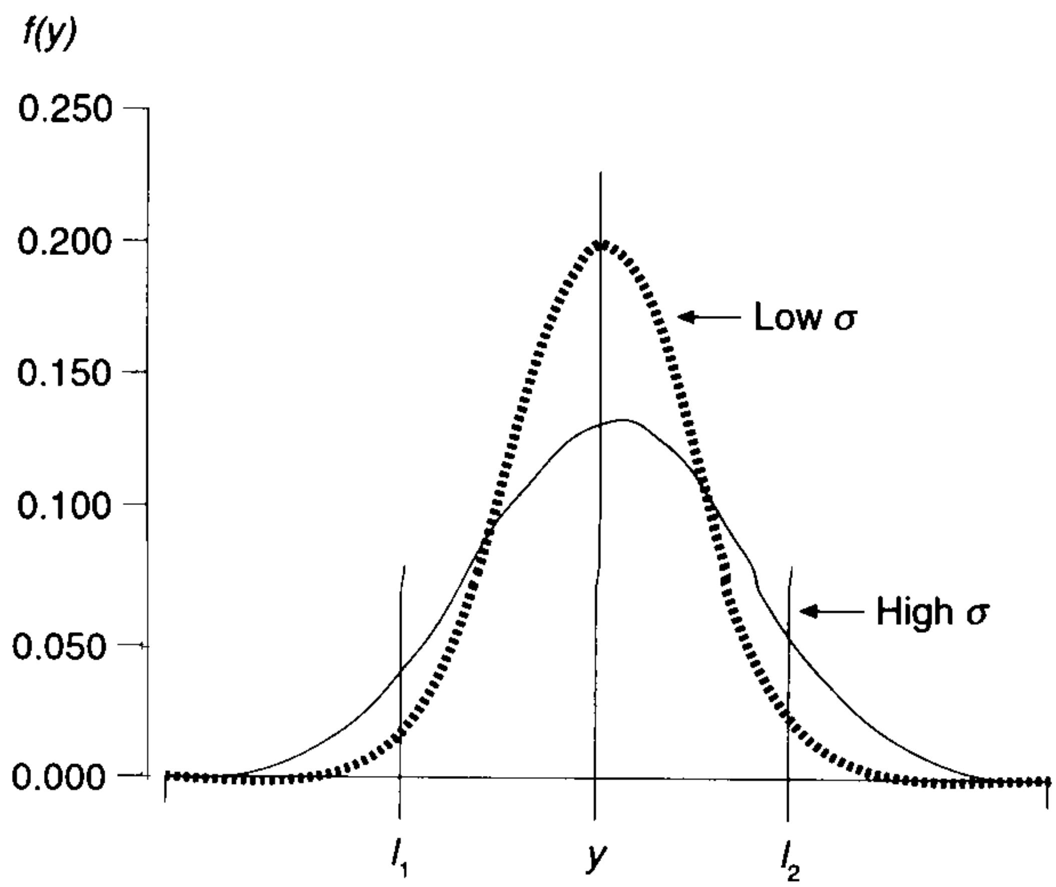
- There is 2 type of risk:

Systemic risk

Company specific risk

Variance

- Note: risk is as much a question of perception as a question of actual risk
- The measure of the actual risk of a company is unavailable to investors
-



Types of risk

ENVIRONMENT RISK

Competitors
Customer Wants
Technological innovation
Sensitivity
Shareholder Expectations
Capital Availability
Sovereign / political
Legal
Regulatory
Industry
Financial Markets
Catastrophic loss

PROCESS RISK

FINANCIAL

PRICE
Interest Rate
Currency
Equity
Commodity
Financial Investment

Liquidity
Cash Flow
Opportunity Cost
Concentration

Credit
Default
Concentration
Settlement
Collateral

EMPLOYMENT

Leadership
Authority /Limit
Outstanding
Performance
Incentives
Change readiness
Communications

INFORMATION TECHNOLOGY

Integrity
Access
Outstanding
Availability
Infrastructure

GOVERNANCE

Organizational Culture
Ethical Behavior
Board Effectiveness
Succession Planning

REPUTATION

Image & Branding
Stakeholder Relations

INTEGRITY

Management Fraud
Employee Fraud
Third Party Fraud
Illegal Acts
Unauthorized Use

OPERATIONS

Customer Satisfaction
Human Resources
Knowledge Capital
Product Development
Efficiency
Capability
Stability
Performance Gap
Cycle Time
Sourcing
Channel Effectiveness
Partnering
Compliance
Business Interruption
Product / Service Failure
Environmental
Health & Safety
Trademark / Brand Erosion

INFORMATION FOR DECISION-MAKING RISK

STRATEGIC

Environmental Sean
Business Module
Business Portfolio
Investment Valuation/Evaluation
Organization Structure
Measurement (Strategy)
Resource Allocation
Planning
Life Cycle

PUBLIC REPORTING

Financial Reporting Valuation
Internal Control Valuation
Executive Certification
Taxation
Pension Fund
Regulatory Reporting

OPERATIONAL

Budget & Planning
Product / Service Pricing
Contract Commitment
Measurement (Operation)
Alignment
Accounting Information

How to measure risk

Bank risk Kd:

- Given to you by the bank who will measure ability of business to repay debt and add the specific risk (+ a margin) to systemic risk (LIBOR)
- Ex: LIBOR +300bps

Equity risk Ke:

- Most used model is CAPM : $Ke = r_f + \beta$ (specific return)
- Empirical evidence suggest specific return to be at 4% in equity markets
- Not really relevant in practice and more arbitrary measures are used
  - 9% for equity markets
  - 15 – 25% for private equity
  - More for VC

- Can represent most of the value of the DCF
- Very sensitive to small changes in assumptions

Continuing Value

1 **Exit multiple**

- Simple
- Can be misleading and should be adjusted if the entry multiple incorporate synergies or significantly different state than forecasted at exit (remaining capacity etc)

2 **Perpertuity:**

- CF_{t+1} / (WACC-g)
- effectively implies that RONIC = WACC

Exercises for next time

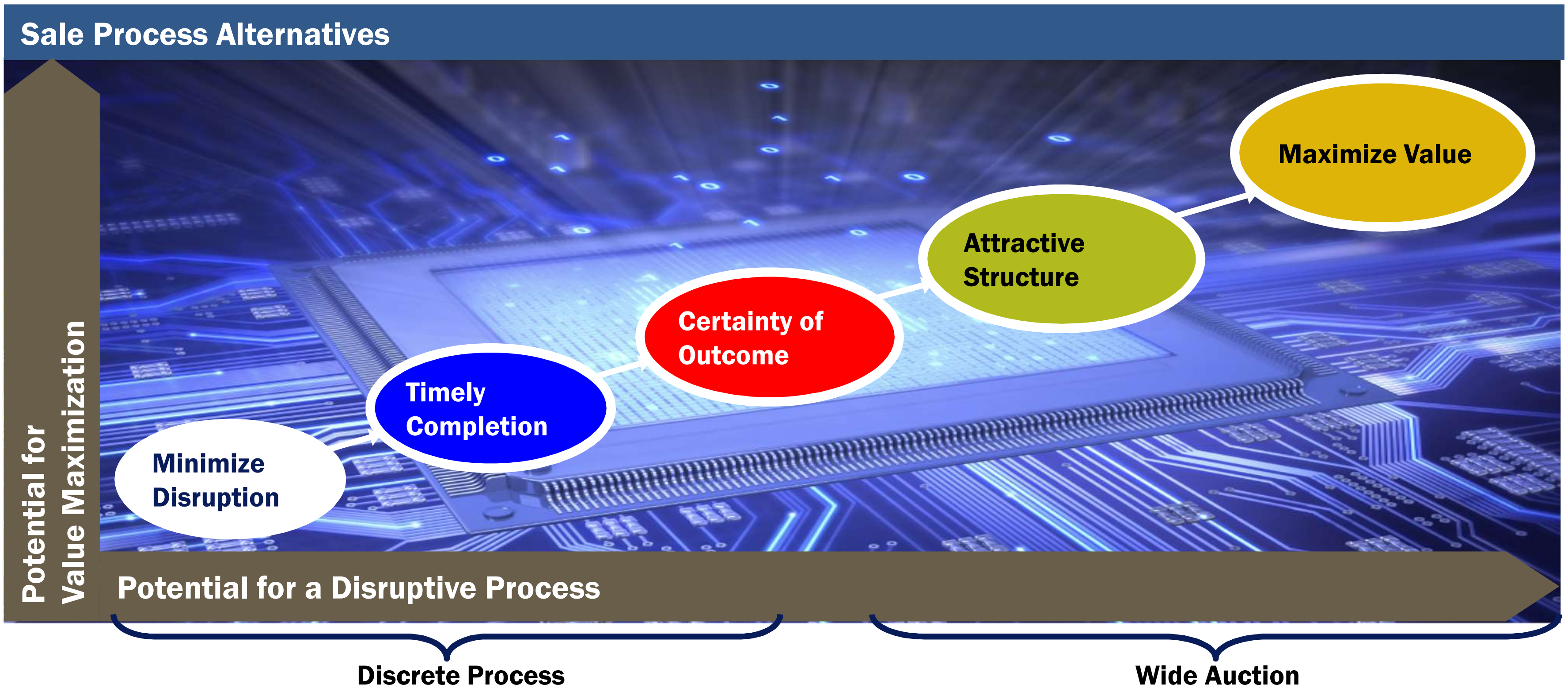
- Can represent most of the value of the DCF
- Very sensitive to small changes in assumptions

- Demonstrate NPV formula given AoA
- Demonstrate Perpetuity formula
- Assuming a company worth $1.0 Bn has $500m of debt what is the value of the Equity. Demonstrate given AoA
- Fin a public company with Investment in associates and minority interest

V. Process Considerations

Process Objectives

- Should a process subsequently and/or ultimately be undertaken, a successful process is typically expedient, minimizes disruption and realizes fair value for shareholders
- In addition to achieving a high value for the assets, one may also desire a discrete and timely process
- Critical to prioritize and find the proper balance between these objectives



Process Considerations

Shorter Process | Longer Process

Priority/Concern?

Value Maximization
Greater access to a larger number of buyers requires significant investment in time and resources to schedule meetings, disseminate information and provide each buyer with sufficient management access to solicit each party's view on value; creates better chance that winning bidder ends up being the party willing to pay the most

Targeted Buyer Universe?
To the extent there is a limited buyer universe, a broad process may not be needed to maximize value, which would also minimize the risks associated with the market, potential leaks, employee distraction and customers/suppliers

Market Risk/Timing
Exposure to an extended time frame increases risk of adverse market events affecting the process; consideration to known holidays and reporting requirements should be factored into timeline

Leaks
Leaks are a risk in any process and increases with the number of people and with the length of the process. Leaks can be disruptive to process - buyers walk, volatile share price, undue distractions

Employee Impact
Employees directly involved in the process will find that a majority of their time will be consumed with activities outside their day-to-day duties; a lengthy process may increase the risk of rumors and leaks and may adversely affect other employees and create uncertainty over future

Customer/Supplier Impacts
In addition to general business distraction, customers and suppliers may react with caution to any news or rumours of a change in control. Message and method of communication should be tightly controlled, and limited to a very limited number of potential transactions and ideally only immediately prior to singing a definitive agreement

Process Alternatives

- The duration of a process depends on the overall objectives and ultimately the type of process undertaken

Sale Process Alternatives

	Discrete	**Controlled**	**Wide**
	(Discussions with one interested party)	*(Simultaneous discussions with a group of interested parties)*	*(Wide open process with closed-bid deadline)*
Advantages	▪ Very limited disclosure ▪ Minimize the uncertainty to employees and customers ▪ Minimize 'widely-shopped' stigma ▪ More control over process and timetable ▪ Preferred approach of buyers (i.e., exclusivity)	▪ High value for the business while maintaining manageable scope of process ▪ Early indications of interest and price level for the business before proceeding with full process ▪ Flexibility to change process, particularly with regards to selling the business to one buyer or several buyers	▪ If sufficient interest, likely to obtain maximum value ▪ Fairly expeditious process with uniform deadline ▪ Widest exposure to potential buyers
Disadvantages	▪ Negotiation tends to be sequential and can drag on ▪ Difficult to create bidding tension	▪ May not attract complete universe of buyers	▪ Confidential data must be broadly disseminated ▪ Considerable commitment of management time ▪ Requires credible 'walk-away' alternatives ▪ Possible employee disruption

Overview of a 2-Stage Auction Process

Stage 1
Surface Initial Indications of Interest

Preparation Stage

3 - 4 weeks

- Organize process
- Collect data
- Develop potential purchasers list
- Prepare Broadcast Letter/Teaser
- Prepare CIM
- Prepare form of CA

Approach Stage

3 - 4 weeks

- Initial contact made to prospective purchasers
- Signing of CAs/distribution of CIMs
- Management presentation preparation
- Data room preparation
- Solicit non-binding expressions of interest

Due Diligence Stage

3 - 4 weeks

- Determine a short-list of partners
- Short-list candidates
- Reciprocal management presentations
- Reciprocal due diligence
- Pre-acquisition agreement

Negotiation/Closing Stage

3 - 4 weeks

- Negotiate final proposals
- Select winning partner
- Finalize definitive agreements
- Execute definitive agreements
- Closing

Stage 2
Finalize An Agreement With A Selected Party

Appendix

Unsolicited Considerations

Early preparations for an unsolicited takeover bid can significantly enhance the effectiveness of a defence strategy

- **Front Door Approach First** - Buyers prefer to go through the 'front door' in order to source the target's co-operation, the board support on price, and the opportunity for due diligence
  - However, unsolicited offers tend to occur in situations where the bidder may be perceived to be the 'enemy' or where front door overtures have been rebuffed
    - Most initial unsolicited bids are unsuccessful, but ultimately cause a change of control
- **Best Defence** - The best defence against any unsolicited proposal is to have the Company's "full value" already reflected in the marketplace – thus avoiding opportunistic advances
- **Advance Preparation** – When a Company finds itself in a vulnerable position, it would be prudent for the Board to prepare for a potential unsolicited bid
- **Proxy Contest** – Activist shareholders may also see opportunities to push the Board into actions to augment value in short term
  - Not necessarily aligned with all shareholders as their interests are short term in nature

Defence Preparation

- **Understanding Alternatives** – An appropriate Board response will only be possible if the Board has a full understanding of all of the company's alternatives as early in the defence contest as possible
  - Ideally _prepared in advance_ of receiving a hostile bid
  - *Time* to respond to an unsolicited bid _can be very limited_
  - True alternatives to an offer must be more favourable to shareholders
- **Preparation** – An appropriate defensive strategy prior to receiving an unsolicited bid would include a preparation stage to establish key elements of the current environment:
  - Clearly _understand value proposition_
  - _Communicate message_ to market
  - _Identify_ likely suitors and _White Knight candidates_
  - Be prepared to _review business in detail_

Shareholder Value Team

- **Shareholder Value Team** - Identify legal and financial advisors to work with senior management and the Company's Board or independent committee (a "Shareholder Value Team") to carry out the necessary analysis and planning functions
- The Shareholder Value Team should undertake certain initial preparations, including:
  – Review existing protection mechanisms (shareholder rights plan, key contracts, etc.);
  – Consider structural initiatives and their role in any hostile take-over attempt;
  – Identify and analyze potential strategic partners; and
  – Initiate a "share watch" program to monitor trading of the Company's shares
- In addition, the Shareholder Value Team should participate in the Company's business review and initiatives to maximize value
- The Shareholder Value Team should have the confidence of the Board of Directors and the authority to respond quickly in the face of an unsolicited bid or proposal
- In response to an unsolicited bid or proposal, the Shareholder Value Team should quickly assess the strategic objectives of the offeror, estimate its maximum price payable, and analyze all aspects of any proposals

Defense Preparation

Before any bid is received, the Shareholder Value Team can take considerable steps towards an unsolicited defence review, and save valuable time should an unsolicited bid surface

Identify Shareholder Value Team

- Key management, legal, financial, and PR advisors
- Consider potential candidates for a special committee

Establish Market Intelligence Program

- Monitor share trading to detect unusual activity; may provide early warning
- Identify key relationships: regulatory, political, customer, supply, lender notification/briefing requirements
  - Relationships should be established in advance to be able to act immediately, if and when required
- Review shareholders' rights plan
  - Buys time

Proactive Investor Relations Program

- Receive and respond to calls, record source and nature of calls, monitor catalyst groups
- Ensure shareholder sentiment is communicated to Shareholder Value Team

Update Business Plan

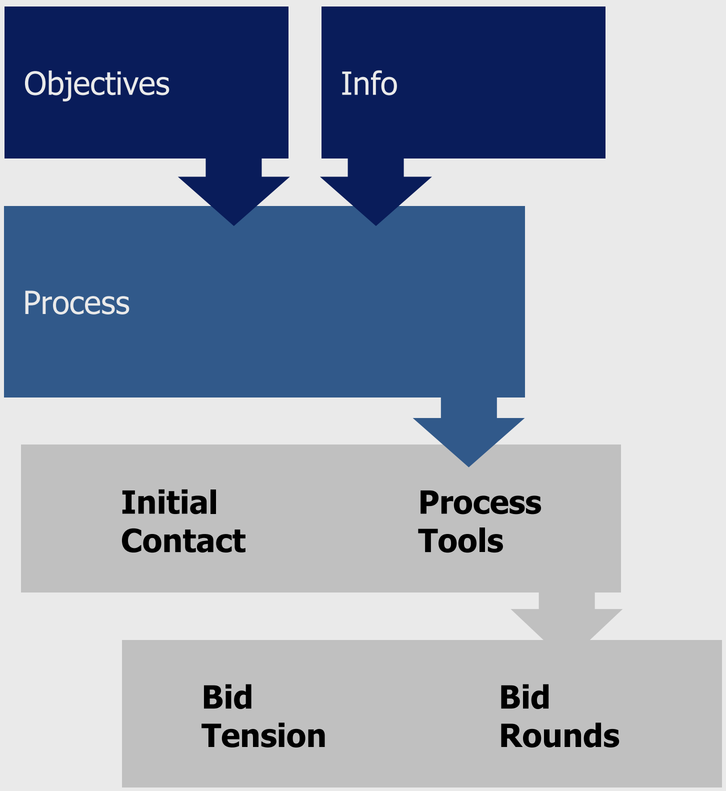
- Update business plan and conduct detailed business and financial review
- Due diligence will be done both by the Company and a White Knight to assess value
- Effective data rooms take time to assemble, which should be spent pre-bid

Identify Potential White Knights

- Refine list of potential White Knight candidates and determine the Company's value proposition to each (ability to pay/synergies, financial capacity analysis, strategic value)
- Focus on the most likely White Knight candidates to maintain credibility and efficiently manage time demands
- Potentially maintain non-threatening dialogue with industry leaders (facilitates first call)

Planning Stage

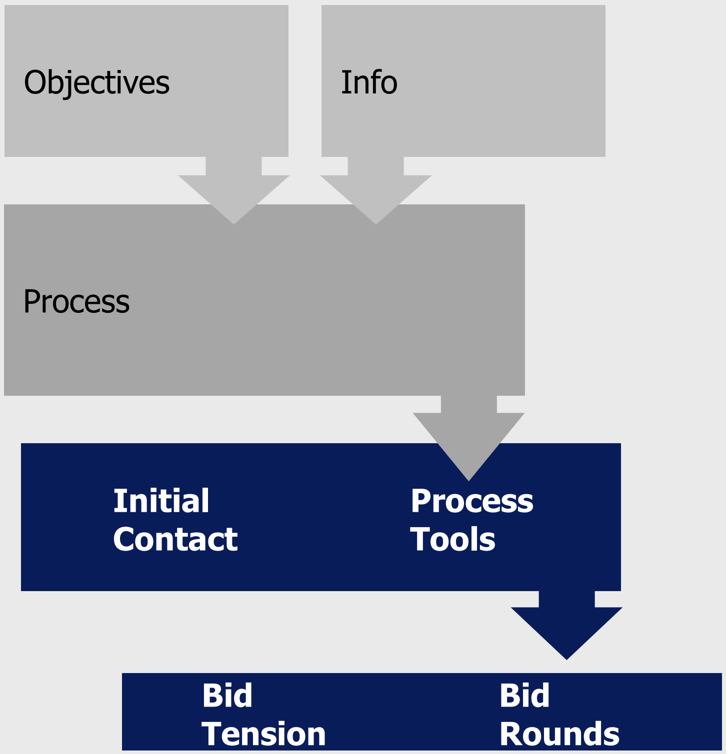
- **The initial solicitation and screening will be structured to produce a sufficient range of qualified bidders so as to establish a competitive process**



- **Tactical Objectives**
  - Once a group of prospective purchasers has been selected, the objectives become:
    - Solicit expressions of interest
    - Create urgency and tension by controlling buyers and maintaining a parallel process
    - Develop negotiating strategies
    - Pursue most serious buyer
    - Verify candidates' financial capacity
    - Engage in negotiations
- **Information**
  - Information is a tool used to motivate the buyer to bid with confidence
  - The seller should produce high quality and accurate information
  - It is materially more difficult to motivate a buyer to submit an aggressive offer when the quality and accuracy of the information cause the buyer to be less confident and less certain about the prospects of a business
- **Process**
  - Process should not impair the buyers' willingness to bid aggressively
  - The sale process should be honest, fair and equal to all participants
  - All qualified bidders should receive the same information, should have adequate time to evaluate the information and equal access to the key participants in the process. Otherwise, certain bidders may choose not to participate to the full extent, or not aggressively
  - Management conflicts need to be addressed prior to launching the auction

Approach Stage

- **The approach will be made once the planning stage is complete, and solicitation will be done in a manner to facilitate a process consistent with tactical objectives**



- **Initial Contact – Canaccord Genuity will initiate**
  - Approach approved buyers at senior level, as appropriate
  - Focus attention on opportunities presented by the Company
- **Process Tools**
  - If a prospective buyer's level of interest is sufficiently high, the initial call from Canaccord Genuity will be followed by a selling packet containing:
    - Broadcast Letter/“Teaser”;
    - Confidentiality Agreement; and
    - Procedures Memo
- **Bid Tension**
  - Competition is a critical ingredient to developing full value for an asset
- **Bid Rounds**
  - A multi-phased process generates more aggressive bids
  - A process which requires multiple indications of interest coupled with greater selectivity can generate incremental levels of aggressiveness with each phase (need to weigh against perception of a “never ending” auction)
  - Clearly the appropriateness and extent of employing this approach is function of the level of interest

Process Tools

1 Broadcast Letter/ Teaser

- A summary of the opportunity and key selling points sent immediately following initial contact with a potential purchaser
- Entices potential interested parties into the auction process

2 Confidentiality Agreement

- Binds both parties to maintain confidentiality of the materials exchanged and nature of the process
- Controls public disclosure and restricts discussions among competing purchasers

3 Confidential Information Memorandum

- Detailed document articulating and supporting key selling points, business plan, financial forecast to assist a purchaser in evaluating the opportunity and assessing value in light of public information available

4 Management Presentation/Data Room

- Access to confidential materials/ management and employees
- Reduces transaction risk to buyer and allows better evaluation of synergies

5 Exclusivity

- Buyer may pre-empt process and ask for period of exclusivity to negotiate a transaction
- May be provided at a late stage in the auction in return for an improved value or structure

6 Definitive Agreement

- Negotiations will ultimately result in finalizing terms in a Definitive Agreement
- It is important for management to remain open and uncommitted to all opportunities in order to help maximize value
- May help if there are regulatory issues

7 Shareholder Lock-up

- Potential buyers will want a commitment from the key shareholders to sell at a specified price

1	2	3	4	5	6	7
Broadcast Letter/ Teaser	Confidentiality Agreement	Confidential Information Memorandum	Management Presentation	Exclusivity	Definitive Agreement	Shareholder Lock-up