

Paradoxes, Problems, and Opportunities

by Bob Shoniker

There's a paradox that exists in Canada's venture capital and private equity industry: There's an abundance of deals but a dearth of funding in the Venture Capital sector, and an abundance of capital but a dearth of deals in the Private Equity sector. So now what happens?

Obviously there is no quick fix for the lack of venture capital funding. The National Angel Organization has a personal tax credit initiative that has gained limited but nevertheless promising traction in a few provinces. Yet, provincial deficits largely preclude enthusiastic support of new tax credits. Meanwhile, the feds have the same fiscal problem.

Some very modest amounts of new venture funding have appeared, with Mantella Ventures (\$20 million), Real Venture (\$45 million), J.L. Albright (\$150 million), Van Edge (\$100 million), and a few others. We expect BDC to be back in business this year now that their new strategic plan has been approved. Clearly these initiatives are not enough to offset the disappearance of the Labor Sponsored Funds as Canada's primary source for venture funding.

What can be done?

We have two ideas: First, turn aerospace/defense spending "offsets" into a source for venture funding. Offsets are the Canadian content that a foreign supplier promises to deliver when winning a federal government defense or security contract greater than \$100 million. The IRB Directorate manages offsets, which are called Industrial or Regional Benefits. This Directorate currently manages more than \$17 billion worth of IRB commitments, and this amount is growing as new projects come online.

Amongst the stated objectives of offsets (IRB) are high quality, high value-added technology and services; and lasting economic value and wealth-generating capacity. Investing in a Canadian high technology venture fund would certainly seem to fit these requirements, and both venture funds Quorum and iNovia have been recipients of IRB funding. Unfortunately, the IRB directorate currently only allows a maximum of 8% of an IRB requirement to be in an investment in a Canadian technology venture capital fund. This might be enough to be a lead order, but it's not really enough to be meaningful or especially helpful. If the 8% rule was changed to 25-30%, then we might see serious new funding for venture capital.

Our second suggestion would be to convince successful Canadian corporations to sponsor industry- or sector-specific venture funds. There are a *few* corporate venture capital funds in Canada, but they are in-house funds for companies like Rogers, Shaw, and Telus. Would a financial institution want to invest in venture capital along side of a successful corporation? We believe they would be happy to do so; for example, RBC joined RIM and Thomson to create a wireless-specific fund. So how about getting financial institutions interested in a Bombardier or CAE-led aerospace fund? Or a Corus or Astral Media led digital media fund? We think corporate-sponsored, industry-specific funds would begin to bring the institutional investors back to funding venture capital in Canada.

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Head Space

Last year we recommended *The \$12 Million Stuffed Shark: The Curious Economics of Contemporary Art*. Now, entertainer/actor Steve Martin has written a very entertaining novel about the contemporary art market from a dealer's perspective. *An Object of Beauty* is a good cottage read. Another good cottage book is Ian Rankin's *Complaints*, which is a murder mystery dealing with unscrupulous real estate developers and Scotland Yard's Special Investigation Unit.

On the business front, *Start Up Nation: The Story of Israel's Economic Miracle* by Dan Senor and Saul Singer, provides a brilliant overview of how Israel in 60 years has become one of the top nations in terms of innovation and entrepreneurship with more companies listed on the NASDAQ than all of Europe.

A more challenging and thought provoking read is Nicholas Taleb's *Black Swan Events: The Impact of the Highly Improbable*. "Black Swans" are events that are thought to be so unlikely as to be impossible or irrelevant. As a result, when they happen, they are a major surprise (to the observer) and can produce major disaster. After the fact, such events are rationalized as being caused by forces that couldn't have been expected, or that are now included in future planning. The two most notable recent Black Swan events are the 9/11 bombings and the collapse of the sub prime mortgage market in the USA. This book provides solid insights into how to spot—and avoid—Black Swan thinking.

Two years ago we recommended reading *Inside Steve's Brain*, by Leander Kahney. Given that Steve Job has taken a health leave of absence from Apple, it's time to reread this book. It will probably convince you to short Apple shares if Steve Jobs doesn't return to the company.

For a much broader view of what happened in 2008, read *The Creation*

and Destruction of Value: A Globalization Cycle. Author Henry James is a professor of history and international affairs at Princeton, and this book traces the many similarities between today and the Crash of 1929 and subsequent Great Depression. He also offers prescriptions on how to avoid that end result. This is not a difficult read, although occasionally technical, but absolutely a valuable wake-up call, especially for policy-makers and investors.

Another book for those willing to look at hard truths is *Water: The Epic Struggle for Wealth, Power, and Civilization* by Steven Solomon. Two-thirds of this book is a fascinating recital of the history of water, humanity's most precious resource. The remaining third is a discussion of the future of water, and it's not encouraging. Solomon points out that water is much more than just the "new oil", because there are substitutes for oil, but there is no substitute for water. This book will change the way you look at a lot of investment-related issues, like geopolitics, finance, and which industries will prosper and where.

And then, for something completely different, try *The Time Traveler's Wife*, a very impressive first novel by Audrey Niffenegger. It's been turned into a movie, which we haven't seen, but the book is reportedly much better. It's another fascinating "what if" book, but this time the supposition is: What if a man is arbitrarily thrown backwards or forwards in time, without warning? What would his life be like? It's a stunning tour-de-force, with first a very unhappy ending, followed by a much happier ending. It leaves one overriding question: What can Niffenegger possibly do for an encore?

Andy's Picks

We have to start by saying that if you play a musical instrument, or have a budding musician in the family, then you need to check out Andy's new www.rhythmtrainer.com for details of Andy's recently released, must-have iPhone/iPad app for musicians.

Mumford & Sons (folk) – It's rare for an acoustic band from Ireland to explode over both alternative radio and the pop charts without having a song that makes you want to tear your eyes out. These guys do it and do it well: they write great songs that are both catchy and emotionally grabbing.

Jason Lindner, *Now vs. Now* (jazz) – One of the best modern jazz composers to appear in the last 10 years. This album is a serious addition to any jazz fan's collection, yet toddlers seem to like it, too!

Nerve, *Ep's 1,2,3* (electronic) – Exploring the distance between 0 and 1 is what this cutting-edge trio is all about. By using the textures of electronic music with world-class jazz technique, they've created something utterly unique.

The National, *High Violet* (rock) – This thinking man's rock band is back with one of their most ambitious albums to date. Combining top-notch production, creative performance, and introspective lyrics makes for an album you'll over and over again.

Dark Night Of The Soul (rock) – A concept album between film maker David Lynch, rock group Sparklehorse, and super-producer Danger Mouse. With guest vocalists on every song, it plays like the soundtrack to a film that you can watch in your head. \$\$\$

In Search of Yield:

An Opportunity?

With interest rates continuing to be low and unattractive, investors are seriously searching for yield. In 2010 there were 16 high yield secured second lien or unsecured notes issued by Canadian public companies that raised \$3 billion with interest coupons in the 7-9% per annum range.

In recent months this search for yield has moved into the private company debt market with the creation of "business finance" and high yield private placement funds that are targeting income returns of 10-12% per annum. By our calculations more than \$500 million has been sourced predominantly from retail investors. Most of these specialty funds have a substantially shorter shelf life than a traditional institutionally funded mezzanine partnership. For the retail investor (and his broker/financial planner) three years is a lifetime. Consequently, they are funding bridge loans, second lien debentures, and subdebt with less than a 36 month term. Most funds have a minimum hurdle rate of 8% per annum before a 20% performance fee kicks in for the managers.

Even though we expect interest rates to rise later this year, the search for yield will continue unabated. This yield quest is an opportunity for cash strapped funders to reposition themselves by creating specialty high yield funds with laddered maturities of 3 to 5 years targeted to the retail investor. With the right sponsorship and track record, tens of millions of capital could be raised. Given the current lack of available mid-market junior debt, these new funds would have no difficulty in finding quality deal flow. **\$\$**

The "D" Factors

in Selling and Buying a Boomer Business

Increasingly we are seeing articles about the half a million baby boomers who own private companies that are going to either change ownership or leadership over the next decade. By and large, the boomer entrepreneurs that we deal with aren't overly excited about either exiting their business through the outright sale or bringing in professional management to take the helm. They think and act as if they are 50 not 60 years old. They like the status quo.

Over the last five years we have been involved in several aborted transactions that involved an ageing entrepreneur who said he wanted to sell his business. It has led us to:

1) Create a publication targeted to potential sellers. A few years ago, we published, "*When Should You Sell Your Business?*" as a guide to the prospective clients. (Please contact us, if you would like to have a copy.); and

2) The creation of "The "D" Factor" analysis. From now on, we will take on divestiture assignments of founding, aging boomers only under the following circumstances:

Death

A health scare is not enough; we've had too many entrepreneurs miraculously feel incredibly better and unwilling to complete a sale once one is in prospect. We mean DEATH. Their estate is almost certain to be a willing seller. We haven't encountered too many situations where the deceased entrepreneur has been able to control the decision to sell the business from the grave.

Divorce

There are two types of divorce situations that create a transaction; namely, marital divorce and shareholder divorces/disputes. Both of these situations are acrimonious and time sensitive, but a deal will be done. **\$\$**

Despair

These are tough deals, as this entrepreneur has made the BIG mistake of not selling when his business was thriving. His despair is experiencing a declining shareholder value coupled by the likelihood that his "friendly" banker wants an equity infusion. Black despair is the banker calling the loan. These are difficult deals to complete, as, more times than not, the businesses need a brain infusion as well as a balance sheet fix.

Divestiture

This is our favourite "D" Factor, but realistically it doesn't pertain to a selling founder but rather a corporate sale of a non-core asset, or a private equity investor's sale of a portfolio company. These sellers are committed and serious. The odds that a deal will be completed are high.

Conclusion

Over the next five years, we should begin to see increasing deal flow from the aging baby boomer. A succession consultant recently told us that his succession seminars are beginning to attract growing numbers of aging entrepreneurs who aren't yet ready to sell, but want to prepare for a possible sale in two or three year's time. Meanwhile, our advice to potential buyers and equity sponsors is to pay attention to the "D" Factor when considering the purchase of a privately owned boomer business. It takes a willing seller to do a deal, and most founding entrepreneurs are, at best, reluctant sellers as their persona and egos are wrapped up in the business. Look for a selling, serial entrepreneur. They like to create shareholder wealth, and a liquidity event is their scorecard. **\$\$**

Now let's turn to the Canadian private equity paradox of lots of cash, and no deal flow. Fundamentally, the problem is public-versus-private company valuations. While the stock market has recovered sharply since its low of December in 2008, ebitda multiples for good-sized, healthy Canadian private companies are at best 6 times up, from 5 times at the bottom. Yet in the U.S.A., American private equity investors are once again outbidding industry buyers at multiples of up to 9 times ebitda.

Why the difference?

The simple answer is access to debt funding. The American private equity firms are taking advantage of low, long-term interest rates, and a buoyant private junk bond market to fund their deals.

In Canada, the senior banks have cautiously crept back to 2 times ebitda for senior debt. Unfortunately, the independent mezzanine market is virtually dead, with two of its major sources going out of business through the lack of new capital, and the last remaining independent source beginning to be tight for active funding. At least three of the banks have active in house mezzanine funds, but they primarily focus on bank client deals of \$5-20 million. So there's opportunity here: the competition is limited, and if you are in a position to sponsor either mezzanine funding, or private equity deals, you're in a position to enforce the Golden Rule of Finance: He who has the gold, makes the rules. A Canadian-sourced mezzanine deal would be done at best at 1.5 times ebitda, and as all venture-some investors will tell you, you make your money on the buy. This is a time when you could have the market almost to yourself.

Likewise, leveraged buyout debt deals can be done at 3.5 times ebitda instead of the 5- to 6-times multiples common five years ago. And since there's no private junk bond market in Canada, to attain the normal 25% IRR mark, the Canadian private equity investor won't bid any higher than they are doing now at 5 to 6 times ebitda.

Until we have more robust debt (especially mezzanine) sources, the private equity paradox will remain. There's real opportunity here for someone with courageous capital to step forward. \$\$

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Deal Seekers

We are in a market where there are more deal seekers than mid market deals. Specifically we have the following potential funders/buyers:

Investor "A" is seeking intermediate term sub debt or bridge financing opportunities greater than \$5 million. No industry or geographic preference.

Investor "B" is a privately controlled Toronto based buyout firm that is seeking to acquire and actively manage a traditional business that is located in the greater Toronto area. The ideal opportunity will have EBITDA of \$1-4 million and would be a platform for scalable growth.

Investor "C" is also a privately owned Toronto based buyout firm that is the investment arm of a very successful management consulting company. They are seeking control positions in growing or stable niche markets. They are want opportunities where their consulting expertise can be leveraged. Deal size is \$10 to \$20 million with an equity interest ranging from 55% to 100%

Investor "D" is a buyout fund seeking distressed or vulture opportunities. Minimum deal size \$5 million. No real estate, resources or retailers. \$\$

Deal Flow

These potential deals are not assignments but rather deal opportunities that have found their way into our office over the last month or so. Call us for details.

Startups:

- Patented food technology company seeking \$1.5 million of equity as part of a \$5 million raise to buy equipment and for working capital.
- Patented advanced composites developer/producer seeking \$1 million for working capital to fulfill significant initial orders.
- Entertainment producer seeking \$15 million to develop 3D content/library for contracted worldwide 3D cinema network.
- Integrated natural beef cattle operations seeking \$75 million of dollars to acquire substantial amount of farmland, cattle and a meat packing facility

Early stage:

- Branded ethnic food marketer seeks a \$1million from a strategic investor to leverage current listings and growth opportunities.
- Specialty premium price beverage company seeks \$1 million to grow both the domestic and American market opportunities.
- Small established fire optic network operator is seeking \$10 million of near equity to buildout its network to meet long term contractual demand from data service, cellular and telcos. \$\$