Barriers to Private Equity Investment in Small and Medium-sized Businesses

Summary of discussions

November **2018**

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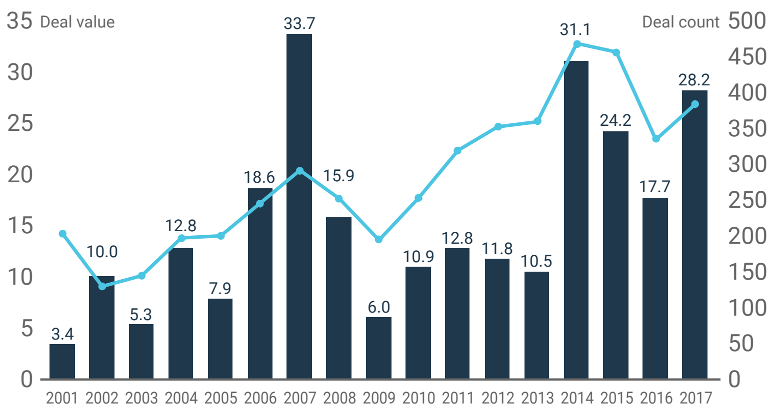
1. Context

In the summer of 2018, BDC partnered with the Canadian Venture Capital & Private Equity Association (CVCA) to organize three industry roundtables to assess unmet needs for private equity (PE) investments among small and medium-sized businesses and how BDC might help to address these needs. The meetings in Calgary, Toronto and Montreal were held in the context of demographic and industry trends that may be leading to a shortage of PE for small to medium-sized businesses.

Over the last two decades, the Canadian private equity (PE) market for growth capital and buyouts has grown appreciably in terms of number of deals, amounts invested and the number of active Canadian and foreign funds (See Graph 1). Returns from this asset class have been very positive,[1] leading to a steady increase in fund size and number of funds raised.

Graph 1: PE investment activity in Canada, 2001–2017

$ in billions, number of PE deals



Note: Canadian PE includes the following types of deals: control stake, minority stake, add-on, mezzanine, private investment in public equity, restructuring and other. The number of PE deals includes disclosed and undisclosed deals.

Source: Thomson Reuters.

While the global financial crisis of 2008–10 badly hurt the PE market, it has recovered well in recent years with the number of deals and amounts invested increasing significantly between 2013 and 2017.

Despite this strengthening, some observers believe there continues to be unmet needs for PE at the lower end of the market due to the following factors.

- An expected strong increase in ownership transitions should raise demand for growth equity and buyout investments, especially among small businesses.
- Institutional investors appear to be withdrawing from smaller PE funds because these investments are not large enough to meet their requirements. This may be reducing the supply of capital for smaller deals.

1 According to the latest available data from Thomson Reuters, as of June 30, 2013, the 10-year horizon return was 14.8% for Canadian private independent buyout and mezzanine funds, and 10.9% for U.S. buyout and mezzanine funds.

A strong increase in the number of ownership transitions

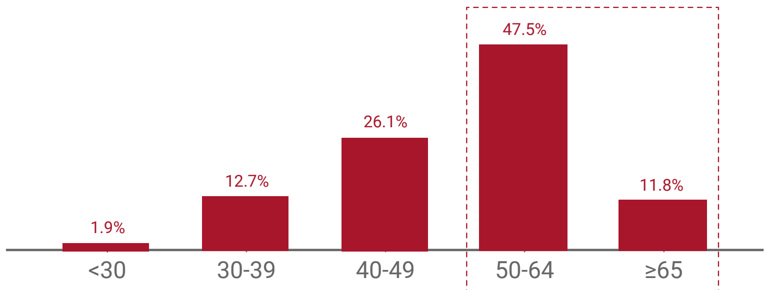
A key concern for policymakers and economic development agencies is to create a financial environment that supports business ownership transitions so the value created over the course of entrepreneurs' careers can be preserved.

Currently, the number of ownership transitions that will likely require external financing is rising for the following reasons.

- The baby-boom generation of entrepreneurs is reaching retirement age. According to Statistics Canada, 60% of owners of Canadian small and medium-sized enterprises (SMEs) were 50 or older in 2014, and 12% of them were at least 65. (See Graph 2.)
- As a result, the number of business owners planning to retire is increasing rapidly. According to similar surveys by the Business Development Bank of Canada (BDC) and the Canadian Federation of Independent Business (CFIB), the percentage of owners planning to exit their business within five years grew from 37% in 2011 to 49% in 2017. (See Graph 3.)

Graph 2: Age distribution of SME owners in Canada, 2014

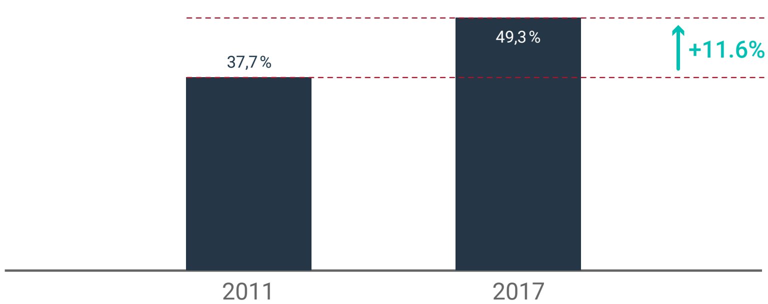
% of survey respondents



Source: Statistics Canada, *Survey on Financing and Growth of Small and Medium Enterprises* (Ottawa: Statistics Canada, 2014).

Graph 3: Intention of Canadian SME owners to exit their business within 5 years, 2004–2017

% of survey respondents



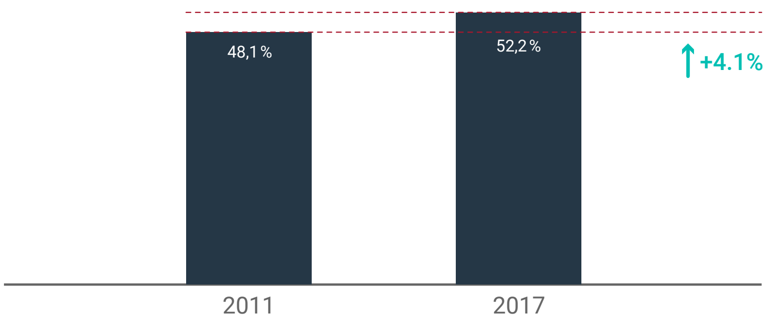
Note: Exit is defined as selling, transferring or winding down a business.

Sources: CFIB, *Passing on the Business to the Next Generation* (Ottawa: CFIB, November 2012); BDC, *The Coming Wave of Business Transitions in Canada* (Montreal: BDC, 2017); and BDC, *What Do Buyers Look for When Purchasing a Business?* (Montreal: BDC, 2017).

- At the same time, the percentage of owners intending to sell to non-family members grew from 48% in 2011 to 52% in 2017. (See Graph 4.)
- Taken together, these findings indicate the percentage of business owners intending to sell within five years to non-family members increased by 50% between 2011 (17%) and 2017 (25%).
- BDC research indicates that the larger the business, the greater the likelihood the owner plans to sell to non-family members. In 2017, the percentage of exiting owners intending to sell to non-family members was almost 60% for companies with at least five employees, compared to 46% for smaller firms. (See Graph 5.)

Graph 4: Intention of Canadian SME owners to sell their business to non-family members, 2004–2017

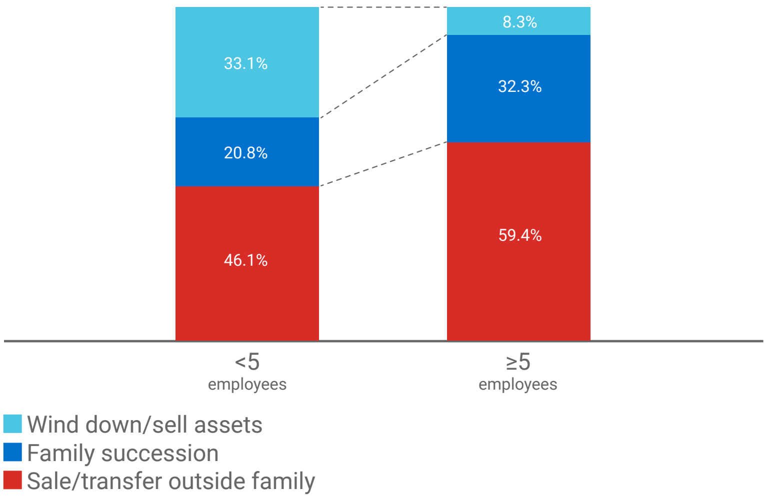
% of survey respondents



Sources: CIBC, *Are Canadian Entrepreneurs Ready for Retirement?* (Toronto: CIBC World Markets, 2005); CFIB, *Passing on the Business to the Next Generation* (Ottawa: CFIB, November 2012); BDC, *The Coming Wave of Business Transitions in Canada* (Montreal: BDC, 2017); and BDC, *What Do Buyers Look for When Purchasing a Business?* (Montreal: BDC, 2017).

Graph 5: Business transition strategies of Canadian SME owners, 2017

% of survey respondents



Sources: BDC, *The Coming Wave of Business Transitions in Canada* (Montreal: BDC, 2017); and BDC, *What Do BuyersLook for When Purchasing a Business?* (Montreal: BDC, 2017).

To sum up, a growing number of retiring business owners intend to sell their business to non-family members within the next five years. This demographic trend should increase demand for investment by PE funds.

There are 228,000 SMEs with five or more employees in Canada.[2] If about 30%[3] of them are sold to non-family members within five years, as anticipated in the BDC survey, 67,000 companies overall (13,400 per year) will change hands. However, the number of Canadian PE deals in all categories, including ownership transitions, totalled just 603 in 2017,[4] which leads to the following conclusions.

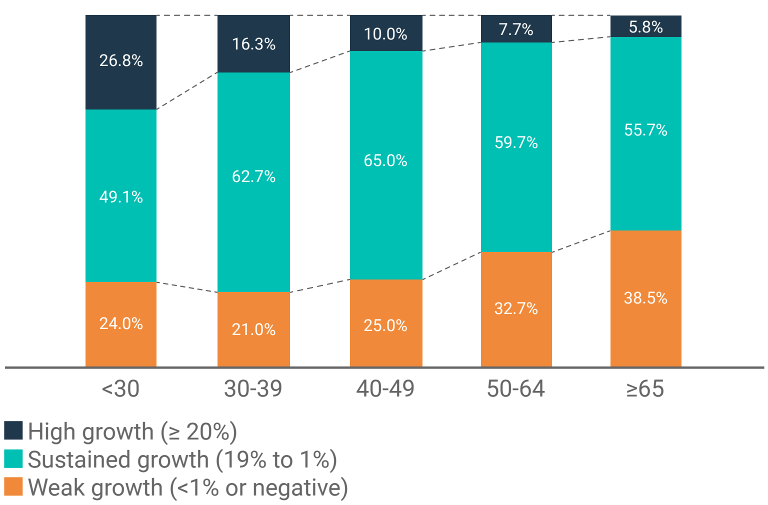
→ The number of potential ownership transitions which is growing could represent a huge growth opportunity for PE investors, although specific conditions are necessary to be met for PE funds to participate in such investments.

→ Increasing the number of transactions could both bolster the PE market and support more ownership transitions.

According to Statistics Canada, SMEs whose owners are 50 or older tend to grow more slowly than other SMEs (See Graph 6). As a result, making it easier for owners to sell should have a significant positive impact on economic growth.

Graph 6: Average yearly growth in sales/revenues for Canadian SMEs, by age of owner, 2014

% of survey respondents



Note: The growth rate shown is the average annual revenue growth rate over the preceding three-year period.

Source: Statistics Canada, *Survey on Financing and Growth of Small and Medium Enterprises* (Ottawa: Statistics Canada, 2014).

2 Source: Dun & Bradstreet (2016). The SME count excludes companies with an unknown number of employees, firms ineligible for financing, and the offices of doctors and other professionals. According to Statistics Canada, there were 1,167,978 SMEs in Canada in 2015.

3 Assuming 49.3% Canadian SME owners intend to exit in the next five years, and that 59.4% of the companies with more than five employees will be sold to external buyers, we could expect that in total 29.3% of business owners in Canada could be looking to sell to third parties in the next five years.

4 Source: Canadian Venture Capital & Private Equity Association (CVCA), VC & PE Canadian Market Overview 2017 (Toronto: CVCA, 2017).

Is there a shortage of capital for small PE deals?

There is anecdotal evidence that fundraising for small PE funds, especially funds smaller than $100 million, has become more difficult over the last decade. Large Canadian institutional investors have withdrawn from this segment, mainly because these investments are too small for them.

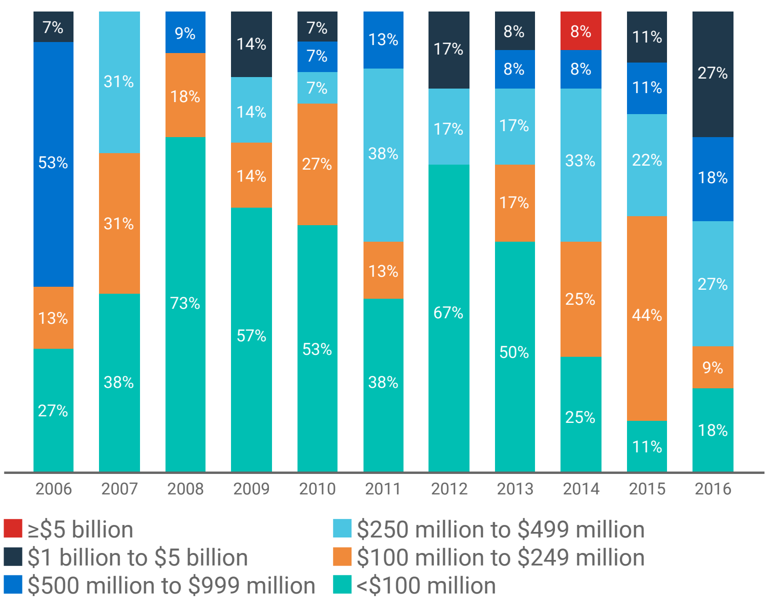
Statistics on the Canadian PE market are incomplete, making it almost impossible to analyze trends in detail—notably, those related to deal size—and draw reliable conclusions. As a result, much of the following analysis is based on surveys and industry roundtables.

However, two quantitative results extracted from PitchBook and CVCA databases are worth noting.

→ According to PitchBook, funds smaller than $100 million comprised over 50% of all Canadian PE funds raised in every year, but one, between 2008 and 2013. However, the proportion fell to 11% in 2015 and 18% in 2016. While this trend is cyclical—it was harder to raise large amounts during the global financial crisis and its aftermath—it nevertheless shows the difficulty of raising smaller funds at present. (See Graph 7.)

Graph 7: Canadian PE fundraising, by size, 2006–2016

% of number of funds raised

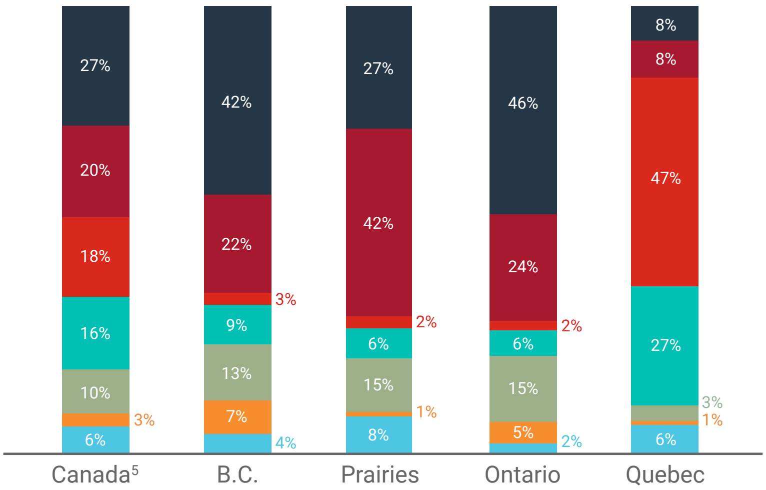


Source: PitchBook, *1H 2018 Canadian PE & VC FactBook* (Seattle: PitchBook, 2018).

→ Types of investors active in PE deals vary significantly by region. In the Prairies and Ontario, the most active investors are foreign, followed by Canadian independent PE funds. In Quebec, government and institutional funds are the main players. (Once again, databases are incomplete, but differences found in this partial data are significant.) Accordingly, responses to unmet needs among small businesses may differ strongly by region. (See Graph 8.)

Graph 8: Participation rate, Canadian PE deals,[1] by investor type, 2014–17

% = normalized participation rate[2]



1 Canadian PE deals include buyout, add-on, growth, debt, privatization and follow-on deals (excluding infrastructure and other deals).
2 Participation rate is the number of deals with a specific investor type/(normalized) number of PE deals; data include disclosed and undisclosed deals.
3 Institutional investors are Canadian asset managers, pension funds, banks, insurance/brokerage companies, funds of funds, LPs and credit unions.
4 Undisclosed includes undisclosed deals made by Canadian and other investors.
5 Participation rates for Canada include all provinces. Due to lack of data and small sample size, no separate analysis was done for the Atlantic region.

Source: CVCA Infobase, team analysis.

Questions discussed at the roundtables

As mentioned above, BDC partnered with CVCA to organize roundtables in the summer of 2018 with market players in Calgary, Toronto and Montreal. The goal of this exercise was to assess unmet needs for private equity investments in small and medium-sized businesses, and how BDC might help meet those needs.[5] The following questions were discussed.

- To what extent is there a shortage of institutional capital for small PE funds?
- Is demand for small PE investments rising due to ownership transitions?
- Are there unmet needs at the lower end of the PE market?
- Are pledge funds and search funds a default solution or the right answer?
- How important are investment readiness and matchmaking?
- Could minority investments be part of the solution?
- What are the regional dimensions of the issue?

In organizing the roundtables, BDC recognized that responses to the questions might vary by sector, region and type of investment (for instance, majority versus minority, ownership transition or expansion).

5 Roundtable participants are listed in the appendix.

2. Summary of roundtable discussions

To what extent is there a shortage of institutional capital for small PE funds?

Participants in the three roundtables largely agreed it is currently very hard—much harder than 10 to 15 years ago—to raise Canadian PE funds smaller than $150 million for the following reasons.

- Large Canadian pension funds no longer invest in this market segment as limited partners (LPs) because it is too small for them. They focus on direct investing (to avoid the need to pay fees to an external manager) and on investing in large PE funds that generate less volatile returns and give them access to large co-investment opportunities. Even intermediate-sized pension funds (with between $20 billion and $50 billion under management) are not writing cheques for less than $50 million.
- Smaller pension funds usually have no alternative asset allocation and lack the sophistication and internal capacities needed to invest in this asset class.
- Unlike the U.S., Canada has only one fund-of-funds—Northleaf Capital Partners—that can manage large pension fund programs targeted to small PE funds (such as the program it manages for the Canada Pension Plan Investment Board), or manage PE allocations from smaller pension funds.
- In the U.S., unlike in Canada, the following factors support the PE market.
  - University endowments are important sources of PE capital.
  - There are many sophisticated investors (wealthy individuals and family offices) willing to invest outside public markets. Some will make the bold move of becoming anchor investors in PE funds.
  - There are important regional sources of PE capital.

In all three roundtables, participants provided anecdotal evidence of institutional investors that had invested in funds smaller than $200 million in the 1990s and 2000s but did not re-invest in subsequent funds because they wished to write larger cheques. This puts pressure on fund managers to either increase the size of their fund and looking for larger deals or look for other sources of capital (such as family offices, high-net-worth individuals and foreign investors).

Is demand for small PE investments rising due to ownership transitions?

There was a consensus in all three roundtables that ownership transitions are a huge opportunity for PE investment. Several participants mentioned that most of their deals come from such situations.

At the same time, they also noted important problems of matchmaking (linking the right sellers with the right buyers) and the investment readiness of businesses in these situations. These two dimensions are often intertwined: In many cases, entrepreneurs are not ready, operationally and emotionally, to sell and let go of their business, which makes the matchmaking process long, difficult and costly.

Are there unmet needs at the lower end of the PE market?

Answers to this question were complex and sometimes contradictory. Here are the common elements of the responses.

- Due to the shortage of institutional capital in this segment of the market, there are very few small, private, independent PE funds—those using an LP or general partner (GP) model and looking for opportunities below $15 million to $20 million in enterprise value. This seems to be true across the country and particularly in Quebec. (The regional dimension is discussed in more detail below.)
- Over the last five years, the number of pledge funds and, more recently, search funds serving this end of the market has risen dramatically. These funds are financed mainly by family offices, entrepreneurs and high-net-worth individuals.
- Some participants—particularly those working for pledge funds and search funds—said there is no shortage of capital for small PE deals.
- However, there are important problems of intermediation, investment readiness and matchmaking.
  - For economic reasons, consulting firms look for deals larger than $15 million in enterprise value. For smaller deals, intermediation is less efficient and relies on family professionals (such as lawyers and accountants) and brokers.
  - Many small companies are relatively unsophisticated. So, it takes a lot of work to educate an entrepreneur on the process of selling his or her company.
  - It may be a long, difficult and emotional process to persuade the owner of a small company to sell.
  - It takes almost the same amount of work to do a small deal as a larger deal.
- Most of these problems are not new. Some participants mentioned that the number of advisors active in this segment, notably in banks and accounting firms, declined after the global financial crisis, contributing to the challenges in this market. Despite these difficulties, participants insisted this end of the market offers tremendous opportunities for PE investors.

Are pledge funds and search funds a default solution or the right answer?

Roundtable participants agreed that, over the last decade, pledge funds—and, to a lesser extent, search funds—have played an increasingly large role at the lower end of the market.

There are no statistics on these funds. However, pledge fund representatives made up the majority of the private sector participants in the Calgary and Toronto roundtables. They said there were many other similar investors in the market, especially in Toronto.

One Toronto participant who manages a search fund said there might be more than 20 such funds in Toronto, and that he often fields phone calls from people wishing to start one. He believes there is no shortage of people, capital and support systems in Toronto to start such funds. Usually, search funds in Canada focus on deals involving businesses with $1 million to $5 million in earnings before interest, taxes, depreciation and amortization (EBITDA). These deals are usually not recorded in databases.

Participants also discussed whether pledge funds and search funds are a default solution for managers because there are no sources of institutional capital that would allow them to raise formal PE funds. Roundtable participants presented the following arguments.

- The increasing involvement of family offices[6] and entrepreneurs through pledge and search funds has many benefits.
  - These investors not only write smaller cheques but are also more open to first-time fund managers and give them the benefit of the doubt.
  - They are more agile investors than larger funds. They make decisions faster, understand entrepreneurs better and do not need complex reporting.
  - They are better at educating entrepreneurs about ownership transitions, because they have typically been entrepreneurs themselves and are often willing to share their knowledge.
  - They may be able to draw on operational expertise from their entrepreneurial networks.
- Pledge funds and search funds may be better adapted than larger investors to smaller companies for the following reasons.
  - Their decision-making processes and the size of their investments may be more suitable for family offices and high-net-worth individuals, especially since they usually raise funds on a deal-by-deal basis.
  - They have lower management costs, due to their lighter structure and less-stringent reporting mechanisms.

Several participants initially chose to run a pledge fund “by default,” to build the track record required to raise a PE fund in the future. However, given their advantages, some participants said they might continue to operate a pledge fund for the longer term.[7]

On the other hand, participants—sometimes the same ones—also mentioned the following points.

- Pledge funds and search funds may have advantages, but they are not scalable and do not have access to stable pools of capital.
- The number of investors ready to invest in pledge funds has increased greatly, but the number remains small and varies by region.
- There is currently plenty of capital to invest in pledge funds and search funds, but it is unclear what will happen during the next downturn.
- It would be very useful for an institutional investor, such as BDC, to help raise small PE funds by becoming an anchor investor.

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6 There are different types of family offices. Large second- or third-generation family offices behave more like institutional investors. First-generation family offices linked to a successful entrepreneur behave in a more entrepreneurial way with far more direct involvement in deals. Many of the roundtable discussions referred implicitly to first-generation family offices.

7 Shortcomings of the pledge fund model usually make it less attractive to sophisticated LPs. These shortcomings include the lack of a stable source of capital, the uncertainty of deal-by-deal fundraising, the lack of a professional investment team, deal-by-deal carried interest and economics skewed to the GP model.

How important are investment readiness and matchmaking?

There was a strong consensus in the three roundtables that, in many cases, the main obstacle to a successful ownership transition is not the availability of capital, but, rather, the emotional readiness of the owner to sell, the company's suitability for sale and difficulty matching sellers with the right buyers.

Advisors, accountants and investors can help in this area. As already mentioned, small family offices led by entrepreneurs may also be particularly well-positioned to help entrepreneurs because they have already gone through similar processes and may be more patient than larger investors.

However, in many circumstances, the process may still be difficult, long and costly. How to accelerate transitions remains an important issue.

Could minority investments be part of the solution?

Fund managers argued that, in most ownership transitions, the entrepreneur has to let go of the business and, therefore, there has to be a transfer of majority ownership. However, minority investments can be a good way to prepare for a long-term transition and play an important role in intergenerational transitions.

Are there different needs for capital among regions?

Toronto roundtable participants argued strongly there is no shortage of capital or expertise in the market, and that pledge funds and search funds are filling the gap, with an increasing number of entrepreneurs and high-net-worth individuals seeding these funds. At the same time, they said BDC could help the market by acting as an anchor investor in small PE funds.

Calgary roundtable participants also mentioned a surge in pledge funds financed by family offices and entrepreneurs. At the same time, participants said there were too few of these funds to meet the needs of small businesses. They noted many Canadian PE funds handle deals larger than $20 million—and that American PE funds are also attracted to these deals because of lower valuations in Canada—but the lower end of the market is underserved.

The Montreal roundtable had a different tone. Participants agreed there is no overall shortage of capital. However, they indicated there may be a lack of diversification of investors. Government and institutional funds are the main players in Quebec, and they tend to focus mainly on minority investments. There are fewer private sector investors who could bring operational experience and expertise to transitions. Participants also noted the buyout market is less developed, both for independent PE funds and pledge funds.

Roundtables participants

Name	Organization	Type of investor
Warren Raby	RayQuest	Family office
David Albo	Ciel Capital	Family office
Kelly Burke	Sculler Capital	Family office
Elmer Kim	Hyatt Bangia	Family office
David Sherman	Sherman family office	Family office
Ludovic Dumas	Claridge	Family office
Enzo Gabrielli	Horizon Capital (Chamendy Family Office)	Family office
Mark W. Auger	Financière Savoie	Family office
Dave Mullen	Highland West Capital	Family office
Mathieu Gauvin	CDPQ	Institutional Investor
Luc Lapointe	Fondaction	Institutional Investor
Jérôme Nycz	BDC Capital	Institutional Investor
Thomas Park	BDC Capital	Institutional Investor
Patrick Latour	BDC Capital	Institutional Investor
Claude Miron	BDC Capital	Institutional Investor
Alexandra Bonnefoy	BDC Capital	Institutional Investor
Mathew Colucci	PillarFour Capital	LP/GP
Randy Garg	Vistara Capital Partners	LP/GP
Michael McGee	Avrio Capital	LP/GP
Art Robinson	Longbow Capital	LP/GP
Matt Hall	Market Square	LP/GP
David Hass	Brookside Capital Partners	LP/GP
Jared Kalish	FirePower Capital	LP/GP
Martin Kent	Kensington Capital	LP/GP
Peter Samson	Ironbridge Equity Partners	LP/GP
Dominic Bécotte	XPND	LP/GP
Marie-Claude Boisvert	Clearspring Capital Partners	LP/GP
Eric Phaneuf	Walter Capital Partners	LP/GP
Christian Turgeon	BDG & Associés	LP/GP

Name	Organization	Type of investor
Jordan Martel	Sequeira Partners	Mergers and Acquisitions Experts
Samantha Horn	Stikeman	Mergers and Acquisitions Experts
Flora Wan	Deloitte	Mergers and Acquisitions Experts
Christine Pouliot	PWC	Mergers and Acquisitions Experts
Éric St-Pierre	Arma Capital	Mergers and Acquisitions Experts
Jonathan Hudson	Glenbow Capital	Pledge fund/search fund
Andrew Bishop	Bingley Capital Inc.	Pledge fund/search fund
Jeff Block	Evora Equity	Pledge fund/search fund
Noemie Ouellet-Gendron	Namakor	Pledge fund/search fund
Michael Arblaster	CPS Capital	Pledge fund/search fund
Raymond Tam	BTC Partners	Pledge fund/search fund
Dan Forest	Alpine Partners/Datavalet Technologies	Pledge fund/search fund
Mike Woollatt	ACCR	Industry experts
Gilles Duruflé	Independent Expert	Industry experts