



Exit Strategies: How to Create the Wealth in Your Company Now!

Bob Roy
Managing Director, Equity
Roynat Capital Inc.

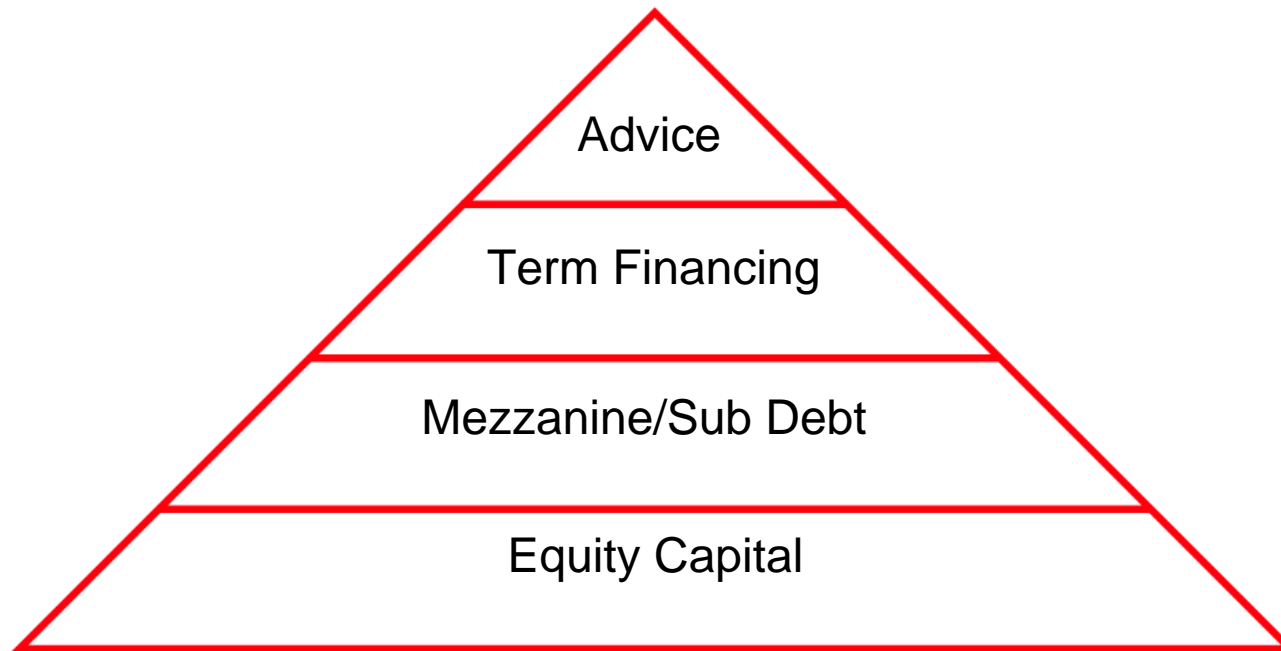
February 23, 2005

Canadian Innovators Forum

Agenda

1. Overview of Roynat
2. Trends in M&A and Financing
3. The “Cram Down”
4. “Let’s Just Sell It”
5. Conclusion

Roynat Capital



An Integrated Approach

Key Statistics

Number of Employees

150 staff

Number of Representatives

100 professionals

Number of Offices

21 locations

Years in Business

Over 40 years

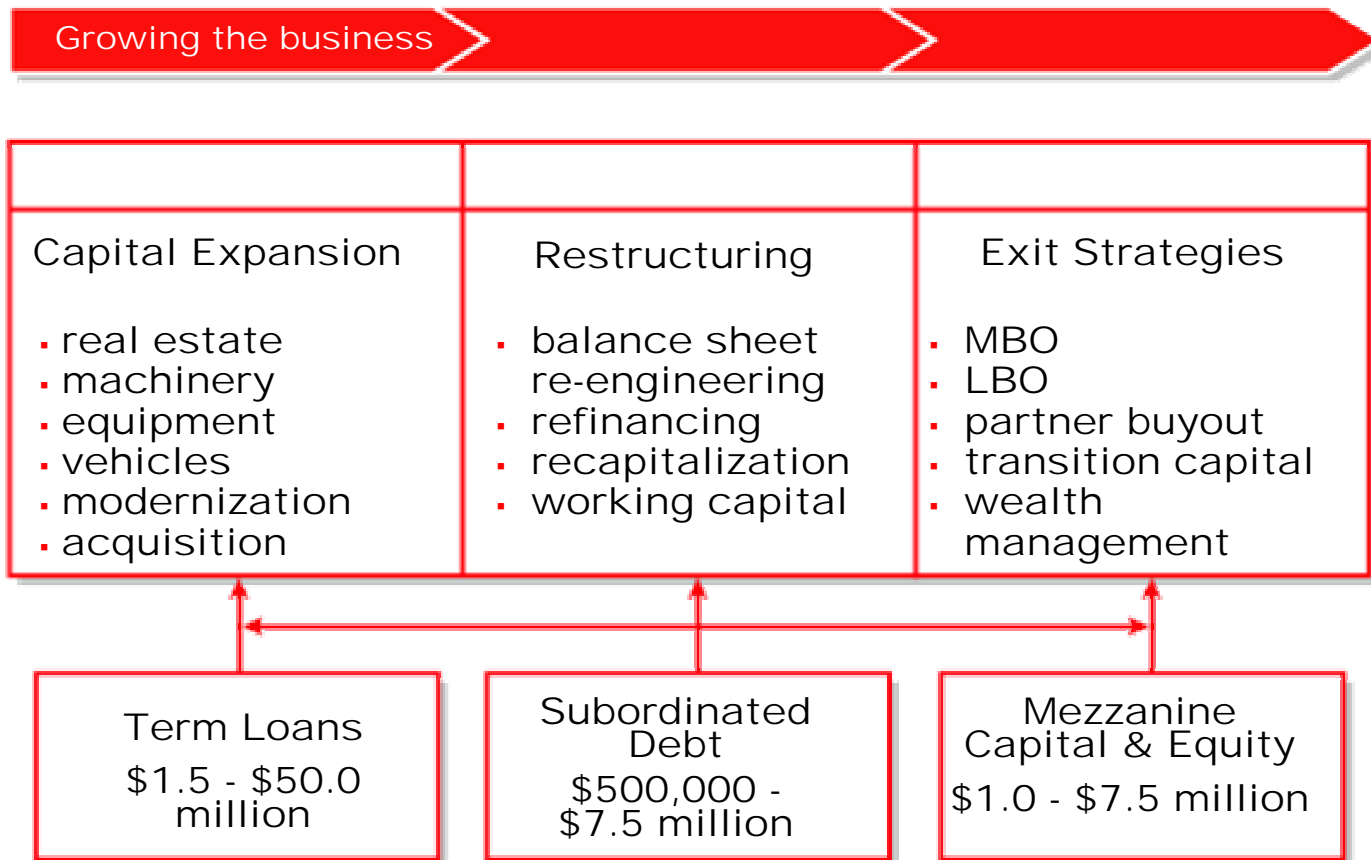
Portfolio

1,600 investments, \$2.5 billion

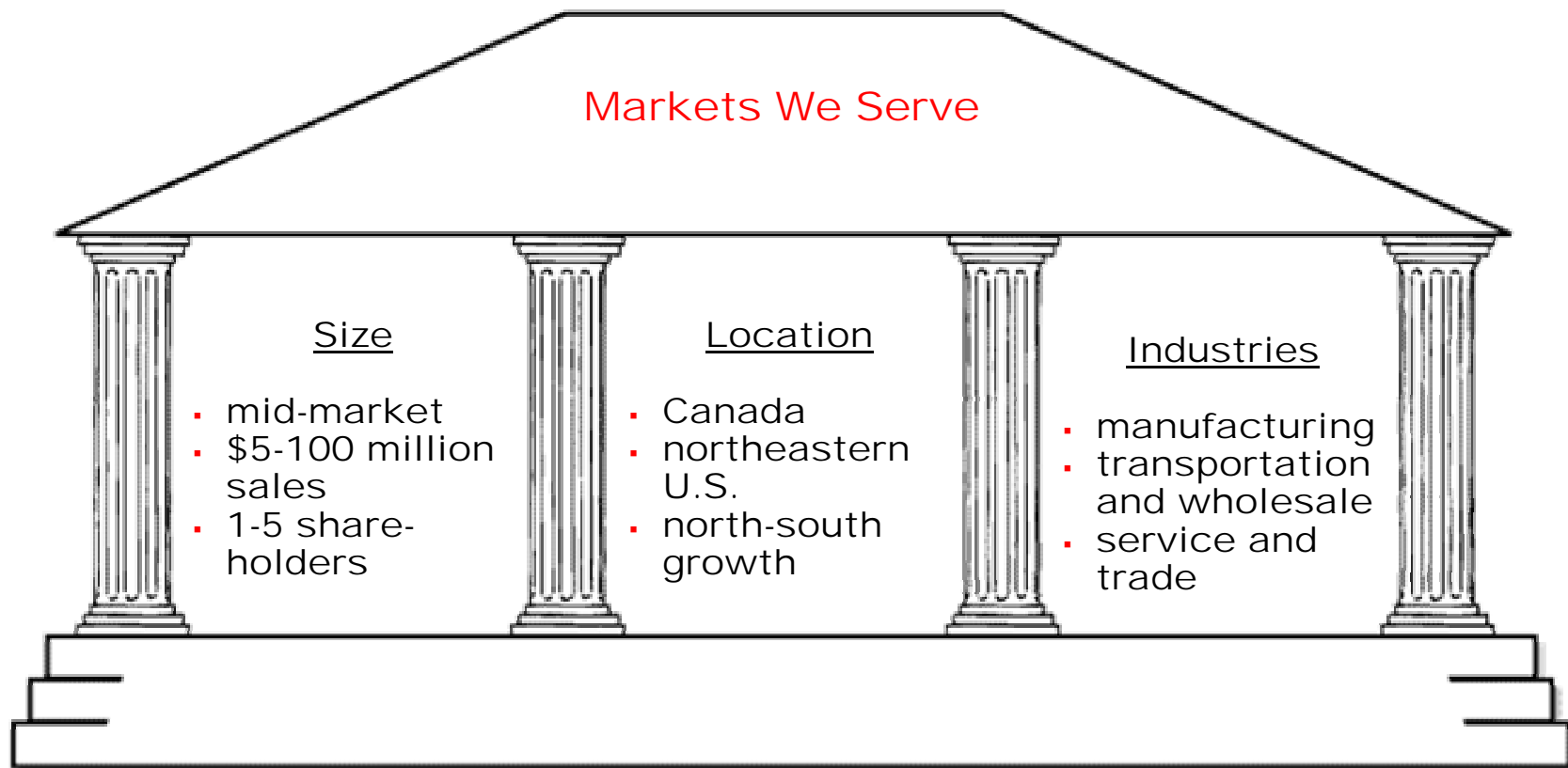
Number of Businesses Served

6,000 companies

A full Menu of Solutions

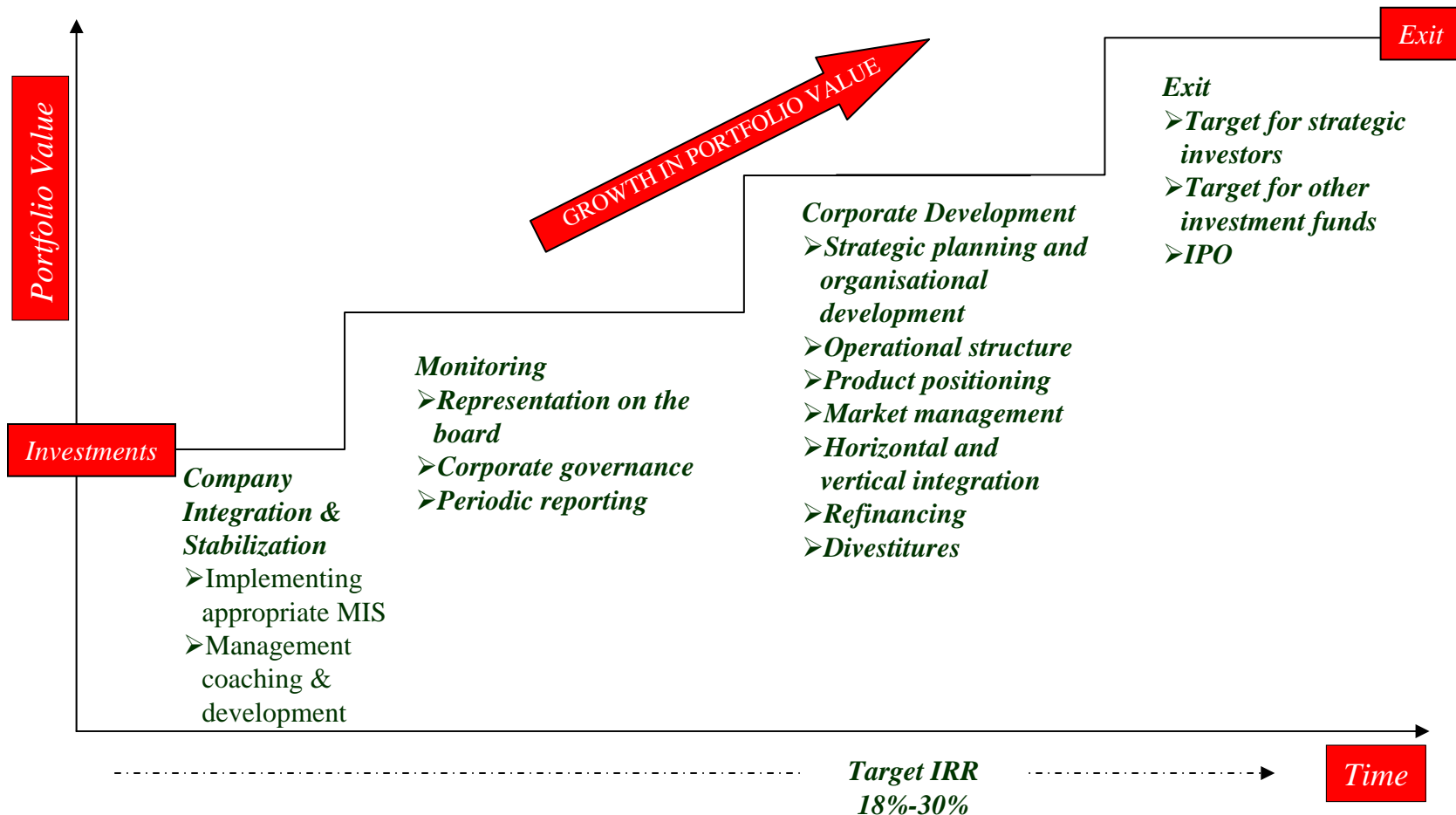


Primary Markets



Our expertise: Companies with special needs requiring a long-term investment approach

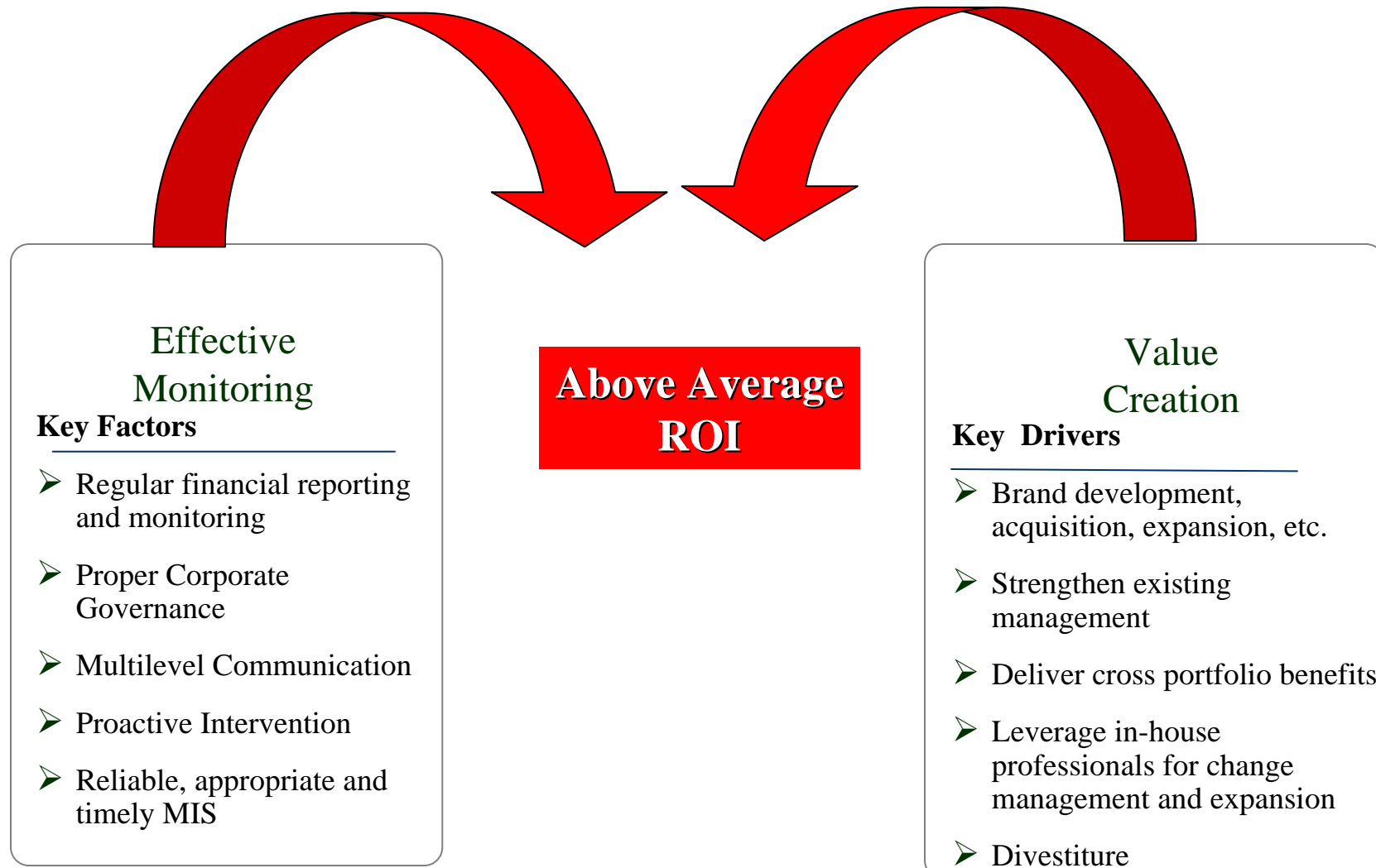
Portfolio Management Cycle



Challenges in Portfolio Management

- Historically, passive portfolio strategy may have been sufficient
- Today...
 - **More Focus on Effective Portfolio Monitoring and Portfolio Value Creation**
 - Prudent investment selection
 - Higher standard of corporate governance
 - Need for more timely and accurate business and management reporting
 - Requirement for proactive intervention
 - Crisis Management
 - More operational and financial discipline in portfolio companies
 - Use of in-house specialists to manage change and create value

2-PRONGED PORTFOLIO MANAGEMENT



INVESTMENT SELECTION

- Preservation of Capital is paramount
- Diversification
 - Across industries and geography
- Down Side Protection
 - Investments structured to minimize risk
 - Current pay, double dipping
 - Lower ROI but Lower Risk
- No cyclical bets
- Limit size of investment as a % of portfolio

EFFECTIVE PORTFOLIO MONITORING

Corporate Governance

- Focus on high standard of stewardship
- Assist management in setting corporate direction
- Assign responsibility to management for achievement of that direction
- Review corporate objectives and monitor performance against those objectives on a periodic basis

EFFECTIVE PORTFOLIO MONITORING

Accurate and Timely Information Systems

- A lot of mid market companies lack reporting sophistication
- Assist the management in implementing business and financial reporting systems
- Instill financial discipline by developing annual budgets, formalizing capital budgeting decisions and implementing periodic management reviews
- Use multi-level communications to obtain independent information and maintain a good working relationship with the management

EFFECTIVE PORTFOLIO MONITORING

Proactive Intervention

- *“No matter how bad things seem to be they are always worse”*
- *We acted too late, its not that we could have done more, but maybe we should have done it sooner”*
- Speed of response is critical due to problems taking time to become evident
- Benefit of doubt given to management within reason

EFFECTIVE PORTFOLIO MONITORING

Use of in-house experts or outside consultants

- Once intervention is deemed important it is critical to have access to right skills
- Rather than replacing the management, deal with the issues directly
- Build a pool of industry experts and specialists to act as advisors, and if needed, as a stand-in for management
- Build in-house expertise in change management and expansion

EFFECTIVE PORTFOLIO MONITORING

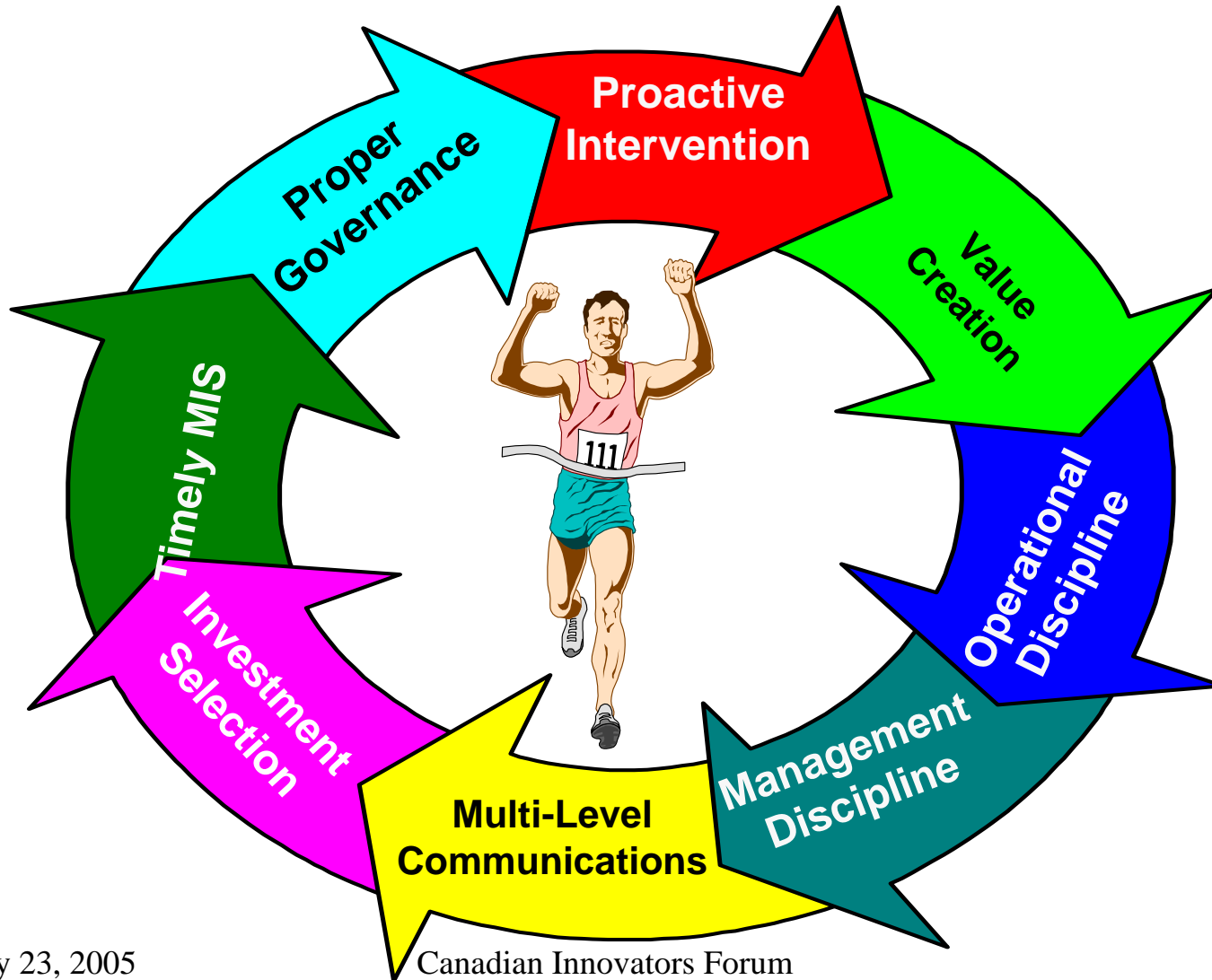
Crisis Management

- Deal with the crisis at the board level and implement recommendations quickly
- Be diplomatic and use “moral suasion” with management to take strategic actions; merger or divestiture
- Bring in a turn around specialists to complement the management team
- If all else fails - Get Rid of the Management Team

VALUE CREATION

- Brand development, expansion, acquisition, etc.
- Work the Balance Sheet
 - Structure investments to optimize Total Return
 - Ability to provide capital with varying risk characteristics; equity, mezzanine, term & leasing
- Maximize cross business opportunities between portfolio companies

SUCCESSFUL PORTFOLIO MANAGEMENT



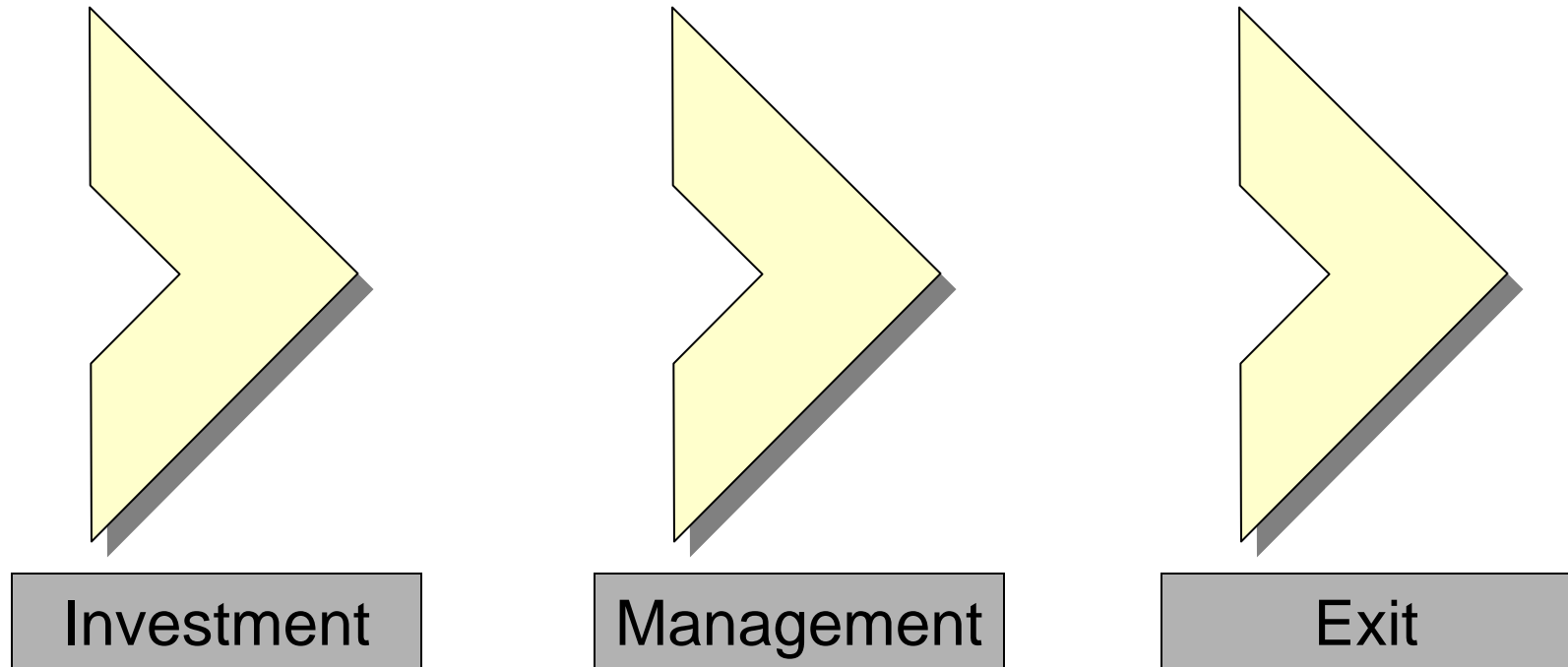
Exit Strategy

- Align the interests of stakeholders
- Plan your exit
- Best interests of the business
- Operate professionally
- Build your business

“Sometimes the best way to double your money is to fold it in half and put it back in your pocket”

Exit Planning

Exit planning begins at the point of investment



Align Interests

- Create a common vision
 - Shareholders' agreement
 - Redemption & “put” provisions
 - ESOP
 - Simplify capital structure
- Identify exit opportunities
- Determine market drivers
- Create a strategic plan
- Incentive programs for management and key employees should support exit

Plan Your Exit

- Exit Strategies:
 - IPO
 - Strategic Acquisition/Merger
 - Refinance Buyback
 - Bankruptcy

It is easy to invest money –
it is getting it out that is difficult

Best Interests of the Business

- Plan for the business & the team
- Fairness guidelines
- Director responsibilities
- Identify M & A opportunities:
- Be realistic about valuation
- Analyze alternatives

Operate Professionally Critical Milestones

- Put your house in order
- Operate the business as the exit will require:
 - Fill management gaps
 - Operate your board as a public company would
 - Provide timely, accurate and meaningful information
 - Set targets, measure performance, take action
 - Separate the CEO and Chairman roles
 - Use independent directors
 - Protect IP
- Hire the right professionals

Focus on the Business

- Focus on:
 - building market share
 - developing sales
 - streamlining operations
 - generating cash flow
- Build the business !!!

Creating Wealth

- Align stakeholders
- Plan your exit
- The best interests of the business
- Operate professionally
- Focus on your business

The valuation of your business
at the point of exit will be based
on the fundamentals of your business

Wealth Creation – Example

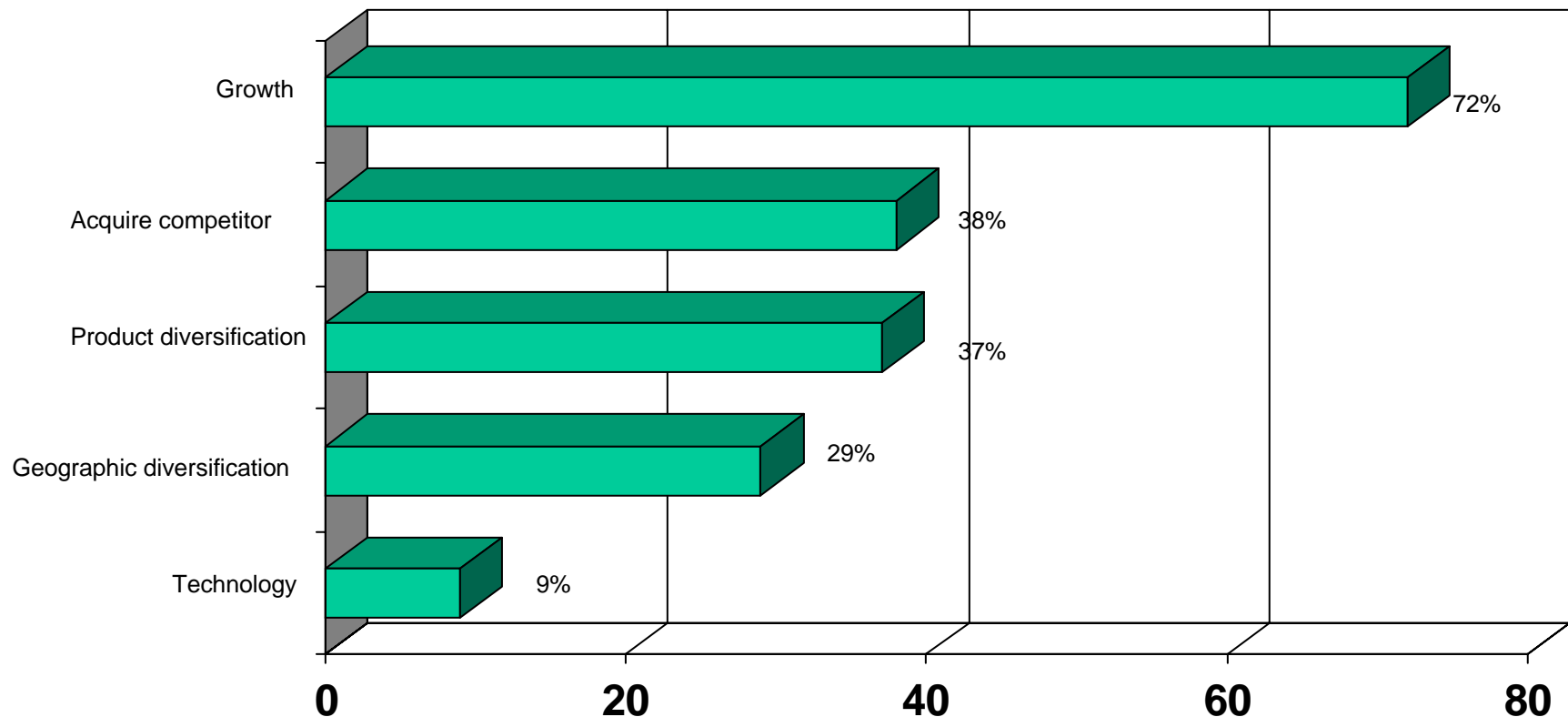
<u>(\$000's)</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Sales	\$100	\$103	\$106	\$109	\$113
SG&A	95	97	99	101	103
EBITDA	5	6	7	8	10
Enterprise Value	22.5	27	31.5	36	45

Assumes: EV multiple of 4.5x and margins constant)

Overview of Trends in M&A and Financing

- Liquidity in the banking market a continuing catalyst for M&A transactions and the Income Trust Market continues to remain strong resulting in reasonable exits for financial buyers.
- Canadian banking market augmented by Asset Backed Lenders (ABLs) aggressively pricing capital, spreads are now as low if not lower than traditional bank lenders even though ABLs only constitute approximately 5% of the Canadian market, yet almost 50% of US.
- Typical ABL spreads now Prime flat to +3/4% or BA's + 1 3/4% to 2 1/2% with BA's at 2.3% Prime 4%.
- High yield market in the US is a significant boom for borrowers with access, although barriers continue to be minimum float requirements but LBO's in the US are up
- Many parallels between the US and Canada and private equity is a big driver of purchase price multiples
- Single biggest reason cited for M&A is growth

Reasons for Considering an Acquisition



* Multiple responses allowed – Source: The DAK Group/Rutgers Q1 '04 – Survey of Middle-Market Companies

Canadian M&A Activity Overview

- Canadian M&A deal value up to US \$36.7 billion for the first half of 2004 up from \$20.5 billion for the first half last year, total deals last year amounted to US \$47.4 billion.
- Despite increase in deal value, no significant impact on number of transactions as first half of 2004 resulted in 544 transactions versus 540 in first half of 2003.
- A few Canadian transactions have impacted significantly on values being enCana Corp purchase of Tom Brown Inc., Jean Coutu Group purchase of Eckerd, Hollinger's sale of Telegraph Group and Brascan's acquisition of Reliant.
- US capital to Canada and robust US market for outbound transactions have pushed acquisition multiples higher.

<u>Lending ratios</u>	<u>2004</u>	<u>2003</u>
Debt/EBITDA	4.2 x	3.6 x
Senior debt/EBITDA	3.2 x	2.8 x
<u>Pricing Multiples</u>		
Transaction Size (USD)	2004 EBITDA Multiple	2003 EBITDA Multiple
Under \$25 million	8.0x	5.1x
\$25 million - \$100 million	7.2x	6.9x
\$100 million - \$250 million	7.2x	6.0x

Sources: Thomson Financial Securities Data Corporation, Bank of America, Piper Jaffray

Investment Returns for Periods ended June 30, 2004

Annual Internal Rate of Return

Investment Category	Periods in Years (all periods ending 30-Jun-04)				Upper		Lower
	1	3	5	9.5	Quartile *	Median *	Quartile *
Early Stage Venture Capital	0.1	-15.3	-0.7	2.1	7.4	0.0	-8.2
Balanced Venture Capital	-1.8	-8.2	2.8	5.3	9.3	-0.3	-11.9
Later Stage Venture Capital	-0.4	-6.0	2.3	5.3	23.4	2.4	-3.4
All Venture Capital	-1.2	-10.3	1.8	4.3	9.8	0.0	-9.2
Buyout & Mezzanine	2.9	10.7	10.4	16.4	23.0	11.7	0.1
All Venture Capital and Private Equity	-0.4	-7.2	3.2	6.1	13.0	0.6	-7.6

Source: Macdonald & Associates Limited, Thomson Venture Economics and CVCA

* Relates to 9.5 year data

Conflict of Objectives

VC'S Want:

VC's Want:

- Low valuation
- Appropriate equity %
- Controls over company
- Developed products
- Board seat(s)
- Exit strategy
- Proprietary technology
- Strong management
- Very large markets

Entrepreneurs Want:

Entrepreneurs Want:

- High valuation
- Minimal dilution
- Operational independence
- Startup financing
- Independence
- Shared vision

The “Cram Down” Case Study

- **Promising Software Inc.**
 - . Toronto-based
 - . Formed in January 1999 by two founders
- **Raised \$10 million Series A round at \$10 million pre-money valuation in June 1999 in a hot-market from three leading Toronto VC’s**
- **Limited customer traction to date through good analyst reviews and growing pipeline**

The “Cram Down” A familiar Scenario

- Growth is slower than expected
- Company is burning cash quickly and drop-dead-date is approaching in 4 to 6 months
- Software market has deteriorated rapidly and valuations are plummeting
- No new VC appears willing to invest
- Existing investors will have to do the round: CRAM DOWN

The “Cram Down”

- **Proposed valuation is significantly below last round**
 - . \$10 million raised at pre-\$ valuation of \$3.33 million
- **Tough terms proposed:**
 - . Milestone based financing
 - . Series B liquidation preference – participating preferred if Series B investors don’t get more than 3 x money back
 - . 10% cumulative dividends
 - . Full ratchet antidilution price protection
 - . Further board control
 - . Tough voting, co-sale, drag-along and registration rights

IMPACT OF CRAM DOWN

- **Before**
- Common – 40%
- Series A – 40%
- Options – 20%
- **Antidilution rights of Series A**
wipes out common shares and options
- **After**
- Common – 10%
- Series A – 10%
- Series B – 75%
- Options – 5%

Tough Terms

- Cram-down
- new investors refuse to invest unless earlier investors give up rights (anti-dilution, subordinate liquidation preference to new preferreds with 3X)
- Pay-to-play
- Prior preferred investors must participate or lose anti-dilution rights. Liquidation preference and prior investors must convert preferred shares to common shares
- Need to pay-to-play to preserve return but may be chasing good money after bad
- Punishing earlier investors for overpaying in the heady times

The “Cram Down” Industry Issues

- **Problem of capital overhang**
- Overfunding companies which are not creating enough value to support post-\$ valuations
- **Problem of how we are financing companies**
- Shouldn't we rather raise smaller amounts at lower valuations and give company chance to create enough traction to justify valuations?
- **Impact on Seed Investors**
- If they are getting washed out, where's the incentive to keep funding new companies?
- **Long Term Implications for Innovation in Canada**
- Entrepreneurs, seed investors, innovation, private equity

Valuation Methodologies Let's Just Sell It

- When valuing revenue generating, profitable companies, investors look to various “tried and true” methodologies to assist in validating valuations
 - Comparable companies analysis
 - Precedent industry transactions
 - Discounted cash flow analysis
 - Internal rate of return valuations

At the end of the day, the “value” of any company is what the highest bidder will pay for it at that point in time

Let's Just Sell It?

Windows of Opportunity

- Business Intelligence
- Network Security Management
- Storage Management
- Application Server Management
- Collaboration Software and Knowledge Management

Let's Just Sell It?

- Don't forget "Sunk Cost"
- Make a decision – walk, fund (must stabilize) or sell
- Do everyone a favour and re-write the capital structure
- How will management be retained/attracted otherwise?
- Structures that "hold on" tend to drive abnormal behaviour
- Inside rounds – get third party support!
- Sell?
- Yes there is an M&A market in a variety of market "niches"
- Don't forget management's liquidation preference
- Manage your exits

Conclusion M&A Motivation

Sellers want:

- Distribution/brand recognition
- Complementary technology
- Financing, access to capital markets
- Broader management expertise
- Cash-out exit strategy (investors or themselves)

Buyers want:

- Product (speed-to-market)
- Customers/distribution
- People, technology
- Good business model, shifting to marketing orientation, “clean” operation

Conclusion - Deal Killers

- Greed
- Control of Technology (IP)
- Litigation:
 Pending/Threatened
- Sloppy Accounting/Controls
- Indecision
- Partner/Shareholder Conflict
- Exclusive Agreements
- Business Downturn
- Loss of Key Personnel
- Misleading/Incomplete Disclosure
- Excessive Buyer Reps/Warranties
- Inexperienced Counsel

Conclusion

10 Biggest Merger Mistakes

- Improper timing
- Not preparing properly
- Ignoring the “B” list of buyers
- Dealing with only one buyer
- Not positioning company properly
- Not selling to all parties
- Ignoring possible structures
- Forgetting the employees
- Letting Buyer dictate structure
- Not getting proper counsel

Conclusion

Ten Ways VCs Can Help a Deal

- Realistic valuation expectations
- Understand diversity of internal interests
 - Both at target and vendor
- Escrow when appropriate
- Management incented to benefit today and stay tomorrow
- Early access to visionary & technical team
- Liquidation preferences
 - In a falling valuation environment
- Full disclosure and honesty
 - Games are exhausting
 - Hiding the albatross
- Retain/pursue what an acquirer values

Conclusion Working Together

- Keep in touch early
- Exchange technical evaluations for business/market evaluations
- Apply current recap thinking to exits
- Put outsiders in Board seats
- Avoid bankers when selling early stage tech companies



TERMINATION LEADERSHIP PARTNERSHIP
VISION INNOVATION DETERMINATION
N VISION PARTNERSHIP LEADERSHIP
LEADERSHIP PASSION INNOVATION
RTNERSHIP LEADERSHIP PASSION
TION LEADERSHIP PARTNERSHIP
ON PARTNERSHIP LEADERSHIP
INNOVATION DETERMINATION

Scotia Plaza
40 King Street West
26th Floor
Toronto, Ontario M5H 1H1
tel: 416.933.2730
fax: 416.933.2783
email: info@roynat.com