

The sky's the limit for private equity in Canada

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Last year, a total of more than \$11-billion was invested in Canadian companies by buyout funds. This set a new record, and more than doubled the 2005 total of \$4.5-billion. This growth continues on a track to double again in 2007, with \$5.1-billion invested in the first quarter of this year. New private equity funds raised also reached a new record level in 2006, with over \$10-billion in fresh investment capital, led by a record total of \$8-billion in new Canadian buyout funds.

Can this growth continue? Of course it can.

The boom we are seeing today in private equity, in our buyout sector, is primarily a boom in activity. The records we are setting are record market volumes, record numbers of transactions completed, records in the sizes of companies acquired, in the size and number of new buyout funds being raised.

Yes, prices are rising, particularly in acquisitions of public companies. But in the mid-market, where the vast majority of deals are completed, these price increases have not been dramatic.

And let's remember: When we do talk about rising prices in the buyout market, we talk about earnings multiples – the price to buy a good company moving up from six times, to seven times or maybe eight times earnings.

Earnings: These companies are all profitable, real businesses with real assets and tangible value.

But if prices are rising, it means that our buyout funds cannot count on finding bargains to drive the returns on their investments. They have to pay up, and they might not see any multiple expansion when it's time to sell.

The only way investors can count on making money in this market is by increasing earnings. Building real value. Building portfolio companies to a new, higher level.

Successful investors understand how to use the natural advantages of private ownership to generate these kinds of gains.

These natural advantages of the private markets are well known, advantages that generally lead to outperformance over the public markets.

These advantages include:

- Better investment selection, with the opportunity for real due diligence.
- Negotiated terms, with deal structures to reduce risk and enhance performance.
- Active investment, with board representation and strong relationships with management.
- Getting off of the quarterly earnings treadmill of the public markets – the freedom to build long-term growth without worrying about missing your quarterly numbers by 2 cents a share.

And the main advantage of private ownership: Following a buyout, all of these companies are run by their owners. The board is dominated by the investors and managers who own the company. They make decisions quickly, seizing opportunities, and taking direct action where necessary. They think and behave like owners.

This is much different than many companies in the public markets, where ownership is dispersed, boards must take on a broad oversight role as guardians of the small investor, and the whole governance and decision-making process is frequently much slower and less effective.

All of these natural advantages of private ownership are real. And skilled buyout fund managers will continue to outperform the public markets. The outstanding performance of the Canadian buyout sector continues: The top quartile benchmark return for our buyout funds has moved up to 21 per cent from 16 per cent at year-end 2005.

So just how far can we go?

The Toronto Stock Exchange has a market capitalization of \$2-trillion, so when we saw our record \$11-billion invested by buyout funds last year, this was roughly equal to ½ of 1 per cent of the size of our public markets.

And let's not forget that the overwhelming majority of companies in our economy are private, and natural candidates for private equity investors. Even in the U.S., which has much broader public markets, more than 80 per cent of all companies with annual revenues over \$10-million, and fully two-thirds of those with revenues over \$100-million, are privately held. There is no shortage for private equity investors to choose from.

Further, the majority of Canadian pension funds still do not have allocations to private equity. As the market grows, more of them are entering the asset class.

Those pension funds who are active in private equity generally have allocations in the range of 5 to 7 per cent of their portfolios, with some of our leading pension funds at higher levels.

There are no visible limits ahead for private equity in Canada. This growth is strong, it is real, and it will continue.

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