Who will buy baby boomer businesses?
WHO WILL BUY BABY BOOMER BUSINESSES?

What is the single largest baby boomer retirement issue? Pension solvency, retirement savings levels, healthcare funding - all important but we believe the one that overshadows all others in terms of absolute dollar size is the question of from where will the capital come to acquire the large cohort of private, baby-boomer businesses coming onto the market? Without the ability to sell their businesses for reasonable valuations baby-boomer entrepreneurs may find it a challenge to fund their retirements.

Just how large of an issue is this funding gap? In a recent report CIBC estimated that “$1.9 trillion in business assets are poised to change hands in five years - the biggest transfer of Canadian business control on record.” and that “by 2022, this number will mushroom to at least $3.7 trillion as 550,000 owners exit their businesses...” ¹

Echoing the CIBC data, accounting firm Deloitte states “Though Canada is known for its large banks and resource giants, a large part of the economy remains underpinned by over 2.3 million small businesses across the country. Many of these businesses were founded - and continue to be run - by entrepreneurial baby boomers. These mature companies are often stable, well-run and cash-rich income providers for the generation that started them. However as these baby boomers begin to retire, SMEs [Small and Medium Enterprises] will undergo a massive collective ownership transfer.” ²

So how will this large cohort of entrepreneurs exit and at what price? The question will come down in part to the amount of acquisition capital flowing into the SME space. Given that this estimated $2 trillion of businesses is twice as large as the assets of the top 1,000 Canadian pension plans and approximately the same size as Canadian annual GDP this is a question without an immediately obvious answer. ³ & ⁴
On the positive side, while the size of the funding challenge is large it does represent a correspondingly large investment opportunity for properly structured and capitalized acquirers.

"An estimated $1.9 trillion in business assets are poised to change hands in five years - the biggest transfer of Canadian business control on record." ¹ - Emphasis added

"With a glut of baby boomer-owned SMEs imminently available, there is an untapped and growing opportunity for Canadian private equity firms to realize significant value at the low end of the micro-cap market. Canada is arriving at a natural inflection point where baby boomer small business owners will need to consider selling. This will sharply increase the supply of available businesses - a market reality that simply did not exist five or ten years ago." ² - Emphasis added

Before we assume that existing large PE funds will simply move down into the SME market it should be noted that the traditional private equity model of “acquire, cut costs, add leverage, grow then IPO” does not lend itself well to SMEs. We do believe however that appropriate investment models will be found as the consequences for failure are substantial.

The Economist reported that the “lack of succession planning from current owners, presents a significant risk to small business formation and the long-term growth and competitiveness of the broader UK
The same risk applies to the Canadian economy - with the baby boomer companies that are expected to be sold in the next five years estimated to employ close to two million people and account for at least 15% of Canadian GDP. The consequences of a disruption to such a large component of Canadian economic activity could obviously be severe.

“Canadian business are undergoing a demographic tsunami as baby boomers - born between 1946 and 1965 - are reaching the age of 65. According to Statistics Canada, there are 1.4 million small businesses in Canada. Almost all of them are owned by baby boomers. In a recent study conducted by a major Canadian bank, more than 500,000 Canadian small business owners are planning to retire over the next five years” – Emphasis added

The research strongly suggests there is currently a substantial mismatch between the volume of businesses coming onto the market versus the available pool of capital to acquire these businesses. While private equity transactions are measured in billions of dollars annually in Canada, the estimates are for trillions of dollars of baby boomer business assets to be seeking buyers over the next decade. This supply/demand mismatch is particularly pronounced for businesses with values in the $2 million to $20 million range.
Equicapita Update (continued)

“The relatively low valuations of many businesses in the current economic environment could represent a largely unrecognized buying opportunity that may not last for long.”

“...There is a backlog of businesses in which the owners were ready to exit in 2008 and 2009, but didn’t, due to a lack of buyers, low valuations and weak operating results... Business owners are seeing that there is a lot of competition when they go to sell the companies they’ve worked so hard to build...”

We believe the SME segment (particularly sub $20 million enterprise value) will be an increasingly important component of the overall private equity universe as investors are attracted by the availability good quality earning streams from stable long standing businesses that can be acquired for reasonable multiples given a unique supply/demand dynamic.

Equicapita focuses on acquiring western Canadian SMEs that have a track record of generating sustainable cash flow from existing operations. Equicapita focuses on sub $20 million acquisitions because of the supply/demand driver set out above and western Canada for a number of reasons including:

1) Growth rates in western Canada have consistently exceeded overall Canadian and eastern Canadian growth rates over the last decade.

2) The proportion of SMEs tends to be higher in the western Canada providing good levels of deal flow.
3) Western Canadian SMEs tend to have long operating track records from which to evaluate their ability to generate cash-flow through both expansionary and recessionary economic cycles. By way of example, according to Alberta Treasury Branch “Alberta SMEs are “well established” with an average of 24 years operational history.  

...half of all small- and medium-sized businesses in Canada are set to retire over the next decade, including 310,000 that plan to transfer control of their companies within the next five years.”

“One projection estimates that 29% of entrepreneurs will retire by 2020.”

4) Western Canadian SMEs founders tend to be more receptive to financial buyers. According to CIBC “entrepreneurs in Alberta and the Central Prairies showing the highest level of intention to sell [to third party buyers], likely reflecting the high concentration of small firms in the primary industries sector in this part of the country.”
Rather than take a traditional PE approach as mentioned above, Equicapita does not rely on growth or public market exits to drive returns. Businesses are acquired for their long standing, stable cash flows which are bundled into a larger portfolio in order to generate yield for investors. We believe that new approaches such as Equicapita’s Income Trust model that brings capital and investors into the SME market are an important part of solution to the boomer entrepreneur retirement challenge.

Regards

Equicapita
NOTES:
1. CBC News “Baby boomer retirement glut poses risk”
2. Deloitte, “Making a market for micro-cap, Small and medium Canadian enterprises: A private equity opportunity”
3. Statscan CANSIM, table 380-0064 (C$1.879 trillion)
6. ATB Business Beat: March 2013
7. CIBC Small Business “Are Canadian Entrepreneurs Ready For Retirement?”
8. Economist Intelligence Unit, “Derailing the future of economic growth: Demographic risks and financing pressures facing the UK SME economy”
9. RBC - “From Downturn to Upside”
10. Meyers Norris Penny - Succeeding at Succession
11. Globe and Mail, “Retiring boomers create immigrant opportunities”
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