Pathway to

Tourism Investor Forum
Hilton Mississauga Meadowvale

February 11th to 13th, 2024

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Nautilus Endeavours' Practice Areas

Nautilus Endeavours
corporate finance | business advisory

Business Advisory

Corporate Finance

Financial / Transaction Oriented Plans

Strategy / Corporate Development
- Expansion plans
- Geographic development
- Product/Service development
- Acquisition decision
- Divestiture decision
- Other

Operational Plans

Company Management Team

Mergers & Acquisitions
- **Buy side** advisory – identifying and pursuing targets, and structuring
- **Sell side** advisory – preparing financial and marketing materials, managing competitive process
- **Succession** structuring
- Whole company or division

Capital Advisory
- Assessing capital structure between **debt, equity, and hybrid** products
- Financial modelling and scenario analysis
- **Accessing and structuring** commercial and private debt and equity sources

Nautilus Endeavours supplements internal management capacity and skills to support stakeholders in developing strategies (long term orientation) and execute financial transactions (short term orientation)

Session 3
Equity Risk and What is it?

October 18, 2023

Key terms – Equity & Equity financing

Equity represents the value that would be returned to a company's shareholders if all the assets were liquidated and all the company's debts were paid off.

Equity risk is the risk involved in the changing value of ownership in a company – compared to predictability of a lender (debt provider).

Equity financing: Businesses typically have two options for financing when they want to raise capital for business needs: equity financing and debt financing.

- Equity financing involves selling a portion of ownership (equity) in a company
- Debt financing involves borrowing money

Summary Reminder of Balance Sheet

Balance Sheet Example

Balance Sheet				
($ Thousands)				
Assets			**Liabilities**	
Current Assets			**Current Liabilities**	
Cash	1,000		Line of Credit	1,500
Account Receivables	2,500		Accounts Payable	1,500
Inventory	1,000		Other	500
Other	500			
	5,000			3,500
Investments	1,000		**Long-term liabilties**	6,500
Fixed Assets	10,000			
			Equity	6,000
Total	**16,000**		**Total**	**16,000**

Note – This represents BOOK VALUE of equity, which may or may not be the same as MARKET VALUE of equity

Importance of the Balance Sheet

Summarizes your company's assets (short term and long term) which you use to generate income

Summarizes your company's obligations:

- **immediate (short term liabilities like accounts payables) and**
- **long term (like a mortgage or term loan)**

Key Takeaways

Ratios tell stories:

- **Long Term Debt to Fixed Assets = 70%**
- **Debt / Equity = 1.7 : 1.0**
- **Debt to Capitalization = 63%**
- **Current Ratio = 1.43%**

Reminder of WACC

Using the appropriate amount of debt enhances return on equity

Assets

=

Liabilities

+

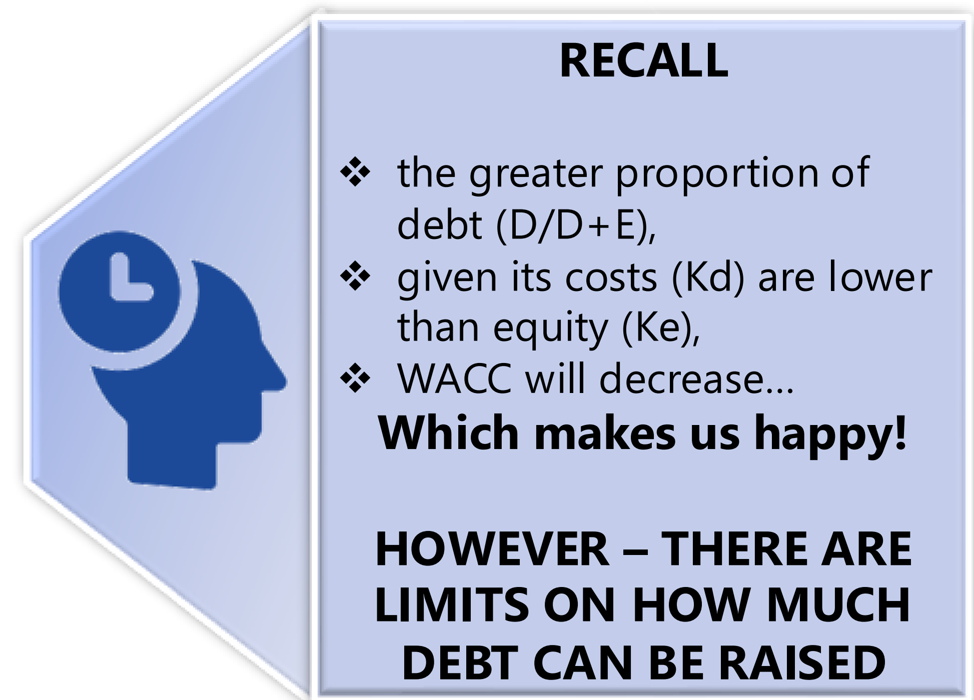
Equity

Return on Assets

$$ROA = \frac{\text{Net Income or Operating Income}}{\text{Average Total Assets}}$$

Weighted Average Cost of Capital

$$WACC = \left(\frac{E}{(D+E)} * Ke\right) + \left(\frac{D}{(D+E)} * Kd * (1 - \text{Tax rate})\right)$$



Once debt is optimized, growth needs to be funded with equity

Determining Equity Requirements

Recall in reviewing debt financing, often lenders have limits on debt based on covenants, or based on collateral

	Test	Covenant
Current Ratio	1.43 : 1	1.25 : 1
		(Min)
Debt/Equity	1.33 : 1	2.00 : 1
		(Max)
Debt/Total Capitalization	0.57x	0.65x
		(Max)
Debt Service Coverage Ratio	2.56x	1.25x
		(min)
Debt/ EBITDA	1.81x	2.50x
		(Max)

Can test what covenants would be based on your current cashflow, and an incremental increase in debt to fund your new venture

($ Thousands)

Source	Advance Rate	
LOC		500.0
Equipment Loan	50%	250.0
Vehicle Loan	75%	187.5
Real Estate Loan	65%	325.0
Equity Requirement	***Plug***	***1,487.5***
		2,750.0

Use of Proceeds	
New Equipment	500.0
New Vehicle	250.0
New Building	500.0
Unused Credit	500.0
Operating Expenses	1,000.0
	2,750.0

Michelangelo:
I created a vision of David in my mind and simply carved away everything that was not David.

Sometimes, measuring how much equity is required is measuring "what's left over" from the valuation of an entire company, after debt is maximized or optimized

Debt vs Equity Characteristics

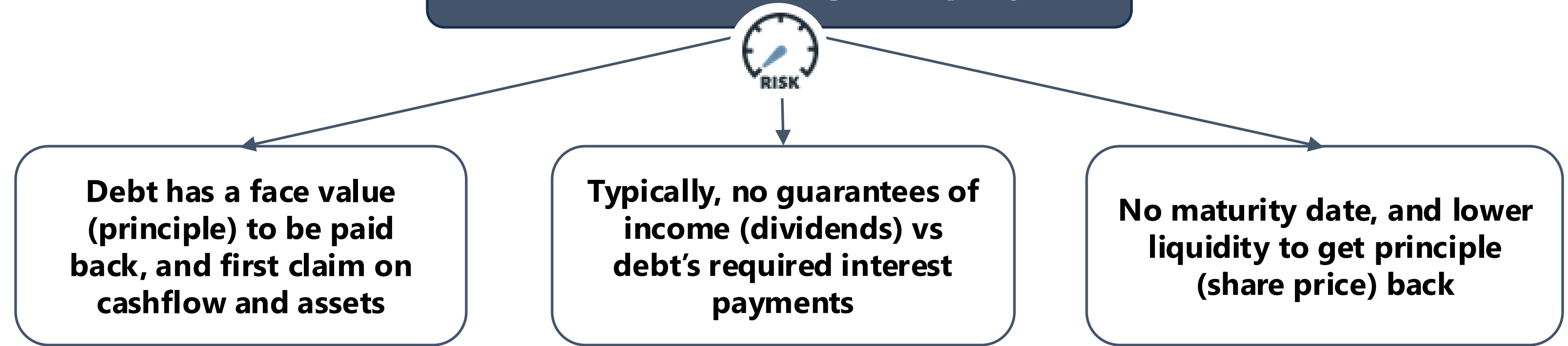
Parameters	Debt	Equity
Ownership / Control	• None	• Partial ownership
Cost **(Short term)** **(Long term)**	• Lower cost of capital (single digit % for senior debt) • Tax deductible financing • None, once debt paid	• Higher cost of capital (teens%, 20s%, or more - dividends or capital appreciation) • Dilution of original company value, if sold
Requirements	• Reporting • Financial covenants • Scheduled payments • Personal guarantees (?)	• Governance • Unanimous Shareholder Agreements (should have)
Characteristics	• Established businesses • Collateral available • Predictable cashflow	• Earlier staged businesses • Limited collateral • Unpredictable cashflows
Security	• Traditionally first position, in front of trade payables (Accounts Payable) and equity.	• Last in line, after all other investors are repaid
Other considerations	• Predictable repayments and expectations from lenders • Maintain 100% ownership. • Increase credit worthiness over time for future business needs.	• No debt repayments • Share profits and less control over the company • Possible synergies/conflicts with partners

Equity – can be suitable for companies looking to avoid (or cannot access) debt obligations – note the match of risk (higher) to returns (higher) for equity

Summarizing Equity Risk

What is Equity Risk?

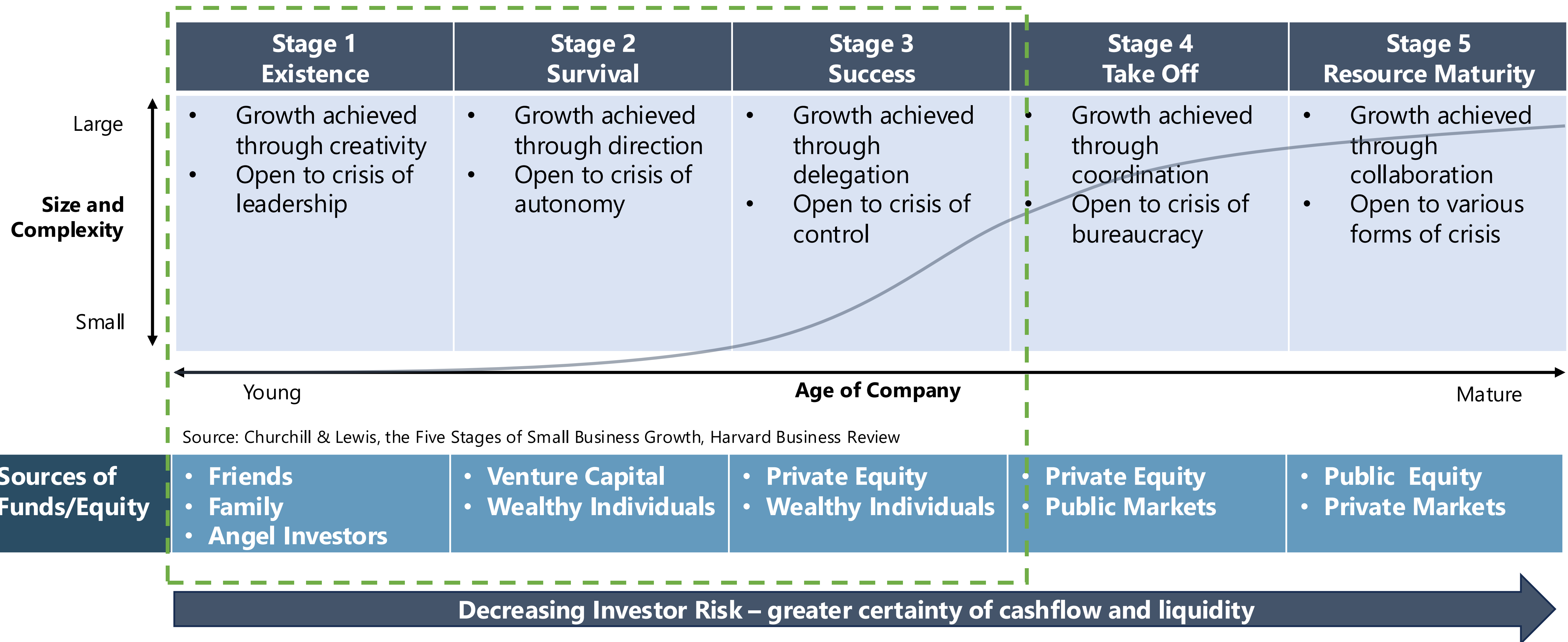
Equity risk is the risk involved in the changing value of ownership in a company – compared to predictability of a lender (debt provider).



Given its higher costs of capital, Equity Financing is more appropriate vs the lower costs of debt capital, when:

- Cashflows are highly volatile
- Preferred choice for Startups
- When a company is experiencing rapid growth
- Lack of Collateral
- High risk ventures

Types of Equity Based on Company Stage



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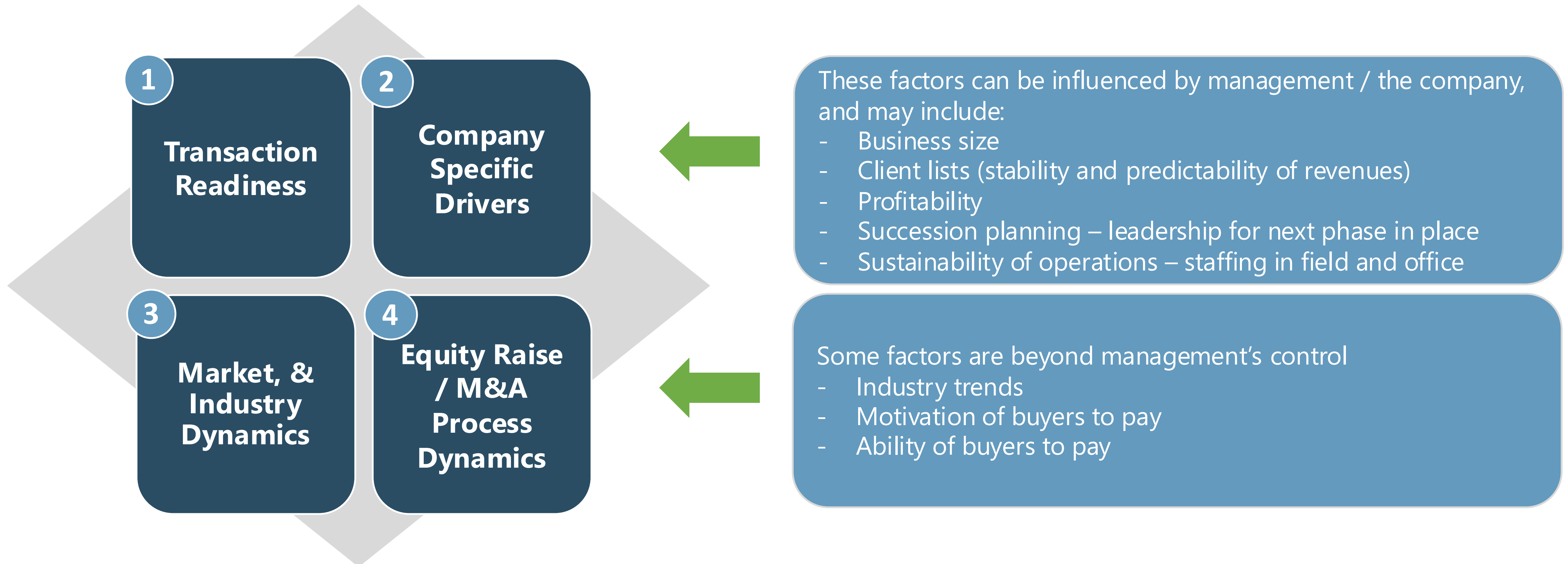
Market Valuation Framework

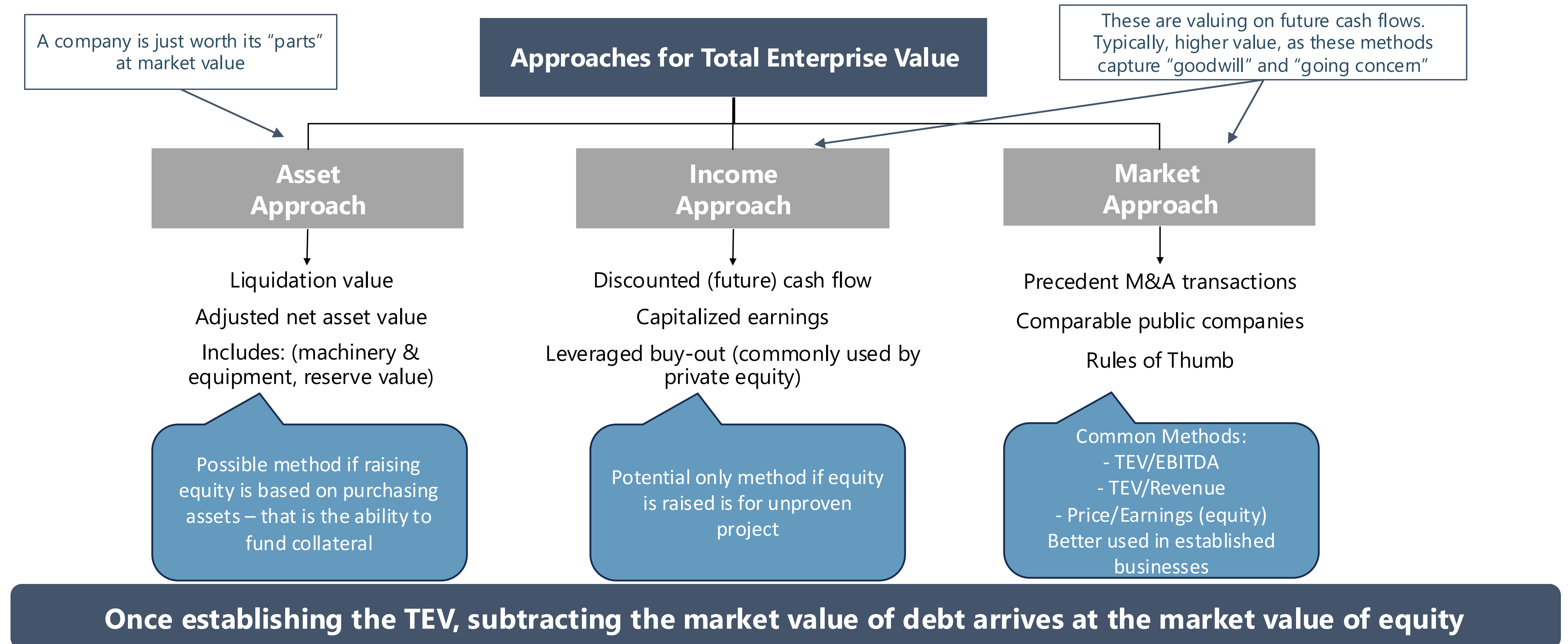
In an open market transaction, valuation reflects four elements. Timing and positioning are key to optimization of the valuation received.



These factors impact the value of the company, or Total Enterprise Value, which in turn is the market value of the debt plus the market value of equity

Valuation Methodology

Companies are valued either on their assets (equipment, buildings, AR, inventory) or their ability to create sustainable and growing cashflow



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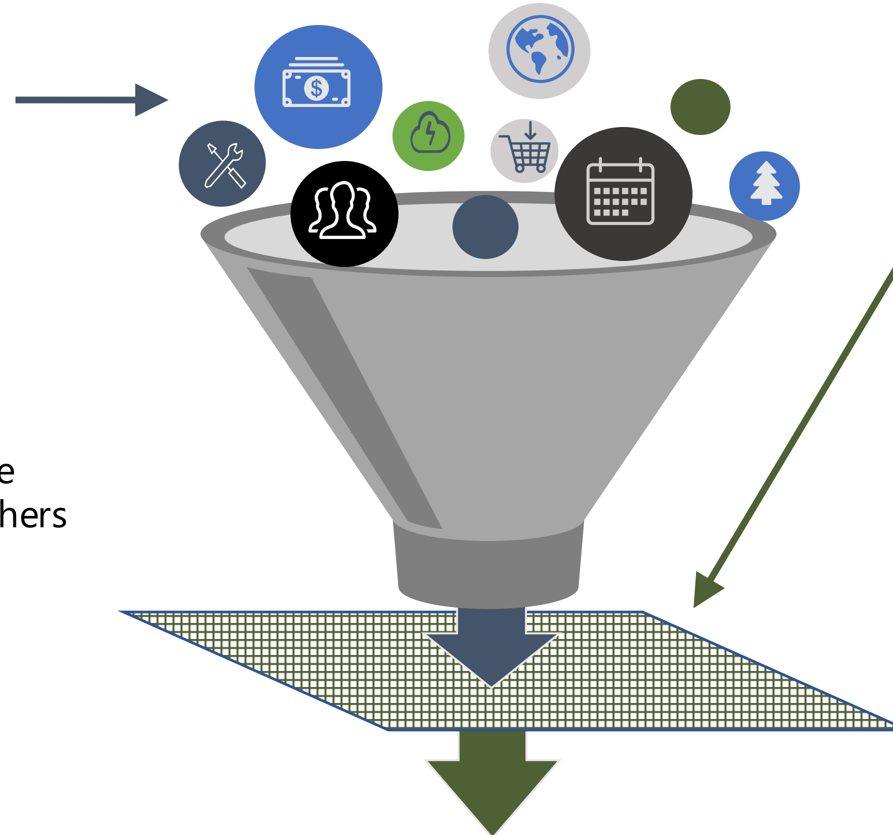
Selling Your Investment Story in a CIM

The Use of a Confidential Information Memorandum (CIM) delivers a consistent message to multiple capital sources and creates competitive tension

Company Factors to engage in market transaction

Transaction Readiness
- Business Plan
- Source and Use of Proceeds

Company Specific Drivers
- Relative opportunities for the Company, compared with others in the industry
- Operational efficiencies
- Sustainability of cashflows



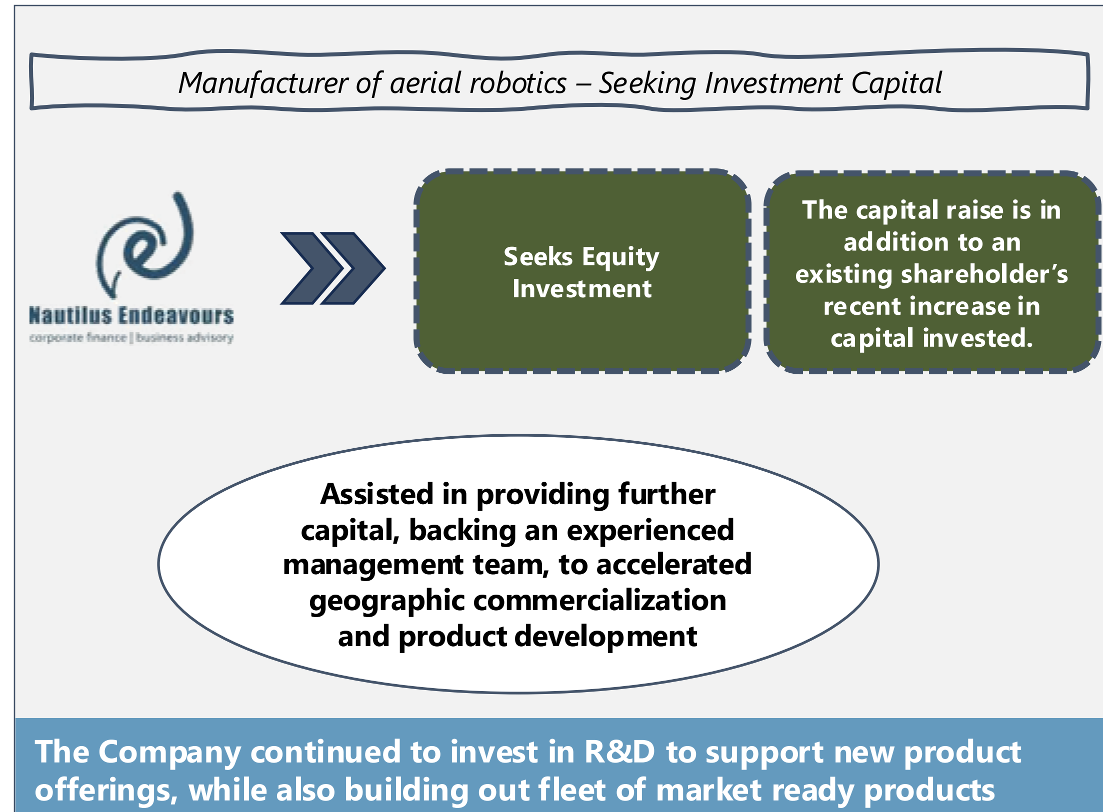
Market Factors determining investor decision

Market & Industry Factors
- Competitive offers (others doing deals)
- Fundamental economics of the sector
- Regulatory or legislative changes impacting how companies operate

Financial / M&A Process Dynamics
- Cost of capital
  - interest rates for debt (driving values)
  - Public equity markets for relative return on equity
- Availability of capital
  - To fund the debt requirements
  - To fund the remaining equity requirements

CIM gathers salient points of both sides of the equation, and presents a digestible and compelling argument for the reader to support the requested transaction

Case Study – Nautilus Past Engagements



Methods for Early-Stage Company

Total Addressable Market
(how much revenue / profits are possible, assuming expansion idea is successful)

Discounted Cash Flows
(assumes future revenues and profits that are discounted to a company value, today, using WACC)

Unit Economics and Break Even
(breaking down the assumptions to the income statement, into digestible and understandable smaller transactions – eg by client)

There are no silver bullets to tell the equity story – use what is appropriate for your situation

Summary of Raising Equity / Selling at Stake

- The smaller the cheque size, there is a less organized market for equity
- The thesis of raising equity differs greatly between capital for new ventures (unproven business) vs selling a stake of an established business (taking chips off the table for the founder) – use of proceeds matters
- The more stable the cashflows of the business, and growing profits help increase valuation of a company (Total Enterprise Value)
- Equity value is what's left behind AFTER you take the debt obligations away from Total Enterprise Value (think of Michelangelo and statue of David)

If you are approaching friends and family, or organized capital, a business plan and model are imperative – CIMs or Confidential Information Memorandums are such documents putting all the qualitative and quantitative factors into a cohesive story for investors

Questions and Dialogue

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