

Business Transfers

- *a challenge for the capital market*

(English summary)

The Danish Investment Fund (DIF)

DIF is a financial organisation that contributes to the development of Danish business and trade.

Our mission is to strengthen development and innovation in the Danish economy by procuring financing for promising projects in small- and medium-sized enterprises.

Operating independently in the capital market, DIF facilitate the supply of venture capital in terms of start-up equity and high-risk loans. The financing is provided on commercial terms.

In the light of our mission, we have set ourselves the ambitious goal: to make the Danish market for finance of innovation the best-functioning one in Europe.

Our capital base is currently DKK 2,400 million, part of which we use for direct business funding, and part of which we use to co-finance venture funds. In addition, we manage VækstKaution, a national loan guarantee scheme for private companies.

1. Introduction

Business transfers is a major challenge to the Danish business community in the years to come. Both individual firms and the Danish economy in general are highly dependent on this challenge being met. From a firm perspective it is crucial, that the transfer is carried out in a way that allows continued operations, growth and innovation. In a broader perspective, it is important to maintain the production and employment contributed by these firms.

A range of different estimates concerning the number of upcoming business transfers in Denmark has been floated. The press and academic analyses tend to agree upon an increasing tendency, but guesses differ as much as from 10-20.000 to 107.000. To face the challenge in a suitable way, it is of great significance to get a grip of the proportions.

The success of a business transfer is among other things dependent on access to financial resources. Even though the Danish market for private equity over the last few years has experienced growth in funds focusing on MBO and MBI, we question whether the supply of risk capital is sufficient to manage such a future challenge.

In addition to financial resources, a principal determinant of success in business transfers is effort and qualifications. During the process, the business must be characterised by management and investors with the ability to exhibit strong performance.

According to the above stated issues, the purpose of this analysis is threefold:

- A statement of an appropriate interpretation of business transfers and based on this an updated estimate of the number of business transfers during the next five years.
- An estimate of fundraising needed to carry out business transfers by external financing and risk capital.
- A description of crucial skills and efforts beside capital needed to secure smooth and suitable business transfers.

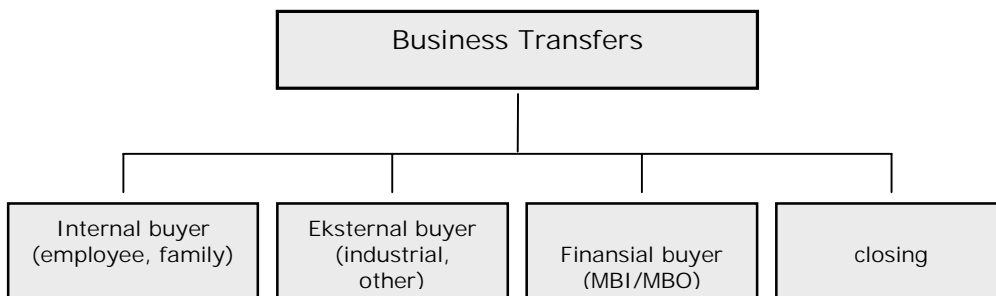
In short, we find that app. 43.000 firms in a 5 year horizon are expected to go through a business transfer. Of these app. 1.600 will be suitable for risk capital funding, which correspondingly generates a total capital need of app. DKK 50 billion. Compared to the supply of capital for MBI and MBO present at the outset (app. DKK 20 billion), the Danish market for business transfers faces a shortage of equal to DKK 30 billion. Beside capital requirements, preparation, progressive management and efficient market communication is estimated by experts to be among the fundamental determinants of success in business transfers.

2. Business transfers as a concept

Basically business transfers are a way to continue the operation of a firm facing a replacement of existing owners or management. This analysis is mainly concerned with the financial aspects of business transfers, as a result the distinction applied here is change in ownership.

A firm facing a business transfer in general has the possibility to take one of the four possible channels sketched by figure 2.1. into use. Whether an internal (family or employee) or an external (other business or financial institution) buyer is preferred differs across firms. A number of firm specific and financial aspects fundamentally determine the optimal buyer. Only if the firm is no longer profitable, closing down operations is the best solution.

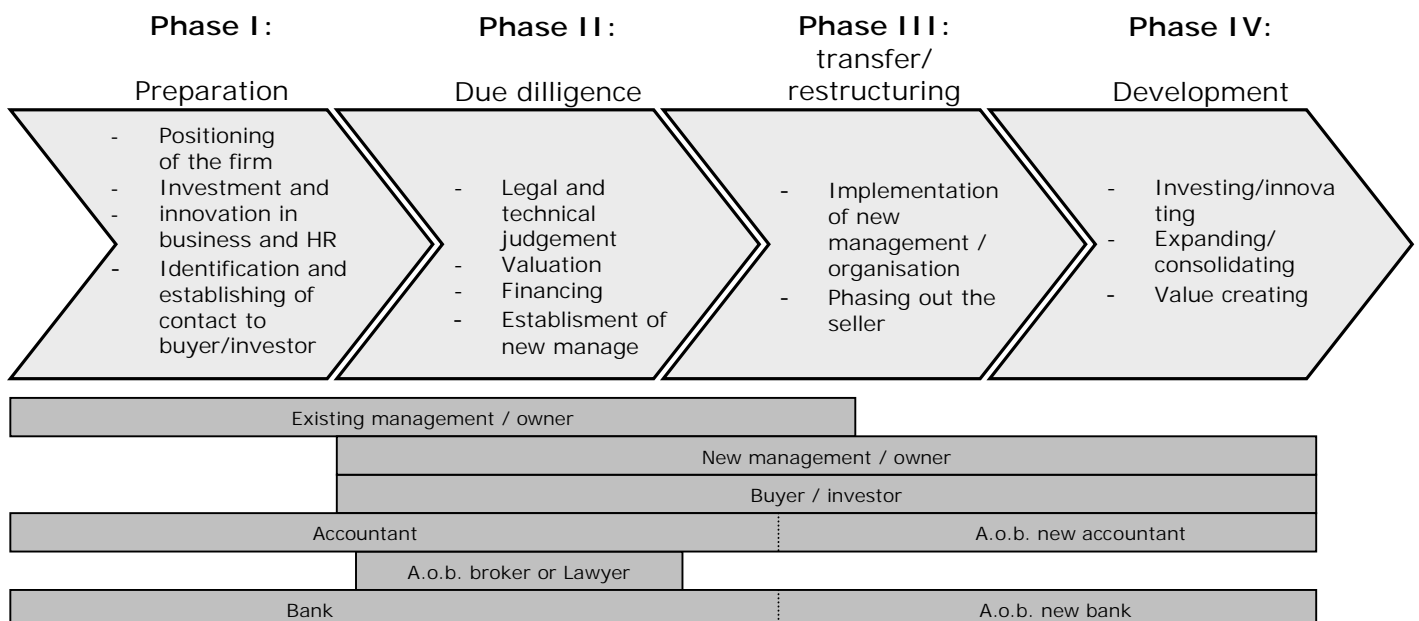
Figure 2.1. Buyers in relation to business transfers



Source: Vaekstfonden

A business transfer is a process of actions influenced by a range of internal and external players. The process can be divided into phases – each crucial to the success of the overall process and each implying requirement of qualifications and specific performance. The process is shown in figure 2.1.

Figure 2.2: The business transfer process



Source: Vaekstfonden

3. The business transfer market – capital

The analysis provides two new estimates of potential business transfers - one based on a survey among experts and one based on registers. Furthermore, the analysis offers a first quantification of risk capital available as well as funding needed for Danish business transfers is presented. Finally, the market for business transfers is evaluated.

Demand side – number of business transfers based on questionnaire

The first estimate of firms facing a business transfer within the coming 5 years is based on a questionnaire given to 183 experts of which 34 % answered. The group consists of representatives among firms, financial institutions, venture and private equity companies, business angels, accountants, lawyers, local authorities and researchers.

Table 3.1: Firms considered potentially business transfers within the next 5 years¹

Number of firms	Firm	Bank	Venture capital and business angels	Accountants and lawyers	local authorities	Others
0 - 10.000	33%	25%	45%	11%	17%	9%
10.000 - 25.000	33%	0%	9%	22%	50%	36%
25.000 - 50.000	0%	63%	27%	11%	17%	27%
50.000 - 75.000	33%	0%	9%	44%	0%	9%
75.000 - 100.000	0%	13%	0%	0%	17%	18%
> 100.000	0%	0%	9%	11%	0%	0%
Average number of Firms within the Individual group	28.333	35.625	28.864	47.500	30.417	38.636

Source: Vaekstfonden

The number of firms going through a business transfer is estimated by the experts to range from 28.000 to 48.000 within the next 5 years, see table 3.1. In spite of the considerable dispersion most weight is put on the lower end (30.000-35.000). It should be noted that venture and private equity companies represent the lowest estimates while accountants and lawyers go highest.

As previously described business transfers can take place through different channels. To focus the analysis, the above listed estimates are segmented into three levels: firms suitable for external financing in general (provided by banks or suppliers of risk capital), firms suitable for risk capital and furthermore firms expected to be able to attract risk capital in relation to business transfers.

The number of firms suitable for external financing in general lies in the range of 10.000 to 22.000, see table 3.2. Similarly, the subset of businesses that are prepared to take in risk capital is judged to be at a level between 1.954 and 8.250. In both cases, the providers of risk capital (venture and buy-out funds as well as business angels) again represent the lowest estimate while accountants and lawyers capture the top. At least 1.450 firms will meet difficulties in the attempt to attract an appropriate amount of risk capital.

¹ The average number of firms assigned to the individual group appears as the average of each interval. For instance 5000 is used in the interval 0-10.000 firms, while 12.500 represents 10.000-25.000 firms. The interval > 100.000 firms is assigned the value 100.000 though.

Table 3.2: Firms suitable for external financing in general, risk capital and the ability to attract risk capital in relation to business transfers.

	Firm	Bank	Venture capital and business angels	Accountants and lawyers	Local authorities	Others	Average
Total number of firms suitable for external financing in general	12.907	18.703	9.814	21.639	13.181	11.591	14.639
Total number of firms suitable for risk capital	5.532	6.336	1.954	8.250	4.119	3.593	4.964
Firms suitable for and with ability to attract risk capital	2.771	4.265	504	3.567	2.340	1.616	2.384
	50%	67%	26%	43%	57%	45%	48%
Firms suitable for but with no ability to attract risk capital	2.761	2.071	1.450	4.682	1.779	1.977	2.580
	50%	33%	74%	57%	43%	55%	52%

Source: Vaekstfonden

The results indicate that the majority of firms facing an external financed business transfer will rely solely on traditional banks as the financial source. Nevertheless, the experts estimate that an essential share of the remaining “risk capital applicable” firms will meet difficulties in attracting risk capital. This could be due to an excess demand for risk capital in relation to business transfers or alternative lacks in market efficiency – for instance it could be a consequence of poor market transparency and thereby inadequate matching of firms and investors.

Typically, the differences in types of firms suitable for risk capital are relatively restricted. Due to the risk, the investor’s required return will be above average and correspondingly the potential earnings of the firm must be relatively high.

Table 3.3: Potential earnings – firms suitable for risk capital

Firms across intervals of potentially earnings	
< 1 mill DKK	12%
1-5 mill DKK	16%
5-25 mill DKK	22%
25-100 mill DKK	22%
100-250 mill DKK	14%
> 250 mill DKK	14%
Total	100%

Source: Vaekstfonden

The typical firm suitable for risk capital has earnings exceeding 5 but not 100 mill., see table 3.3. Not as many but still a large share is found above 100 mill DKK, while only few firms with potential earnings below 1 mill DKK is considered suitable for risk capital.

Demand side – number of business transfers based on register

To compliment and verify the above estimates, registers from Købmandsstandens Oplysnings Bureau (KOB) and Statistics Denmark have been used to calculate the total number of firms expected to go through a business transfer within the next 5 years. Furthermore, these have been divided into different industries and earnings intervals. Finally, the demand for risk capital in relation to business transfers has been estimated.

To reach the final estimate, it is assumed that the age distribution and pattern of withdrawal among self employed and business owners are identical. Next, the investment preferences regarding industries and earnings of business angels, venture and private equity corporations revealed by the questionnaire are applied to select the relevant subset of business transfers.

The estimate of firms going through a business transfer within 5 years is 43.000, which is in inside the range mentioned above.

Table 3.4: Firms suitable for risk capital in relation to business transfer

Industry	Potentially earnings (mill DKK)						Total
	< 1	1-5	5-25	25-100	100-250	>250	
Food, beverages and tobacco	23	5	17	20	7	1	73
Textiles and leather	22	3	17	4	1	0	48
Wood, paper and printing	49	13	30	14	1	0	108
Ref. petroleum, chemicals and plastic	10	4	15	14	2	2	46
Other non-metal mineral prod.	13	2	8	8	1	0	32
Basic metals	96	32	82	41	9	4	263
Furniture and other industries	29	6	19	10	1	1	66
Construction	97	22	17	5	1	1	143
Sale and repair of motor vehicles	61	8	13	3	1	0	86
Wholesale and commis. trade excl. of m. veh.	85	14	32	11	2	1	145
Detailhandel og rep. virksomhed undtagen biler	114	6	9	5	1	1	136
Hotels and restaurants	32	3	2	1	0	0	37
Transport	96	13	16	10	5	1	140
Post and telecom.	4	0	1	0	0	0	5
Finance, insurance and pension	21	3	5	3	1	1	33
Real estate and renting	67	2	2	0	0	0	72
Business service e.t.c.	79	7	7	3	1	0	98
Sewage and refuse disp, culture, org.	77	6	5	2	0	0	91
Total	974	150	298	153	35	13	1.623

Source: Vaekstfonden

Within 5 years, 1.623 firms going through a business transfer will be suitable for risk capital, see table 3.4. This is fairly close to the estimate based on the questionnaire (app. 2.000). The majority of firms achieve earnings lower than 1 mill DKK and therefore caters mostly to business angels as providers of risk capital. However, by employing a strategy of consolidation among small firms they could also make up attractive assets to venture and private equity companies also. Among the firms listed in table 3.4, app. 500 have a business size that meets the criteria of traditional buyout funds.

Demand side – amount of risk capital demanded in relation to business transfers

Whether additional fundraising is needed or not depends on two aspects. The number of firms positioned in the field of interest and capital demand caused by these firms. By the principle of discounted earnings this leads to an estimate of the demand for risk capital in relation to business transfers.

The employed discount rate is based on two assumptions - investors required return and the degree of leverage. We use a required return positioned at a level similar to the realized return among the upper quartile of European buyout funds – 34%. In addition, we use the fact that typically an acquisition is partly financed by debt- as it is assumed that 2/3 of the total investment is debt carrying an interest rate of 8%. Of course, the method allows for different scenarios, but the above stated is found most reasonable.

Table 3.5: Capital demand in relation to business transfers

Potentially earnings per year (mill DKK)	Number	Share	Capital demand (mill DKK)			
			Total	Debt 2/3 of total financing	Risk Capital	
					bill DKK	share
< 1 mill DKK	974	60%	5.844	3.896	1.948	4%
1-5 mill DKK	150	9%	2.700	1.800	900	2%
5-25 mill DKK	298	18%	26.820	17.880	8.940	18%
25-100 mill DKK	153	9%	57.375	38.250	19.125	39%
100-250 mill DKK	35	2%	36.750	24.500	12.250	25%
>250 mill DKK	13	1%	19.500	13.000	6.500	13%
Total	1.623	100%	148.989	99.326	49.663	100%

Source: Vaekstfonden

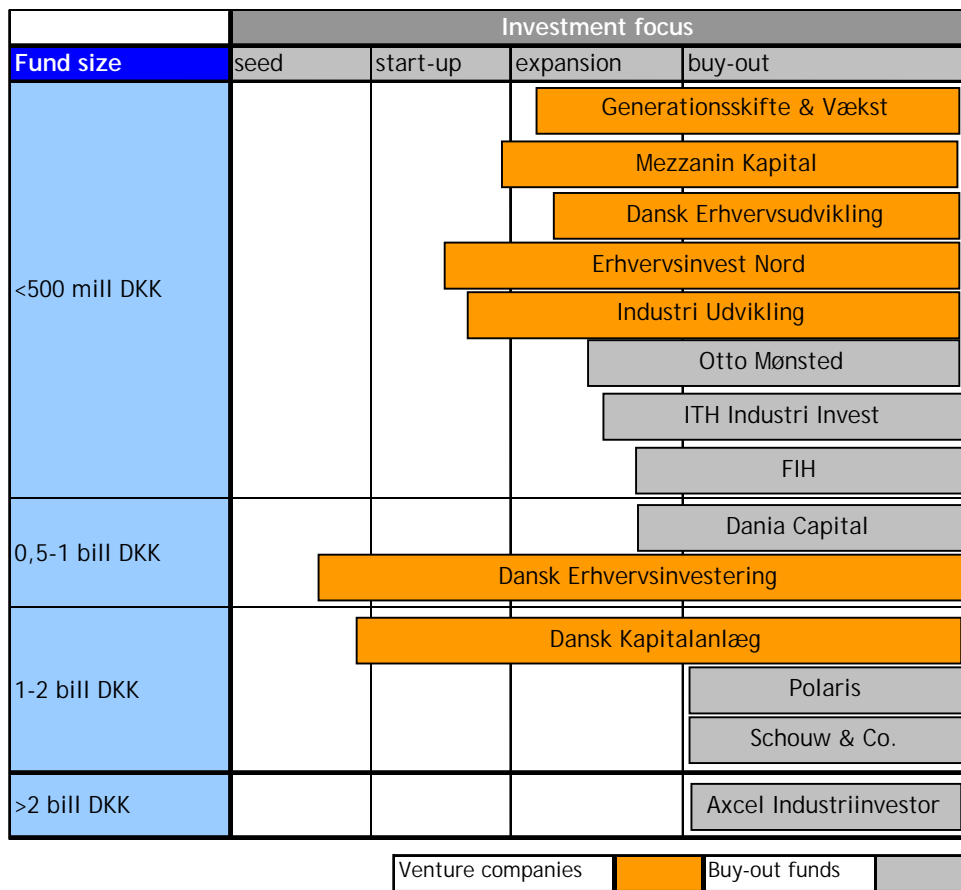
Smooth and appropriate completion of business transfers among firms suitable for risk capital generates a total capital need of 149 bill DKK within 5 years, see table 3.5. Of this 99 bill DKK should be covered by loans, while app. 50 bill DKK must be procured by providers of risk capital. Thus, the total amount of risk capital needed to fund business transfers over the next five years is close DKK 50 mill.

Supply side – amount of risk capital supplied in relation to business transfers

Danish as well as international investors act as sources of funds to firms present in the Danish business community.

The Danish dimension of the supply side is outlined in figure 3.1 with financial size as well as preferred development phase taken into account.

Figur 3.1: Danish investors in relation to business transfers



Source: Vaekstfonden

In all, the Danish funds manage app. 12 bill DKK. Of this 3 bill. DKK has already been invested, which leaves app. 9 bill DKK to new investments. Adjusting for firm-specific investment focus, the actual resources available to business transfers reach a total of app. 7,5 bill DKK. In addition business angels are expected to contribute app. 1,5 bill DKK during the next 5 years.

The international dimension contains fewer but larger funds. In figure 3.2 these are sketched according to similar criteria as in figure 3.1.

Figure 3.2: International investors in relation to business transfers

	Investment focus			
Fund size	seed	start-up	expansion	buy-out
< 10 bill DKK				Accent Equity Partners
				Procuritas Partners
≥ 10 bill DKK				Nordic Capital
				Industri Kapital
				CVC Capital Partners
				EQT Partners
		Capman		
	3i			

Source: Vaekstfonden

The international funds in figure 3.2 represent a financial volume exceeding 100 bill DKK. A part of this will be channelled into Danish business transfers, which form an international supply of app. 10 bill DKK during the next 5 years. Here as well as in the case of Danish funds, the estimate is based on the investors' statements about foci.

Table 3.6: Expected supply of risk capital in relation to business transfers

Potentially earnings per year (mill DKK)	Danish funds	Danish business angels	International funds	Total
< 1 mill DKK	7	225	0	232
1-5 mill DKK	255	575	0	830
5-25 mill DKK	1.214	700	0	1.914
25-100 mill DKK	4.056	0	585	4.640
100-250 mill DKK	1.905	0	6.000	7.905
>250 mill DKK	0	0	3.500	3.500
Total	7.437	1.500	10.085	19.022

Source: Vaekstfonden

Firms with expected earnings lower than 5 mill DKK is estimated to attract only app. 5% of the total supply. Medium sized firms (earnings between 5 and 100 mill DKK) are assigned app. 7 bill DKK - primarily contributed by Danish investors, while large firms by nature are the focus of international investors and thereby expected to receive the largest share of the supply, see table 3.6.

The market – demand and supply of risk capital supplied in relation to business transfers

Comparing demand and supply of risk capital reveals a significant disparity. During the coming 5 years a smooth and appropriate completion of business transfers requires risk capital in the range of 50 bill DKK, but at the outset only 19 bill DKK is available. This means that further funds of at least 30 bill DKK has to be raised to meet the demand.

Table 3.7: Capital demand across earning intervals

Potentially earnings Per year (mill DKK)	Capital demand (mill DKK)	Supply of capital (mill DKK)	Requirement of new funds by investors		Number of firms not being financed without further fundraising	
			Mill DKK	Distribution	Number	Distribu- tion
< 1 mill DKK	1.948	232	1.716	6%	858	69%
1-5 mill DKK	900	830	70	0%	12	1%
5-25 mill DKK	8.940	1.914	7.026	23%	234	19%
25-100 mill DKK	19.125	4.640	14.485	47%	116	9%
100-250 mill DKK	12.250	7.905	4.345	14%	12	1%
>250 mill DKK	6.500	3.500	3.000	10%	6	0%
Total	49.663	19.022	30.641	100%	1.238	100%

Source: Vaekstfonden

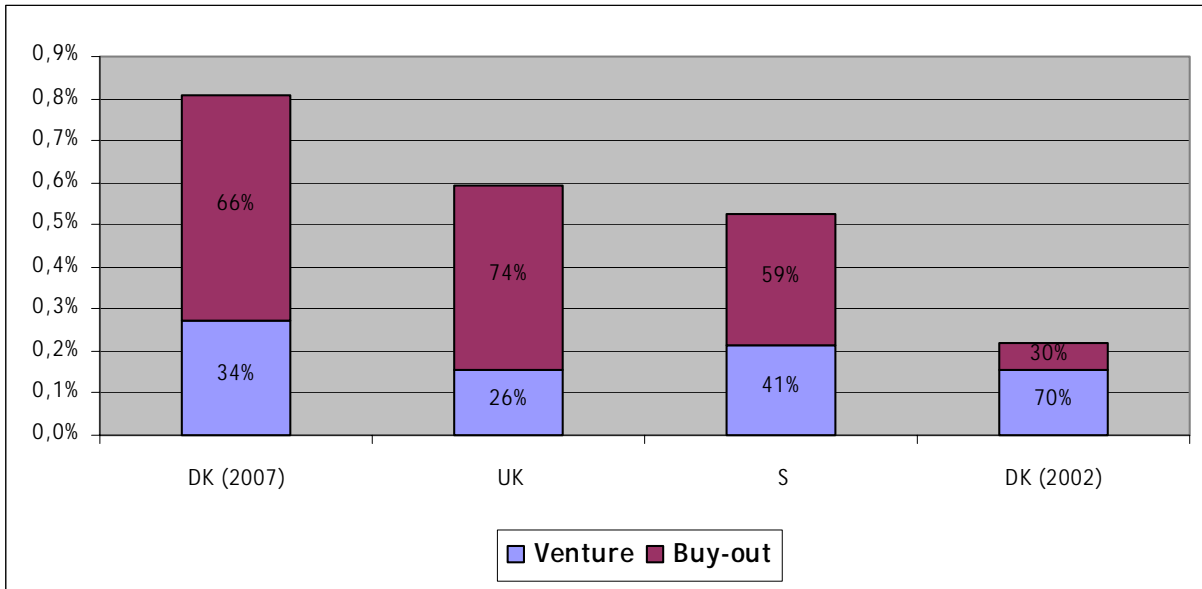
Keeping in mind the overall situation, the existing required fundraising within the individual segments varies considerably. An inverse relationship exists between the number of firms not being able to attract risk capital and the total amount of capital needed across earnings segments. For instance only 10% of firms with potential earnings exceeding 25 mill DKK will need risk capital but still this capital amounts to 71% of the total capital needed, see table 3.7. In contrast, the smallest firms (potential earnings less than 1 mill DKK) account for only 6% of the excess demand but still 69% of the firms positioned here will not be funded.

Even though there is a general requirement of new funds to be raised, challenges faced by different firms vary in nature.

International perspective

The volume and composition of risk capital investment determines the efficiency of a market. Compared to other countries, the Danish buyout market for business transfers is still in its infancy, see figure 3.3.

Figure 3.3: Venture- and buyout-investments (% of GDP)



Source: Vaekstfonden

Due to a longer track record, UK and Sweden perform better in terms of the volume of investments. But more remarkable is the fact that while the share of total investment made up by buyout investments is 30% in Denmark, the corresponding rates for UK as well as Sweden is respectively 74% and 59%, see figure 3.3.

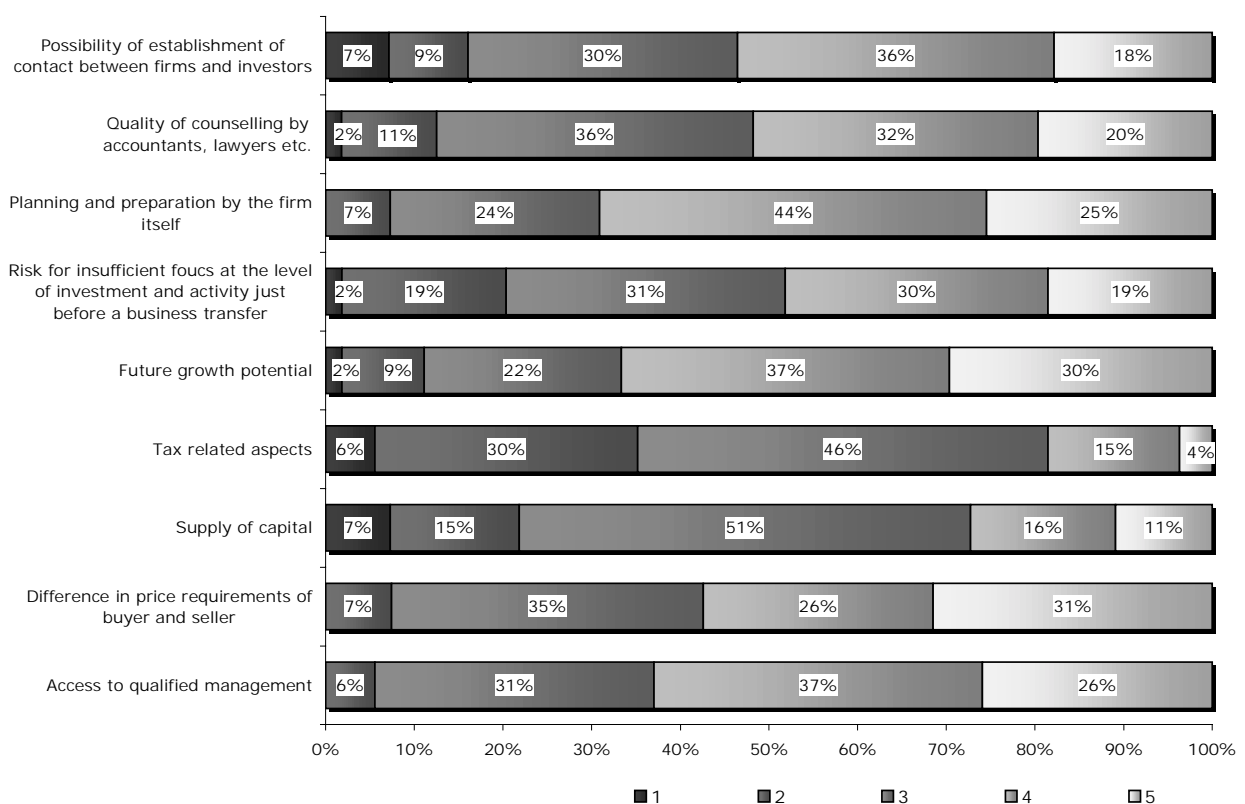
Further development of the Danish market should help catch up with leading markets in Europe.

4. Business transfers – more than capital

Access to financial resources is only one dimension in determining factors that are crucial to the success of going through a business transfer. Other factors are the possession of sufficient qualifications, committed efforts, good planning, qualified management, firm specific opportunities, efficient market communication, transparent agreements, and appropriate counselling.

To clarify potential inertia and challenges, the experts were asked to evaluate different aspects of the business transfer process. The results are shown in figure 4.1.

Figure 4.1: Challenges in relation to business transfers (1 = absolutely not, 5 = very noticeably)



Source: Vaekstfondem

According to the experts the greatest challenges concern the ability to establish contacts between firms and investors, the quality of counselling, and the risk of not being focused on innovation and growth in the preparation of a business transfer.

In contrast, tax related issues and supply of capital are not considered major challenges.

5. Perspectives

The above analysis investigates the dynamics of an efficient market for business transfers. In particular, risk capital, more qualified investors, and the need for careful planning by firm owners of emerges as key aspects of successful business transfers.

In the next 5 years, additional fundraising in the buyout segment is needed. In fact, the forecasts presented above reveal a potential excess demand for risk capital in this segment of 30 bill DKK. The demand arises from around 1.600 firms that have the characteristics of fundable businesses. To raise this kind of capital for buyout funds, more allocations from Danish pensions funds in particular is needed.

But raising capital is not enough. More buyout teams with deep commercial as well as financial experience must enter the market to manage this capital. In particular, that requires top- and middle-management from existing companies to break out and form their own venture funds.

On the part of current management in the firms facing succession, fulfilment of that goal demands that they devise a carefully thought out plan for handling the process.

The sheer numbers on companies and buyout capital highlighted in the above analysis emphasize how important it is for the Danish economy as a whole that the merger of capital and businesses be effective.

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