



EQUITY STEP-UP

Valentis Capital

Abstract

An overview of the concept & mechanism, a numerical example, detailed calculations, and investor outcomes.

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Introduction

This document provides an in-depth overview of the Equity Step-Up, a financial mechanism often used in search fund transactions. It includes a detailed example of how the model works, illustrating the potential impact on investor ownership and returns.

Disclaimer

The example presented in this document is for illustrative purposes only. Any resemblance to actual financial figures or real-life businesses is purely coincidental. *The information contained herein is not intended to be, nor should it be understood or construed as, financial advice.*

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What is the Equity Step-Up?

The Equity Step-Up is a mechanism designed to amplify investor ownership relative to their monetary contributions in a deal. By employing a multiplier, or “step-up,” this approach adjusts the equity distribution to incentivize investors while preserving meaningful ownership for other stakeholders, such as the searcher or operator.

Document Overview

This document is structured to provide a clear and comprehensive understanding of the Equity Step-Up:

1. **Concept and Mechanism** – A theoretical explanation of the Equity Step-Up, including key terms and the rationale behind its application.
2. **Example Overview** – A practical walkthrough of an example deal, highlighting assumptions, calculations, and equity splits.
3. **Detailed Calculations** – Step-by-step illustrations of Free Cash Flow (FCF) calculations, debt servicing, and the distribution of profits to investors and other stakeholders.
4. **Investor Outcomes** – A summary of key metrics, such as Internal Rate of Return (IRR) and Multiple on Invested Capital (MOIC), to demonstrate potential investor benefits.



Concept & Mechanism

Foundational Concepts

Understanding key financial terms is essential to grasp the mechanics of the Equity Step-Up. Below are definitions and typical ranges for critical metrics used in this model:

1. **EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization):**

A measure of a company's profitability before non-operational expenses. It is widely used to assess operational performance.

Typical Range: Varies by industry but often 15-30% of revenue in service-oriented businesses.

2. **EBITDA Multiple:**

This ratio compares the company's value (e.g., purchase price) to its EBITDA. It reflects market expectations of growth and risk.

Typical Range: 2.5x to 5.0x for small- to mid-sized businesses.

3. **Exit Multiple:**

Similar to the EBITDA Multiple but applied at the time of sale or exit. It gauges potential valuation appreciation.

Typical Range: Slightly higher than acquisition multiples, often 3.0x to 6.0x for growth-oriented businesses.

4. **Equity Step-Up:**

A financial structure that adjusts ownership percentages in favor of the searcher or operator by applying a multiplier to the equity injected by investors.

Typical Range: 1.5x to 2.5x equity invested.

Introduction to the Mechanism

The Equity Step-Up is designed to balance the interests of both investors and search fund entrepreneurs (ETA partners). It works by amplifying the searcher's ownership relative to their monetary contribution, acknowledging their critical role in sourcing the deal, conducting due diligence, and operating the acquired business. For example, a 1.5x Step-Up results in a more favorable equity split for the searcher while still offering compelling returns for investors.



Why It Works

- **For Investors:**

Assuming a 25% equity contribution, the Step-Up adjusts their ownership to reflect the enhanced risk-reward profile. For example, a 1.5x Step-Up increases their equity stake to 37.5%, offering strong returns while ensuring alignment with the searcher.

- **For ETA Partners:**

With a 25% equity investment from investors, the Step-Up enables the searcher to retain a meaningful ownership share (62.5%), recognizing their efforts in sourcing, managing, and guaranteeing the deal while reducing their financial burden.



Example Overview

The assumptions, sources, and uses outlined below fall within typical ranges for deals of this nature and provide the basis for calculating ownership splits and returns. This is a base case example, with minimal revenue and multiple growth.

Assumptions

This example uses a purchase price of \$1,985,000 and an adjusted EBITDA multiple of 2.7x, both common for small-to-medium business acquisitions. The seller finances 30% of the purchase price through seller debt, and the projected exit multiple is 3.0x. Other key assumptions include a 4% revenue growth rate, annual maintenance capital expenditures of \$20,000, and a 40% tax rate. These inputs are critical for evaluating cash flow and investor returns.

ASSUMPTIONS	
Purchase Price	1,985,000
x Adj. EBITDA	2.7
Seller Debt as % of PP	30%
Exit Multiple	3.0
Revenue Growth Rate	4.0%
Annual Maintenance CapEx	20,000
Tax Rate	40%

Sources and Uses

The total project cost of \$2,185,000 includes a purchase price of \$1,985,000 and \$200,000 for deal expenses and excess cash. This is funded through \$989,500 in BDC debt, \$595,500 in seller debt, and \$600,000 in equity from investors. These sources align with common financing structures in similar deals.

USES		SOURCES	
Cash at Closing	1,389,500	989,500	BDC Debt
Seller Debt	595,500	595,500	Seller Debt
Deal Expenses	100,000	600,000	Equity - Investors
"Excess Cash"	100,000	-	Equity - Searcher
Project Cost	2,185,000	2,185,000	Project Cost

Ownership

With a total equity contribution of \$600,000, investors fund 27.5% of the project cost. Applying a 1.5x Step-Up adjusts the equity split to 41.2% for investors and 58.8% for the searcher. This structure ensures alignment between the risks taken and the rewards distributed.

OWNERSHIP	
Total Equity	600,000
Gross Equity %	27.5%
Step-Up	1.5
Equity % - Investors	41.2%
Equity % - Searcher	58.8%



Detailed Calculations

This section provides a breakdown of how Free Cash Flow (FCF) is distributed between lenders and owners.

FCF to Lenders

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	2023	2024	2025	2026	2027	2028
Revenue	2,183,873	2,271,228	2,362,077	2,456,560	2,554,823	2,657,015
PF Adjusted EBITDA	722,341	760,035	799,236	840,005	882,406	926,502
Interest		(181,931)	(151,194)	(116,637)	(77,782)	(34,096)
Depr. - Deal Expenses						
Amort. of Goodwill						
Annual CapEx		(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
Taxable Income	722,341	558,104	628,042	703,369	784,624	872,406
Tax Payment to CRA	(288,936)	(223,242)	(251,217)	(281,348)	(313,849)	(348,962)
Sale Proceeds						2,779,506
FCF to Lenders	433,405	516,793	528,019	538,658	548,556	3,337,045

Free Cash Flow to Lenders is calculated by deducting Capital Expenses (CapEx) and taxes from the adjusted EBITDA. In Year 5, sale proceeds are added to reflect the final cash available for debt servicing. This ensures all debt obligations are met before distributing cash to owners.

FCF to Owners

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Senior Term Loan	12%					
Term (Months)	60					
Beginning Balance		989,500	835,840	662,693	467,586	247,734
Interest Payment		(110,471)	(90,983)	(69,024)	(44,279)	(16,396)
Principal Payment		(153,660)	(173,148)	(195,107)	(219,851)	(247,734)
Ending Balance		835,840	662,693	467,586	247,734	0
Seller Note	12%	Rate: Fixed				
Amortization (Years)	5	After Standby				
Standby Period (Years)	0					
Beginning Balance		595,500	501,763	396,777	279,192	147,498
Interest Payment		(71,460)	(60,212)	(47,613)	(33,503)	(17,700)
Principal Payment		(93,737)	(104,986)	(117,584)	(131,694)	(147,498)
Ending Balance		501,763	396,777	279,192	147,498	(0)
FCF to Owners	433,405	87,465	98,691	109,330	119,228	2,907,717



After servicing the debt, the remaining cash is distributed to the owners (investors and searcher). In this example, there are two lenders:

- **Seller Note:** A fixed-rate loan with a 12% interest rate, amortized over five years.
- **Senior Term Loan:** A similar 12% fixed-rate loan with a five-year term.

Debt service schedules for both loans, including interest and principal payments, are detailed in the table above. Once these obligations are fulfilled, the remaining cash flows are available to owners.



Investor Outcomes

After servicing debt, the Free Cash Flow (FCF) to Owners is distributed to preferred investors and the searcher based on the equity split.

Distributable FCF

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Year to Start Principal Paymer	3					
Preferred Equity (Rate)	5%					
Beginning Balance		600,000	600,000	600,000	520,670	427,475
Preferred Dividend		(30,000)	(30,000)	(30,000)	(26,034)	(21,374)
Principal Payment		-	-	(79,330)	(93,195)	(427,475)
Ending Balance		600,000	600,000	520,670	427,475	-
Distributable FCF	433,405	57,465	68,691	-	-	2,458,868

The distributable FCF is used to fulfill obligations to preferred investors, including a 5% preferred dividend and the repayment of their initial equity contribution. Principal payments begin in Year 3, ensuring cash is available for operations during the initial years.

Cash paid to Preferred Investors

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Equity % - Investors	IRR	26.2%	MOIC	2.9		
Initial Investment	(600,000)					
Preferred Dividend		30,000	30,000	30,000	26,034	21,374
Return of Capital		-	-	79,330	93,195	427,475
Profit Distributions		-	-	-	-	1,012,806
Total	(600,000)	30,000	30,000	109,330	119,228	1,461,655

Preferred investors are entitled to three components:

- **Preferred Dividends:** Paid annually at a 5% rate.
- **Return of Initial Capital:** Beginning in Year 3, principal payments reduce the outstanding preferred equity balance.
- **Profit Distributions:** Upon sale of the company, investors receive 41.2% of the total profit distributions as per the equity split.



Investor Returns

The returns for preferred investors reflect the benefits of the Equity Step-Up mechanism. Investors achieve an Internal Rate of Return (IRR) of 26.2% and a Multiple on Invested Capital (MOIC) of 2.9x, demonstrating strong performance driven by effective debt repayment and equity leverage.

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For access to the supporting Excel model or for additional questions, please contact Laura Lopez at **Laura@ValentisCapital.ca**.