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A Primer on Private Equity

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A Primer on Private Equity: Basics for Counsel to Middle Market Companies

By Joseph Feldman, President, Joseph Feldman Associates[1]

Many business owners are unfamiliar with or misunderstand the world of private equity investors. This may be a significant limitation as they consider (or too quickly dismiss) private equity as a potential alternative to their financing and ownership decisions. Below is a four-point primer suitable for advisors to share with such clients and to facilitate a more informed discussion about the potential relevance of private equity investors to their businesses.

1. What's a Private Equity (PE) Investor?

The short answer: A "private equity investor" commits money for ownership of companies that are not publically traded. Unlike venture capital firms (which invest in start-ups and "ideas"), a private equity investor invests in established companies. Some common features of private equity investors include:

- A PE investor typically focuses on companies in particular industries, geographies, financial stability (*e.g.*, growth vs. turnaround), and enterprise value. Start-ups are the domain of venture capital, *not* private equity investors.
- The focus of a PE firm is driven by the experience of that firm's managers; their particular expertise and experience typically increases their likelihood of success in a given area of interest.
- Through private ownership, companies owned by PE firms may avoid certain disclosure requirements (*e.g.*, SEC, Sarbanes-Oxley) and the quarterly earnings orientation of public companies. For some companies, public ownership is simply unavailable due to their size or other factors, and PE firms are a suitable alternative.

2. Top Reasons Private Equity Firms Invest in Middle Market Companies

Liquidity	• Simply speaking: there comes a time in the evolution of the business and the financial needs of its owners that leads to a desire to sell all or part of the company
Diversification	• Opportunity for a seller to reduce concentration of wealth in a single business
Access to growth capital	• Expansion of the business may require more equity than the current ownership is prepared to invest, or that can be secured from bank loans or other capital sources • New capital can support expansion of manufacturing capacity, sales/marketing team, new supply chain, new products/technology, acquisitions
New growth opportunities	• Potential for combining multiple business may enable new growth prospects: customer access/leverage, sourcing, channel access, employee recruiting/retention • Potential access to enabling expertise, such as: cross-border sourcing, international expansion, lean manufacturing, debt financing alternatives
Absence of viable succession plan	• No "family" member is suited or interested to succeed the current CEO • Potential internal buyers (*i.e.*, members of management) cannot secure capital to buy the business; sale by earn-out over time is deemed too risky or inappropriate for current owners
Alternative to liquidation	• For distressed or otherwise troubled companies, sale to a private equity firm may be the most advantageous way to retain/salvage value

3. Importance of "Fit" Between Business Owner & Private Equity Investor

As with any important business transaction, the likelihood of a positive outcome is greatly enhanced when the two parties' goals, personal chemistry and readiness to act are sufficiently in sync.

The descriptors below of "fit" are certainly important for a business owner considering the sale of all or part of their company to a private equity investor. And while these may not guarantee the finalization of a deal, their presence will surely enhance the potential for an attractive transaction, closed on a timely basis.

	Key Drivers of "Fit"
Before the deal	• PE firm's experience in company's industry and/or key challenges/opportunities particular to the business • Transaction size and post-closing investments suited to PE fund size and investment time horizon
Negotiating the deal	• Industry familiarity lowers risk of surprises that derail a deal • Shared view of key risks, opportunities
After the deal	In transactions where the "seller" retains management role and/or equity ownership in the business: • Alignment regarding go-forward investments in the business, operating priorities, performance expectations • Sufficient trust/respect to foster a constructive working relationship suited to the business

4. What to Expect in a Sale Process: FAQs of Business Owners

Q: "How can I maximize the value realized in the sale of my business?"

A: A tough one for generalizations, but below are a few ideas:

- Be prepared to demonstrate the value of the business and its potential: market trends specific to the company, financial results, customer/product understanding, and growth opportunities.
- Work with a knowledgeable buyer (*i.e.*, knows your industry), with access to capital (*i.e.*, avoids financing risk), and a good reputation (ask around).
- Anticipate and respond to a buyer's uncertainties and perceived risks about your company; this will minimize unnecessary valuation discounts; be appropriately supportive in due diligence.

Q: "What information will be expected during 'due diligence'?"

A: The basics you should anticipate include: financial statements; incorporation/ownership documents; agreements with customers, suppliers, employees; regulatory documents (*e.g.*, permits), contingent liabilities. More importantly, anticipate information specific to your company that a buyer will want to confirm their understanding of value and to reduce/eliminate their perception of risk.

Q: "What if I'm not sure if I want to stay on after the sale?"

A: When the time is right, candidly discuss your post-closing plans and concerns with the buyer… and earlier is generally best. Many investors are keen for the company's owners/managers to continue with the business, perhaps even to retain an ownership stake.

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