Is private equity funding the right choice for you?

If you're seeking capital to help grow your business—not for shareholder liquidity—the answer may be yes.

By François de Visscher

Five years ago, a landscaping company in the Midwest with annual revenues of $40 million developed an aggressive growth plan to expand its business into several new locations. To finance this expansion, the family shareholders decided to recapitalize the company, including an injection of $12 million in new private equity capital: $10 million to finance the expansion and $2 million to provide some liquidity for the eight family owners. After the recapitalization was completed, the family's stake in the company declined from 100% to 40%; the private equity partner owned the remaining 60%.

The family members continued to manage the company successfully. After 3½ years, they were able to recapitalize again—this time with debt—to buy out the private equity investors and go back to a control position, while returning about $24 million to the private equity fund. Today, the company has doubled in size. It will use its expanded cash flow to repay the debt.

As the number of private equity funds continues to grow, so does their interest in investing in family businesses.

To private equity investors, family firms are a good investment because of their financial stability, their long-term investment orientation and their solid brand and customer loyalty.

Under what circumstances should a family business consider tapping private equity? The answer depends on how you plan to spend the proceeds. Are you hoping to provide liquidity to get some chips off the table? Would you like to sell the entire business for succession or strategic reasons? Or do you want to take advantage of an expansion opportunity?

For the most part, private equity investors are interested in the growth of your company. They are in the business of building a portfolio of

investments that must grow to create value for the limited partners, and must be realized in a reasonable time frame.

Private equity investors are not likely to invest in your company solely to provide dividends or buy out existing owners. In those instances, their capital is not used to finance growth. Private equity investors typically expect to double their investment before they exit within five to seven years. Funding liquidity programs alone is not likely to generate such returns. However, private equity funds are very well equipped to provide capital to finance a growth plan or to fund an acquisition—even in combination with a liquidity event.

Think of private equity as transitional capital. In most cases, your family's patient capital will outlive the investment period of a private equity partner. Planning for the exit of the private equity investor after the transition is completed is as important as attracting the right partner at the outset.

You'll need to do some homework before entering into discussions with any private equity investor. Here are some guidelines to help you determine who would be the right partner for you:

General due diligence

- **Chemistry and trust.** As is true of any partnership, a private equity relationship must be developed on the basis of mutual trust and respect. Conduct extensive research on the managers of the fund—their background, reputation and integrity.

- **Knowledge of your industry.** Capital is not the only benefit you should derive from your private equity partners. They should also assist you in implementing your growth plans. Look for a partner who knows your industry and has contacts within it.

- **Experience with family businesses and how they operate.** Ideally, you want a partner who understands and can relate to family business issues—shareholder liquidity and control, family governance, family culture and heritage, attachment to the community. Investigate and evaluate your potential partner's past investments in family companies.

- **Track record and general reputation.** Check out the private equity literature—journals, newsletters and Internet resources—to get some idea

of returns in the industry. Assess how your potential partner's track record compares with these statistics. Look behind the numbers; examine the quality of the firm's investments. What is its reputation in the investment world? You want to work with a fund that is in good standing with institutions and investors. A good partner is one that has been supportive of its investments, even when the financial performance has not been as expected.

Structure of the fund

- **Size.** The fund should be small enough that its investment in your company is important to your partners. For instance, if you're looking for a $10 million investment, you don't want a $500 million fund. The firm will consider the amount it's investing in your company to be so small that no one will pay attention to you.

Similarly, the fund should not be too small. If you need more money down the road, the investors should have the capital to provide it. As a general guideline, the fund's investment in your company should not represent less than 5% or more than 25% of its portfolio.

- **Governance structure.** Most private equity funds consist of several professional investment partners and are managed by a general partner. It is important to understand who your contacts are going to be and how they plan to oversee their investment. You want someone who can pay attention to you at the senior level and provide continuity in dialogue with the family.

- **The fund's investors.** Not all private equity funds are the same. The type of investors in the fund will often dictate the degree of flexibility and the terms of the investment. For instance, private equity funds whose investors are multifamily offices or individuals will typically have the largest degree of flexibility regarding investment terms as well as timing and structure of their exit.

- **Other capabilities.** What sorts of strategic guidance, board representation or industry networking contacts can the partners provide? For example, Parthenon Capital, based in Boston, initially was a strategic consulting firm that branched into private equity. It obviously brings a deep strategic angle to investments.

Terms

• **Structure of the investment.** Do the investors expect their stake in your company to be in the form of common or preferred stock? What length of exit do they want? What kind of approvals would they require? What percent of your company will they expect in exchange for the funds they invest in your company? Remember: Transitional capital can be majority or minority capital. Will the deal come with control clauses that will allow the private equity fund to take control of your company if it doesn't perform at a certain level?

• **Board seats.** How many board seats will the investors want, and how active will they be on the board? What outsiders might they bring to the board in addition to one or two of their own representatives? What resources and experience—such as in technology or overseas contacts—do these outsiders bring to the table?

Because many private equity funds are competing for a finite number of investment opportunities, you can be very choosy. Look for someone who can bring you more than the money. With careful due diligence and planning, you should have no trouble finding a private equity partner who can help you meet your business, family and liquidity goals.

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Prerequisites for a successful private equity transaction

• **A well-defined growth story and a plan to implement it.** Before seeking a private equity partner, your company must have a well-thought-out business plan that describes how the capital will be used, and how that will translate into growth. Your management team must be on board with the business plan and understand the methods by which they will be rewarded.

• **Clearly defined liquidity needs of the owners.** In structuring the transaction with the private equity partner, you would be well served to

identify and provide for the immediate and ongoing liquidity needs of the family owners. After the private equity partners have entered your company, they will define the liquidity opportunities for the family. They will want to see all or most of their capital going to finance growth—not shareholder liquidity.

- **An effective family governance structure.** Before you bring in a private equity investor, ensure that your family governance structure is in place and well functioning. Your board or shareholders' assembly can help crystallize the family's goals and provide a strong interface with the private equity partner during the investment period.

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