

Is private equity right for your family-owned business?

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Family-owned businesses and private equity: the two are hardly strangers. Over the years, there have been private equity investments—of all types and across a myriad of industries—in family-owned entities.

That said, thanks to retiring baby boomers, such investments might become a larger part of private equity portfolios in the coming years. Given the demographics of this large and entrepreneurial generation—78 million Americans born between 1946 and 1964, according to the U.S. Census Bureau—we are just entering an era where increasing numbers of family business owners will be looking to partially or fully divest their ownership in firms they or a family member founded. In fact, a 2007 Grant Thornton International study found that four in 10 businesses will change hands in the coming decade.

For these reasons, more private equity firms may decide to explore investments in family-owned businesses.

These types of deals are often very personal and the transactions call for a nuance and finesse that might not be necessary in other types of dealmaking.

As an illustration, a Grant Thornton client, the founder and CEO of a successful manufacturing firm, recently decided the time was right to diversify his wealth. He wanted to realize some liquidity and pursue philanthropic and other interests. Although he was ready to relinquish majority ownership, he wanted to continue running the company, at least for several years.

As a business owner, and not a dealmaker, the client was unfamiliar with the finer points of a recapitalization and had many questions. To help allay his concerns and educate him on the finer points of private equity, a series of meetings was held with several private equity firms. Armed with a list of questions, the client quizzed each of the firms' representatives on its investment process, plans for running the company, the likely exit, and the history of the private equity firm itself. The marathon sessions, which took place over three days, illustrate the concerns central to family business owners looking to sell.

Control

The idea of giving up control is not easy.

As the person at the helm, you want to leave a legacy for the business, your family and your employees. When meeting with private equity firms, align yourself with one that presents itself as a partner and sees the investment as a true collaboration designed

to further grow the company and benefit investor and owner alike. Some private equity firms, of course, insist on full control, while others are flexible. The key is to match the fund with your objectives.

Clearly outlining the difference between economic and operational control is of paramount importance. There is often a misperception among owners that a private equity firm will constantly be looking over their shoulder, involved in every decision concerning the operation of the business. In most cases, however, the investor wants the person who has so successfully built and run the business day to day to continue doing so.

Leverage

Business owners fear it. Private equity firms can't do a deal without it.

Many business owners have never operated with leverage. The idea of placing significant debt on the business can be troubling. A primary concern is the possibility of default, and what it may mean for the business and you personally. Will the private equity firm show you the door, or use its influence with the lender to help remedy the situation?

Education here is all-important. While the downside may be obvious, having your adviser help you understand the necessity, benefit and significant future gains made possible by the use of leverage often times can help you get over the hump.

Deal structure and fees

A deal must be equitable to both sides.

In addition to leverage, there are certain elements of a deal structure that particularly resonate with owners and that need to be addressed up front and clearly explained. Private equity firms frequently prefer to use a different type of financial instrument than what a business owner will receive to guarantee downside protection. This could be a deal breaker.

Private equity firms should be willing to share in the same risks and rewards as you. If there are incentives for you to get a greater piece of the upside upon exit, such as a clawback, the private equity firm should ensure that you fully understand them.

Some transactions include a closing fee, which is often very unpalatable to business owners. If the private equity firm plans to take a payment at closing, this must be clearly stated and a cogent argument provided for doing so.



Value-add

Value-add may be the Achilles Heel of private equity firms when pitching family business owners.

Private equity firms may not perceive it as a weakness, however, and, in fact, may view it as a strength. But the value-add could hobble or cripple the chances of closing a deal. Private equity firms often believe they bring significant added value to a prospective portfolio company. That may not always be the case. It is critical that the firm knows your business. In some cases, private equity firms can demonstrate the expertise they can bring to bear on the business.

It can be difficult to imagine that an investor can bring meaningful know-how and skills to further grow the business of a sophisticated enterprise. On the other hand, private equity firms that can demonstrate expertise in product sourcing, acquisitions, international expansion or strengthening the executive team or board could be an asset to a mature business.

Chemistry

The baby boomer generation is as diverse as its numbers. An owner of this generation can be an urbane, sophisticated 40-something with Ivy League credentials, or someone from rural America who learned the business from the ground up and is nearing retirement age.

Regardless of background, the private equity firm should establish a true rapport with the owner from the start. The firm needs to be thoroughly versed in the company and its history, and the firm representative must clearly communicate an understanding of the business and a respect for the business owner and what you have accomplished. Ultimately, you must be convinced that the private equity firm is providing a fair valuation and an equitable deal structure. Select a firm that will be a true hopefully value-added partner that shares your vision for the long-term continued success of the company.