Charter Capital Partners

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WHY BUSINESS OWNERS PARTNER WITH PRIVATE EQUITY FIRMS

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Misconceptions about private equity firms

Many stereotypes have been associated with private equity firms, some of which even show up in the news headlines from time to time. Reducing employee count to save costs, shutting down locations, and making decisions only on financial metrics, are only a few examples, but there are certainly others. While these examples happen sporadically (and mostly in extremely large companies) the vast majority of private equity firms focus on growing businesses, increasing headcount, expanding product lines, and growth through acquiring additional related businesses.

When it comes time to think about succession planning and long-term business planning, there are many benefits of partnering with a private equity firm. In the following whitepaper we focus on a series of questions that we often hear from those looking to learn more about private equity firms, and some facts that may help uncloud the mystique of the industry.

What is a private equity firm and what do they do?

Private equity firms seek to invest, grow, and return capital to investors in private equity funds, which are essentially pools of capital that get raised from a variety of investors in the market. These investors are typically segmented into two types:

1) **Institutional investors**, such as pension funds, insurance companies, and endowment funds.

2) **Non-institutional investors,** such as high net worth individuals and family offices.

While access to investing in these funds can be somewhat limited as an individual, many investors look at private equity investments as another method of portfolio diversification as it offers a different risk/reward profile than more generalized investments in the public stock or bond markets.

Like any other business, a private equity firm's primary goal is to make money, and they do that by purchasing individual businesses and selling those businesses in the future for more money than the original purchase price. A simplified way to think about this is the "revenue" of a private equity firm is the enterprise value of a business when they sell it, and the "costs of goods sold" is the enterprise value of the business when they purchase it. In practice, there are many ways that private equity firms can accomplish profitability and thus generate a return for their investors:

1) **Earnings Expansion:** Purchase a company at 8x earnings, grow earnings, sell at 8x earnings.

2) **Multiple Expansion:** Purchase a company for 8x earnings, improve non-earnings aspects of the business, sell at 11x earnings.

3) **Debt Paydown:** Purchase a company with 50% equity and 50% debt, pay down debt to zero, sell the company for same price and generate a 100% return on equity.

In an ideal scenario, private equity firms will attempt to execute on all three of these approaches, among many other more niche strategies to maximize the return for their investors.

How does a private equity firm make money?

In the previous section, we discussed how private equity firms make money for their investors, but not for the firm itself. Private equity firms, and their partners and employees, make money primarily via asset management fees and performance fees.

1) **Asset Management Fees:** Private equity firms typically charge annual management fees, often times around 2% of assets under management. For example, a $500 million fund would earn $10 million in asset management fees per year.
2) **Performance Fees:** Performance fees, referred to as carried interest, can vary from firm to firm, although typically average ~20% of profits from investments after a certain baseline rate of return is met for limited partners, and even higher profits when higher return hurdles are achieved. This profit flows to the general partner (GP) entity of the fund and results in long-term capital gains tax rates of 20% for the GP.

What benefits does a private equity firm provide to a company?

While some business owners fear the impact a private equity firm may have on their business, the right private equity partner can use their experience and expertise to greatly benefit a business. Successful private equity firms will often provide strategic and operational support following an acquisition that can help businesses with developing a detailed growth plan, process improvement, labor challenges, and more. Some examples include:

1) **Strategy Development:** Private equity firms can aid significantly in setting both the short-term and long-term strategy of the business. Short-term strategy (often called a 100-day plan) typically focuses on low-hanging fruit such as cost savings initiatives and infrastructure development where the private equity firm may have experience and/or advantages of scale through existing companies/relationships that smaller single business entities may lack. Examples include materials/vendor sourcing, insurance/benefits plans, and information technology/security protocols. Long-term strategy focuses on what the company looks like in five years and the specific avenues to get there.
2) **Knowledge Sharing:** Private equity firms will often host periodic meetings with leaders of their portfolio companies to knowledge-share strategy and best practices. From talent acquisition to combating inflation, no topic is off limits, and these meetings can help companies improve by learning from others facing similar challenges in the market.
3) **Establishing a Board of Directors:** If not already in place, private equity firms will seek to establish a board of directors for the company. Leveraging industry and business connections, they are able to recruit board members that have extensive insight into areas like the company's end markets and customers that can help improve the business going forward.
4) **Capital for Growth:** Private equity firms will often earmark additional capital in a specific deal to invest in growth for a portfolio company. Examples include acquisitions, new machinery and equipment, facility expansion, increasing the geographic footprint, and additional people/talent.
5) **Dedicated M&A Support:** Private equity firms significantly aid in all aspects of inorganic growth for their portfolio companies. From sourcing and executing add-on acquisitions to integration support, private equity firms help drive growth outside the core business.
6) **Equity Incentive Programs:** In a private equity transaction, the buyer typically sets up an equity option pool for a mutually determined employee group. While some firms focus primarily on providing these option pools to company leadership, others will open it up to the broader employee base. Specific structures can vary, but most plans allow employees to share in financial upside if business value grows above and beyond a predetermined value range upon the private equity firm's eventual sale of the company. This helps align incentives for all parties and can provide meaningful compensation for the employee group at the second sale.

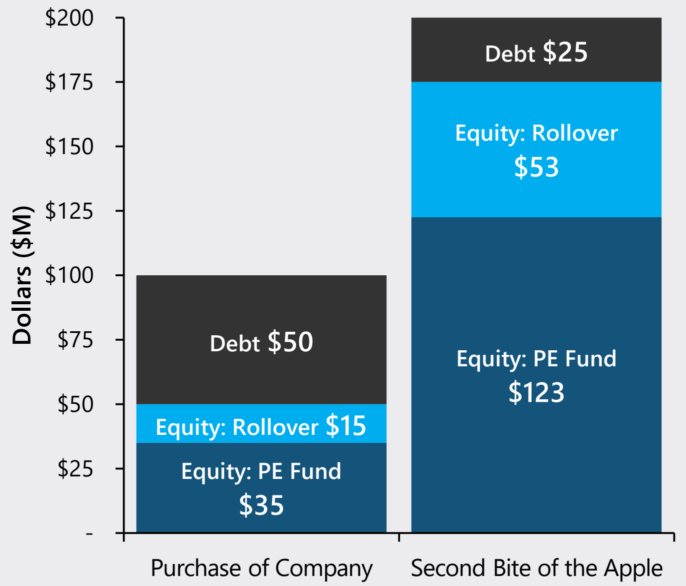
What is rollover and why can this be good for a seller?

Private equity firms generally view their portfolio companies as partners. While the private equity firm can provide significant strategic, operational, and financial support, they still need a management team (and potentially existing business owner) to run the day-to-day operations of the business post-close. So outside of the incentive equity program, what strategies can the private equity firm use to keep those people motivated?

One of the most popular strategies is "rollover equity," or the concept of the existing ownership group effectively reinvesting a portion of their proceeds from the sale back into the business in the form of minority ownership. This allows owners to realize a significant liquidity event and also provides monetary upside for a seller as they get a "second bite of the apple" when the private equity firm eventually exits the business.

Levels of rolled equity can vary drastically from deal to deal and some private equity firms may even require it, but we typically see seller post-close equity ownership of 10% - 30%. It's also important to understand that because private equity firms leverage debt to help fund a transaction, a 30% equity roll does not equate to a 30% post-close ownership in the business. Below is an illustrative example of how this works in conjunction with debt paydown and business growth, assuming a seller rollover of 30%.

Rolled Equity Example



In this example, where 50% of the $100 million initial purchase price is being funded through debt, a 30% rollover only requires reinvestment of $15 million, or 15% of the business owners' total pre-tax proceeds. Assuming that 50% of the initial debt is paid down, and the equity value of the business has doubled to $200 million by the time of the second exit, the business owner stands to increase their initial $15 million investment to ~$53 million, earning a 3.5x multiple on invested capital.

Final thoughts

To some people, partnering with a private equity firm is synonymous with large-scale negative change. The private equity "do anything for profit" mindset implies headcount rationalization and restructuring, facility relocation, etc. But in reality, today's private equity firms are focused on driving value through revenue growth vs. cost reduction while offering people, processes, and technology that can help owners and entrepreneurs to grow businesses, increase headcount, and generate a return for all parties involved.

Hopefully, this paper helps shed light into the world of middle market private equity firms, a few of the strategies they use, and what partnering with a private equity firm can mean for business owners considering a sale. Even so, we've only scratched the surface of the private equity world and the many nuances and levers that are at play in a private equity transaction. If you have any questions, or would like to discuss more about partnering with a private equity firm, we invite you to contact a member of Charter's advisory team.

Note: Rollover equity does not guarantee profits and use of leverage can accentuate both gains and losses.

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About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, succession planning, business valuation and capital raise.

Charter was named one of the top 100 most referred middle-market advisory firms in the US, according to a survey of 1,000 private equity firms, strategic acquirers, and family offices compiled by Axial, a network of middle market investors, advisors, and CEOs. Our mission is to deliver superior professional guidance throughout the complete business lifecycle.

About the Author

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Zach Wiersma has transaction experience across a variety of industries, including facilities services, business services, diversified industrials, and specialty contracting services.

His investment banking expertise includes merger and acquisition advisory, private capital raising, and strategic consulting for privately-held and family-owned businesses as well as divisions of large private and publicly-held corporate entities. He has advised businesses ranging in size from $10 million to $500 million of enterprise value.

Prior to joining Charter, Zach was an Associate at a Chicago-based middle market investment bank, serving clients across a variety of industries.

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Zach earned a BA in Finance from Michigan State University, graduating with honors. He has attained FINRA securities registrations including the Series 63 & 79.

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