Seeking Private Equity Partnerships—Rules of Engagement for Growth Businesses

The Vice President and Founding Partner of 3 Rivers Capital share the best strategies for increasing the value of your business to a private equity firm or strategic buyer

By Rob Carskadden and Greg Martin / August 16, 2022

One of the most important and often life-changing decisions a business owner makes is to sell their business. Every owner follows a different path to that decision. Having worked with a number of owners through that process, I've heard several common rationales. The first and most obvious is diversifying the family's wealth after devoting a lifetime to incubating a stable, successful business. In some cases, the owner is nearing retirement and their family's entire net worth is tied up in the business. In multigenerational, family-owned businesses, the net worth of several families may be at stake. If there is no obvious successor within the family, a sale is the natural conclusion.

Less obvious but equally important are situations when an owner recognizes an inflection point in the business where additional investment in the balance sheet would transform the business, allowing it to access new markets, customers, or projects, generating significant revenue (and profitability) growth. Rather than take that financial risk on their own, the owner can sell a majority of the business. This gives them the opportunity to retain a smaller slice of the economic upside and continue to run business operations, but acquire a partner with expertise in rapidly growing businesses and the desire and capacity to risk capital to significantly transform the business in a short period of time.

So, you've decided to sell your business. Now what? Unfortunately, it isn't as easy as selling a car or a house. The process in most cases takes many months and sometimes many years, particularly if you wish to maximize the return of your years of investment. To whom do you sell? What will buyers care about? How do you sell to them?

Below, we share some ins and outs of this process and provide a basic guide to preparing your business for sale in a way that will maximize its value. Our suggestions are from the perspective of a business buyer. Although we have many years of experience in this area, you should always consult with your professional business and legal advisors for specific guidance through this process.

TO WHOM DO WE SELL?

Answering the "who" of this process is relatively straightforward. There are two basic exit options: a private equity firm like 3 Rivers Capital or a strategic buyer, a company that is either a direct competitor or is seeking to enter your markets by acquiring your company. There are other potential exit options (management buyout, employee-owned ESOP, etc.), but the remainder of this article focuses on the typical exit transaction to a private equity or strategic buyer.

WHAT ARE BUYERS LOOKING FOR?

At their core, all buyers are looking for a good investment. They are willing to pay cash now in exchange for a return later. Private equity firms typically operate on a three- to seven-year time horizon and are seeking to generate cash returns at the end of that period that significantly exceed those typically available from public equities. A strategic investor's timeline for return can be infinite. And a "good" investment from a strategic point of view may have less to do with generating an immediate cash-on-cash return and more to do with diversifying service offerings, acquiring customers, or eliminating a competitor. Each of those ends creates value for the strategic investor's shareholders that may or may not be readily apparent to a seller or a competing private equity buyer.

So, buyers are looking for value. But how do you, as the business owner, increase the value of your business to a private equity firm or strategic buyer? The short answer is by increasing the business' free cash flow. Just as important, however, is by improving your firm's ability to generate accurate insights into your business performance on a detailed and timely basis.

Increasing cash flow is a business owner's bread and butter, but for a potential buyer it goes beyond just improving revenue and reducing expenses. A purchaser cares less about past cash flows—those belong to the business owner. They are buying future cash flow. The company's history, and the ability of an owner to produce evidence and commentary on that history, paints a compelling picture of the future. But a sophisticated buyer will be looking for more:

- How has the business positioned itself to capture future cash flow?
- How has your company differentiated itself from competitors in the market?
- Put simply, why are you better than competitors and how do you win business from them?

Being able to tell a credible story around differentiation, backed by the financial results of the company, goes a long way toward satisfying a potential buyer that the future may look somewhat like the past, or ideally, that the future is even brighter.

Your company has great cash flow and has differentiated itself in a compelling way from competitors. But once you sell the business, who is going to manage the day-to-day operations? Who is going to be responsible for capitalizing on the firm's positioning and capture those future cash flows? In many cases a private equity firm may have an operating executive they would like to place in the business, but rarely will a firm in the middle market show up to the table with an entire management team ready to go. Your firm becomes more valuable in their eyes if there is a professional, hungry management team in place that is ready to chase down those future cash flows. Not only does having an established, experienced management team reduce the perceived risk of the transaction from the buyer's point of view, but a good management team should be able to help you tell a credible story about your company.

A strong finance executive in place before you sell your business will help you produce a clear, accurate history of the firm's financial history. And an operations manager can help you prepare for sale by reducing any unnecessary operating expenses and inefficiencies out of your business. Going to market after having maximized current cash flow with a reliable financial reporting structure that proves your story will maximize the value of your company.

PREPARATION FOR SALE

If you think you'd like to sell your business, the first step is actually a step backward. Think long and hard about what you are trying to accomplish with the sale:

- What type of owner are you?
- Do you want to retire from the business or continue owning equity and/or managing the business with a sophisticated financial partner by your side?
- Do you have a number of shareholders to satisfy with the deal or is it just you and your immediate family?
- Do you want the business name to continue?
- Do you want the management team and employees protected after the business is sold?

These are only a few questions to consider, and your answers will help guide you through the process and may limit the number and type of potential buyers for your business. Come to an agreement with any other stakeholders that are important to you during this process and write down your decisions.

A transaction process can become emotional at times, and it can be helpful to return to these agreed-upon goals to keep all participants grounded throughout the process. Buyers will also want to know your answers to these questions as your business is more valuable to them if your goals align with theirs.

After establishing the "why" for your transaction, it is time to start working on the "what." What do you really have in your company? Take an independent look at your company and identify its strengths and weaknesses as if you were being asked to invest significant cash in your company today. Are you operating as efficiently as you can? Are there immediate revenue capture opportunities with significant future cash flows attached to them? Can you produce accurate financial statements for the last five years? Do you have a solid management team in place that can help you with those items? Essentially, you want to complete your analysis with a list of what makes your company more valuable and what makes it less so. After you have your list, set about capitalizing on what makes your company valuable and improving those things that do not.

At some point it will make sense to include some trusted managers in this preparation process. Their ability to participate in the transaction process and assist you in answering myriad data requests from buyers will relieve stress on you and put another check in the buyer's "value" column.

A VARIETY OF DEAL TEMPLATES

You've decided on your "why" and have analyzed (and improved) your "what." Next is the "how." One of the most common types of private equity investments is a control buyout. In a control buyout, a buyer purchases majority control of a company. After the transaction the buyer controls the company's free cash flow to make strategic decisions that will improve the buyer's return on investment. Those decisions could include making investments in employees and equipment, acquiring additional companies, or issuing shareholder dividends.

There are typically two ways to structure a business acquisition: as an asset purchase or stock purchase. Most common for private equity buyers is the stock purchase, where the buyer will buy the business owner's stock directly, stepping seamlessly into the business owner's shoes. The parties will agree on what if any liabilities will remain with the company after the transaction is complete. Often these transactions will be on a "debt-free, cash-free basis," requiring the business owner to repay any long-term liabilities but allowing the owner to sweep any excess cash from the business at close.

In an asset purchase, the buyer will not buy the business owner's stock but will acquire specific assets and liabilities from the company. This structure is more common when a strategic investor with an operating company wishes to acquire the operating assets of a business without also inheriting potentially harmful liabilities associated with the operating entity. There are potentially significant tax implications associated with each structure that are best discussed with your financial advisor and attorneys.

IS PARTNERING WITH A PRIVATE EQUITY FIRM RIGHT FOR YOU?

If your "why" includes continuing with the business in any capacity (as a manager or owner), partnering with a private equity firm can allow you to realize financial diversification while working with a sophisticated financial partner to drive rapid value creation. Some business owners find that their "second bite" when the private equity group exits the investment can be as lucrative (or more so) than the initial sale of the company to the private equity firm. Choosing the right firm for your business and management team is essential to a successful second exit. The ideal firm will be able to clearly identify how and why they can add value to your business. Many firms can assist with day-to-day operational improvements like adding systems to improve "business science," adding governance structures and financial controls, recruiting new management members, and supporting growth initiatives (whether organic or by acquisition) with financing.

Of utmost importance, however, is finding a firm whose strategic vision aligns with your own. A private equity group will bring with it powerful resources, but if you disagree with their strategic vision, two powerful forces will operate in opposition, dooming the relationship. The great thing about the transaction process, however, is that it is two-sided. While the buyer completes diligence on you and your business, you have an equal opportunity to vet the buyer and question their intentions with your company. If everyone has done their job properly, when the deal closes, both sides will be happy with the transaction result and excited to capitalize on the next stage of the company's life.

3 Rivers Capital is a private equity firm based in Pittsburgh, Penn., that focuses on acquiring founder- and family-owned businesses with free cash flow of $3M to $15M. If you are interested in discussing your strategic options, please feel free to contact Rob Carskadden at (412) 764-2491 or carskadden@3riverscap.com.

< PREVIOUS   NEXT >

3RC

437 Grant Street, Suite 500 | Pittsburgh, PA 15219

412.765.2491 | info@3riverscap.com |