Are You Really Ready for Private Equity?

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There are a number of reasons that successful businesses look for private equity investment. Private equity can provide growth capital and some liquidity for business owners while they continue to grow their businesses. While more expensive, private equity also tends to be more flexible in its terms than traditional debt financing. Hence it may be particularly attractive in today's challenging economic environment where bank and similar debt financing is becoming harder to get and more restrictive in its terms.

Still companies need to carefully consider whether private equity is right for them. Investors typically take a significant minority or even a control position that may leave the CEO in a position where he or she can be removed at will and gives the investors control over the timing of an exit. Private equity firms also typically impose extensive reporting and similar obligations that can be time consuming and at times frustrating for entrepreneurs. Private equity is a viable option for many growing companies but must be regarded as a long-term solution and will only work if the interests of the investors and operators are clearly aligned.

The decision to go the private equity route is only the first step in a long process. Companies need to ask themselves if they are truly prepared for the rigors of an institutional investment. Most private equity firms are fiduciaries to their own investors and as such conduct extensive due diligence prior to making an investment. Companies considering private equity financing need to prepare carefully. A lot of the frustration and delay that sometimes arises during the diligence and documentation of private equity transactions can be avoided through careful planning and preparation.

Choose your partner carefully. Investors come in all shapes and sizes. Some private equity funds restrict their investments to verticals with which they have significant experience. Other private equity firms are "generalists" who are willing to look at any attractive opportunities. It pays to do some research upfront on any potential partners. What sort of companies have they invested with in the past? What, in addition to capital can they bring to the table to assist the growth of the business, whether through expertise, contacts, or otherwise? The management team also needs to be clear among themselves how open they are to such input. How large have their investments been? What is their stated investment philosophy? The prospect of cashing out on part of their shareholdings may be appealing but it is important that management have a workable partnership with their investors going forward.

In many instances it may make sense to hire an investment bank or other advisors to conduct a formal process to evaluate potential investors. Third-party professionals can help vet private equity firms as well as create a competitive dynamic between private equity firms and potential strategic acquirors. Investment banks charge significant fees and aren't appropriate in all circumstances.

Choose your advisors carefully. It is very important that any company contemplating a deal with a private equity firm choose advisors who know the ins and outs of this world. A company's normal law firm and accounting firm may be fine for the company's regular business needs, but if they are not versed in the terms and conditions of private equity deals, the company should consider retaining specialists. Experienced CPAs can shape the way in which a company presents its historical financials and projections, which can have an important impact on valuation. Similarly, experienced law firms can ensure the company gets a market deal on the purchase and sale terms and conditions and workable governance documents. This infrastructure is critical in creating a working partnership going forward. Private equity firms can drive hard bargains on both the accounting and legal fronts, and it is best to have experienced representation at the table to protect your interests.

Get your financial statements audited. Private equity firms feast on financial information, sometimes to a fault. If a company has not historically had its financial statements audited, it should consider doing so in anticipation of a financing. The reliance on internally generated statements can prove costly, as it may significantly delay the process and subject the company to the risk of last-minute adjustments in valuation. At a minimum, a company should have its financials reviewed by an independent CPA firm. Similarly, it is worth hiring an independent accounting firm or investment bank familiar with the financial underpinnings of private equity deals to review the company's projections. It may cost some money in the short run but will prove worth it.

Create an electronic data room. The due diligence required to complete a private equity financing can be exhausting. Both the private equity firm and the lender in a leveraged deal have detailed requirements and will want to carefully review a company's contracts, intellectual property, employee records, litigation history and so on. Many deals lose momentum when a company is unable or slow to respond to diligence requests. The best way to handle these extensive data requests is to prepare in advance. We recommend that the company establish an electronic data room. There are a number of companies that provide such services, so they are no longer prohibitively expensive. There is a predictable set of documents and other materials investors will want to review so counsel can work with management to identify and gather the key materials and load them into a data site at the outset of a transaction. This will eliminate the need to send multiple copies to potential investors and their counsel, accountants, and bankers. It will also significantly reduce the workload when there are multiple bidders. By organizing this material upfront management will be free to respond to the myriad questions that will inevitably arise during due diligence. This can prove key to the timely completion of a transaction.

Eliminate the noise and focus on valuation and growth. It is extremely important that management face early on potential financial and legal issues that are likely to come up during due diligence. Many deals go sideways on issues that are uncovered late in the process. It is better to do a thorough and honest assessment of potential problems at the outset, connect the issues, and develop answers to questions upfront. Have a heart-to-heart with your lawyers and accountants upfront, and they should ask the tough questions. Are there any issues that will prove to be non-starters? Does the company know of any intellectual property infringement or other legal issues? Is there any major unfunded pension or similar liability? A lot of time and money can be saved by identifying major issues sooner rather then later. Investors hate surprises, and sometimes when managers are caught unaware on an important issue, they lose credibility.

Compile customer and vendor information. Private equity investors typically spend a lot of time looking at customer and vendor data. Companies can be expected to ask to identify their largest customers and vendors over the past five to seven years. Companies normally have this information in some form, and it is better to pull it together upfront. Have there been significant changes in the mix? If so, be prepared to explain this and any concentration issues in the company's customer base. Are the company's margins under pressure. Investors will also want to know the competitive landscape. Who are the company's competitors, and what is the company's competitive advantage? Again, advance preparation is important.

Before making their investment, private equity firms will want to speak to these key relationships, but this can be back-ended in the process.

Investors always ask a lot of questions, some good and others less so. Still the company looking to close on a private equity transaction that has prepared to go through the exercise is much more likely to survive it.

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