The Life Cycle of a Private Equity Investment

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When owning and operating a business, owners face a variety of decisions regarding their ventures. They face some minor but necessary choices, such as the type of marketing avenues to consider or what kind of accounting software to use for better record keeping. Then there are decisions that require more thought and research, namely those that deal with finances and how businesses will go forward into the future. For many developing companies, the choice of whether to sell their operations to investors in exchange for additional capital and opportunities for expansion and innovation represents one of the biggest decisions that owners will face. These new opportunities give businesses a compelling reason to seek out private capital, and the relationships established between the two parties helps boost company operations and establishes investors as industry leaders, providing benefits all around.

For the purpose of this white paper, three Boston-based industry professionals gave their opinions about the trends, changes, impacts and other factors that private equity investments have seen recently and could possibly experience in the near future. Robert Emmert is a managing partner with private equity firm McCarthy Capital. John Surrette is an audit principal with accounting firm Kahn, Litwin, Renza & Co. Christian Atwood is an attorney with Choate Hall & Stewart LLP. Their insights into the industry can give companies a better understanding as to what a private equity deal is comprised of, how legal and financial aspects play out and what businesses need to create an effective deal process and ensure smooth transactions.

When they consider selling a part of their business, owners will want to equip themselves with the basic knowledge of private equity and how investments will impact a company's current processes as well those in the future. Investopedia gives the simple definition of private equity, stating that it "consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity." (1)

However, as with any aspect of business, the true nature of private equity is much more complex. The Private Equity Growth Capital Council (PEGCC) writes that while these investments significantly help companies in need, private equity deals also drive economic growth by creating millions of jobs as well as give developing companies a way to improve their current strategies and develop successful ones for the future. (2) The PEGCC also notes that the overall goal of private equity investments is to increase businesses' value and performance over a longer time period. Therefore, the relationships established in these deals need to be strong, as PE firms and companies will be working together for quite a while. (2)
So how do business owners know if a private equity deal is right for them and will help them achieve their goals? Inc. magazine offers some insight into which factors inform this kind of decision for many company leaders. Of course, the main reason developing businesses primarily seek out private equity deals to obtain capital, whether it be for growth, expansion or just to stay afloat. (3)

While some owners may believe that finding other sources of capital - such as banks - could solve their financial issues, the truth is that these institutions often offer a limited amount of capital. So if a business hopes to access more funds, options may be few and far between, which builds the appeal of private equity.

In addition, finding a team of partners who understand a certain industry or the processes involved in keeping operations running are other elements that many owners look for in the PE firms that they want to work with. (3) PE deals often result in the creation of more structured plans and procedures for company success, as well as the enhancements of that are already in place. Also, as investors may be more involved and hands-on in day-to-day operations of the businesses they invest in, the availability of this expert advice and guidance play into the decision-making process for many owners. (3)

Generally, PE firms decide to work with businesses in order to seize the opportunity to maximize their own investments while also helping owners and their operations. However, investors look for several factors when determining whether a small company is worth the time, money and resources. In a separate article, Inc. explains there are several metrics that PE firms look for in a potential business partner. Investors want to conduct a deal with a healthy company, the magazine states, and also seek to determine whether a business is stable, PE firms analyze cash flow, products, liquidity and how well companies are managing their current expenses and whether they can continue to do so in the future. (4)

There are also times when PE firms decide to work with companies that are not performing as well as others in their industry or those that are failing or could very well be on their way to shutting down. The main reason for this approach is the fact that investors can purchase these businesses at a discount, which in turn boosts PE firms' ability to turn a profit. By doing this, fledgling companies are provided with opportunities for growth and investors bring in profits. Of course, the money that PE firms bring in depends on how well the bought businesses perform, as any operational improvements and prosperity result in investors' profits.

Robert Emmert, managing partner at McCarthy Capital, says that his firm looks for all of these components, along with well-defined business goals and an articulated vision for growth. In addition, when seeking out PE deals, many companies fail to figure out how much of their venture they want to sell. Emmert states this is an element that must be figured out well before deals begin. If businesses cannot clearly articulate their goals and visions, along with why they want to work with PE firms, investors may not be interested in putting in the time and effort to develop deals.
"Other than giving you money - which anyone can do - how can we help you accomplish your goals?" Emmert says, explaining the view from the private equity side when determining which businesses to work with and what investors want to see. "Why are you here talking to us as opposed to the other firms that can do the same thing? We need to know what their vision of a partner is."

The benefits of PE deals are not seen immediately, but once investments have been made and businesses begin working with PE firms, these advantages instantly become obvious. The PEGCC notes that companies are made stronger through these opportunities and become more valuable by increasing their revenues as well as reducing costs. (5) They are more competitive and create more innovative solutions and ideas. PE firms benefit by being a part of a successful venture and developing into leaders in certain industries, giving them more chances to invest in other sectors and businesses.

In the United States, private equity, like many other industries, found itself negatively impacted by the economic recession. Emmert says many companies cut their workforces and revenue levels coming out of the recession, many now wonder whether these reductions are viewed as sustainable by PE firms and if businesses can keep growing.

The PEGCC states that PE deals are picking back up across the country, as the last two quarters of 2012 saw boosts in the number of investments. For the third quarter, firms invested $66 billion in 433 deals while in the fourth quarter, $102 billion was put into 451 companies. Overall, 2012 saw $313 billion invested in 1,807 firms, and while this isn't as strong as the $359 billion into 2,106 deals throughout 2011, analysts believe 2013 will see a continuation of strong growth. (6)

As with the overall fluctuations in the PE industry, the most invested-in sectors also change over time. Pitchbook conducted a study to determine which industries are set to be the focus of PE investments in the near future. The research looked at the trends that happened within the PE sector in 2012, as this is a good indicator of the industries that will be the focus of firms this year. Although healthcare investments declined over the past few years, the recent implementation of the Affordable Care Act and the regulations companies will be required to follow have brought more clarification to the industry, which Pitchbook estimates will result in more investments in 2013. (7)

Information technology is a sector that has seen strong PE investments over the past few years, and analysts expect this trend to continue. In 2012, 18 percent of the $55 billion that was invested in IT companies came from private equity. Energy firms are getting a fair share of PE investments as well, Pitchbook discovered, as 58 percent of total investments last year was from private equity.
There are also legislative changes that are set to take hold of private equity deals this year, affecting not only the investors' side, but the legal and accounting aspects as well. Dealbook reports that the tax advantages PE firms enjoyed in the past could be revisited, meaning that the carried interest income rate may increase, although certain alterations have not yet been implemented. However, Emmert states that these proposed changes might be viewed as "neutral" within the industry, mainly affecting firms that deal with smaller investments.

"In terms of corporate tax reform … we feel it's going to be largely neutral for us," Emmert notes. He adds that larger deals could be affected, however, but changes are yet to be seen.”

Christian Atwood, partner at Choate Hall & Stewart LLP, says one trend he noticed toward the end of 2012 was a "deal frenzy," or a rush by investors to get deals done before the end of the year in preparation for potential tax increases. This has impacted Atwood's role but didn't necessarily change the structures of the deals, which is one key aspect that attorneys work to hammer out with PE firms and companies.

Atwood notes that another trend with regards to deal structures is more diligence from investors. By taking this approach, PE firms can ensure the businesses they are working with have everything in order and will experience growth once deals are finished.

"Buyers are increasingly doing more extensive diligence and taking longer and being more thoughtful potentially about making investments," Atwood explained. "They want to see financial performance carried out."

Once businesses are aware of the state of the PE industry and whether deals will help their operations, owners should investigate how long a typical investment will take. Emmert states that for his firm, the average timeline is 12 months, but deals vary based on the different factors facing companies, the due diligence processes and how much money is being exchanged. He notes that within the industry overall, deals are increasingly compressed, as intermediaries are becoming more efficient, and both people and funds are moving faster.

Emmert calls the first four months of the timeline the "dating stage," as this is when PE firms and businesses get to know one another and become familiar with employees and partners. The first meetings take place before financial, legal and management aspects are discussed, and during these months, no third parties are brought in. Emmert says it is important for investors and companies become acquainted as they will be working exclusively with one another.

Over the next two months, PE firms and businesses start the process of laying out a deal structure, and details become more apparent, according to Emmert. He says this represents the most opportune time for entrepreneurs to explain their goals to investors, giving them time to understand these missions and how they can be realized through the eventual deal.
"Months four to six is when you start to get into the meat of the discussion and start to frame the outline of the transaction," Emmert states.

However, third parties, such as attorneys and accounting firms, do not yet enter the process, as this stage focuses mainly on what companies are looking for in a deal and how PE firms can help make those wishes a reality.

The final step within the timeline, which typically takes place between the sixth and twelfth months, is when the details are hammered out and the deal is finished, notes Emmert. In addition, this is when outside intermediaries, such as legal and financial professionals, are brought in.

Atwood states that he is normally asked to step in during this time period to perform due diligence for his clients, which are the PE firms. He says he has noticed changes in deal structures in the recent past, mainly due to increased due diligence and changes to taxes and regulatory procedures. He states that his role is to become a trusted advisor throughout the deal process for both parties, but particularly for PE clients.

"You are the architect of the documentation," he explains. "Your job is to figure out how to get that deal done in a way that is palatable to both sides, while protecting your client."

Atwood adds that while the typical role of the lawyer in growth equity deals has evolved as the industry has matured, he doesn't expect it to change dramatically in the future, as the way that attorneys interact with PE firms and the relationships between the two are "well-oiled machines."

Another task that falls under Atwood and the legal team is risk allocation, which he explains does not only involve the risks his clients would face, but the companies as well. He states that both parties need to be aware of any problems or issues that could occur soon or in the near future, and these potential threats are normally highlighted within the deal contracts. He says that investors and businesses should enter into the agreement with an "eyes wide open" approach.

Along with the legal expertise they bring in, PE firms also work with accounting firms to handle the financial elements of transactions, which is an extremely vital task. Of course, the financing of an investment varies depending on the business sector, how much money is being exchanged and what kind of deal it is - stocks, assets or some other form.

John Surrette, audit principal and Certified Public Accountant with the accounting firm Kahn, Litwin, Renza & Co, Ltd., explains that he is brought in on a deal around the sixth month mark to help both parties with the financial aspects. He notes that once an offer has been put on the table, accounting expertise becomes necessary and his services are requested. His job is to perform due diligence to determine if the company has their finances in order and is ready to go through with the transaction. Surrette adds that he also deals with a variety of local, state and federal tax issues as well as international issues - all of which both the PE firm and the business need to be aware of beforehand.
He says that while he handles mostly the financial side of a deal, his firm also looks at other aspects of the company’s systems and its personnel. One of Surrette's tasks is to make recommendations based on where certain support is needed, such as information technology upgrades and (or) additional personnel needs. He, as part of the process, may also be responsible for helping companies get their finances in order, which is a problem he runs into when owners believe their operations can be sold but books and records are not organized effectively.

One main thing that Surrette notes is important to keep in mind throughout the deal process is that these transactions often involve family or founder-owned businesses, which means the sale of a part of their hard-won operations is one of the biggest decisions they will face.

"It is a life changing event, in some of these cases," Surrette explains. "We want to be sensitive to that fact and we want to try and make the experience as painless as it can be."

He adds that while he does work mainly for the PE firm and his job is to call attention to any financial issues that arise, ultimately he wants to keep the needs of the business in consideration as well and treat everyone with mutual respect. Surrette also states that he often collaborates with all parties, including attorneys, to ensure that all targets are being met and the right focuses are being developed.

Once a deal has closed and ownership has been transferred, then begins the "first 100 days" time period, in which several key operational aspects are focused on to get companies on the road to growth. These elements can include anything from developing sound financial strategies, restructuring salaries, managing inventory and cost consolidation, among other vital components. The goal of this starting step of the "first 100 days" is to pinpoint where improvement is needed and then implement methods to achieve those goals.

Next, investors and businesses will work together to figure out why and in which areas there were aspects that led to poor market value and customer retention, along with other issues that were occurring before the deal was made. The goal of this step is to focus on companies' core competencies and grow on their strengths. Outsourcing competitive processes, focusing on successful products and evaluating relationships with other businesses are all strategies that are used during this time.

Toward the end of the "100 days," private equity firms then turn their attention to determining add-ons - such as mergers and acquisitions or sales alliances - as well as improving margins and boosting the competitiveness of companies to spur additional growth.

Once deals are finished and the "first 100 days" are over, the process does not stop there. Emmert notes that establishing an effective working relationship in the beginning stages of a deal is crucial, as companies and PE firms go on to work with one another. Investors continue to make major decisions regarding future operations, so building a deep understanding of what the owner wants and where the company is headed is vital for success.
In addition, the roles of legal and accounting professionals don't end once transactions are closed. Atwood says that he continues to help out with regulatory issues for PE firms and the businesses they acquire, while Surrette notes that his post-deal focus is on providing financial services for both parties.

For businesses seeking out private equity deals, knowing the ins and outs as well as the process involved can help owners determine whether investment is the right path for them and their operations.

Often times, leaders realize that by working with PE firms and legal and financial experts give them the tools needed to propel their companies forward and turn their dreams into realities.

As outlined in this white paper, accepting the investment - and the subsequent partnership with PE firms - is an extremely important decision for any business owner. The insights of Emmert, Atwood and Surrette highlighted the trends impacting the industry, which in turn affect companies seeking out investment and growth opportunities. Despite the changes, the most invested sectors, potential impacts and a variety of other factors, companies that have a clear vision of what they want in a partnership with PE firms, financial professionals and attorneys can set their operations on the road to success.
About the Industry Professionals

Christian Atwood, Esq. is an attorney with Choate Hall & Stewart LLP and has been named a Massachusetts Super Lawyers Rising Star in each of the last five years. Mr. Atwood has also been singled out in The Legal 500, a guide to the preeminent law firms and lawyers in the US, as a leading M&A lawyer in the field of private equity buyouts. Christian represents private equity funds and their portfolio companies through all phases of the funds’ investment process and their portfolio companies’ life-cycle – from initial investment to exit, including with respect to add-on acquisitions, carve-outs and other divestitures. He also represents institutional investors, portfolio companies and management teams in negotiating and structuring leveraged buyouts, recapitalizations, mergers and acquisitions.

Robert Y. Emmert, is a Managing Partner with McCarthy Capital. Mr. Emmert manages McCarthy Capital’s Boston Office. Prior to joining McCarthy Capital, Mr. Emmert was a General Partner with Alta Communications, a media and telecommunications focused private equity firm based in Boston. He has also worked in the Investment Banking division of DB Alex. Brown and the Corporate Finance division of Brown Brothers Harriman & Co. where he evaluated investment opportunities for the 1818 Fund, a private equity partnership. Mr. Emmert also assists with existing portfolio management where he serves on the board of directors of NRG Media LLC, Advantor Systems LLC and The Remi Group LLC.

John E. Surrette, Jr., CPA is an Audit Principal and Chair of the Private Equity and Venture Capital Services Group at KLR (Kahn, Litwin, Renza & Co., Ltd.) and has diversified experience with a variety of industries including renewable energy, private equity, casino gaming, auto dealerships, manufacturing and others. He works closely with private equity and venture capital firms in meeting both back office and portfolio company needs. He assists clients looking to obtain debt and equity financing and is experienced in evaluating investment opportunities as well as hands on experience during the pre- and post-transaction process.
Over the past several years, KLR has become a trusted advisor to the industry during all phases of the transactional cycle. Our deep understanding of the financial markets and numerous industries allows us to bring a level of experience that the industry requires. Please visit our website at kahnlitwin.com to learn more about our Private Equity Services Group and the services we offer.

Sources:

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