PointeBreak Solutions Inc.

A private investment bank providing transactions services to the middle market.

Partnering with a private equity firm

Experienced executives need apply

Private equity firms, or partnerships that buy partial ownership in private companies, have been around for several decades. During the 1980s, private equity firms were generally known as leveraged buyout (LBO) firms. LBOs acquired bigger companies using large amounts of bank and other debt, only to break the companies into smaller components and sell them off.

The hostile takeover tactics and highly leveraged nature of LBO deals earned them their share of bad press and disfavor among investors and the public. But since the early 1990s, private equity firms that emphasize improving a company's existing operations rather than profiting from its breakup value have emerged as the dominant players in the field.

While today's private equity firms still leverage investor equity with bank debt, they rely on it much less than LBOs did in the past.

Since 1990, private equity firms have raised record amounts of money from individuals and institutional investors. In 2000, fund raising exceeded $100 billion — more than 10 times the $8 billion raised in 1990.

How they're structured

Private equity funds are typically structured as limited partnerships, with fund managers acting as general partners and the providers of capital making up the pool of limited investors. Fund managers are compensated through an annual management fee — typically 1% to 2% of the fund's total capital — and an interest in any profits.

Partnership agreements between fund managers and limited investors usually provide for an investment period of five to seven years for any acquisition, and a total partnership term of 10 to 20 years. At the end of the partnership term, assets are sold and proceeds distributed.

How they operate

Private equity firms generally prefer to acquire a mature business and often back a particular entrepreneur or management team to run it. While some private equity firms specialize in turnaround situations, the firms aren't usually structured to provide operational input. Therefore, most private equity groups prefer to acquire a business along with executives with profit and loss experience.

The purchase price they offer for a company usually reflects a combination of equity and debt. In the past 10 years, lenders have become more conservative in their lending practices and now look primarily to assets as collateral and, to a lesser extent, cash flow. As a result, the required equity component in transactions today can be as high as 40% — up from 10% to 20% in the 1980s. Because of decreased leverage, private equity firms can also expect a lower return on their equity, from 40% in the early 1980s to 30%, or even less, today.

Further, equity firms can no longer rely on expansion of purchase price multiples — for example, buying at five times cash flow and selling at seven times cash flow — to achieve high returns.

So they tend to focus on building value operationally, or by increasing sales and decreasing costs.

Using private equity

Experienced entrepreneurs and management teams with limited financial resources can take advantage of equity firms' lack of operational experience. Partnering with an equity firm enables executives to achieve ownership that might not otherwise have been possible.

Private equity groups typically offer meaningful economic incentives to individuals or teams they back in an acquisition. In addition to a standard executive compensation package, the sponsoring firm typically allocates 10% to 20% of the acquired company's equity to management.

For example, a private equity firm might offer stock options of 10% for staying at the company for a certain time period, and an additional 10% based on achieving certain financial metrics such as revenue growth and profitability. If an executive has already identified a target business for acquisition, the equity sponsor may grant 5% equity.

Issues to consider

Private equity groups can differ greatly in terms of their size, geography and industry focus. It is important, therefore, that your target acquisition be aligned with the preferences of potential equity groups.

When choosing a private equity firm you should also know:

- Whether most of its limited investors are institutional. If so, its investment horizon is likely be in the three-to-five-year timeframe, vs. five to seven years with individual investors.

- How often the firm will communicate with you — weekly or quarterly. The more confidence an equity sponsor has in its executives, the less involved it's likely to be in day-to-day operations.

- The likely composition of the acquired company's board of directors. If the private equity group has a controlling interest, it will choose the board.

Ownership opportunities

The private equity industry has evolved over the past 20 years. Gone is the 1980s "greed is good" mindset that fostered hostile takeovers. Today's private equity acquisitions are less leveraged, expected returns are lower and a greater emphasis is placed on operational improvement.

This shift is good news for experienced executives looking for equity partners that will help them pursue ownership opportunities.