A STRATEGIC CHOICE

Family businesses have never had it so good. Private equity investors have realised that they are an extremely lucrative investment option. But don't jump in, says **François de Visscher**, do your research and make sure you choose the right partner for your particular business

Global private equity investments reached almost $500 billion last year, up 59% since 2002, according to Thomson Financial. In 2005 alone, private equity sponsors raised more than $172 billion worldwide, an increase of more than 30% over 2004, according to Standard & Poor's. With so much capital in search of places to invest, private equity firms have become very aggressive participants in the financing and mergers and acquisitions markets.

Until recently, family businesses were of little interest to private equity funds. Most funds did not have the resources to get involved in family squabbles, long histories of low growth and management challenges. Increasingly, private equity investors are realising that family firms represent a very lucrative investment for several reasons. First, family businesses represent a solid base of operations with a long operating history. They have a high-quality asset base, they establish trusted brand names and maintain a conservative financial structure. Also, family businesses that have professionalised the business promise attractive growth opportunities: they are poised to capture untapped operating performance potential, broaden their board's strategic vision and even diversify their financial sourcing opportunities.

> FAMILY BUSINESSES SHOULD VIEW PRIVATE EQUITY AS A SOURCE OF TRANSITIONAL, NOT PERMANENT, CAPITAL

The private equity market consists primarily of pool of funds from institutional investors, such as public or corporate pension funds, foundations, bank holding companies or insurance companies, and recently from wealthy individuals and families.

This new breed of private equity, funded primarily by family offices and wealthy individuals, is more attractive to family businesses than traditional institutional private equity investors. The advantage of this new type of private equity investors is that they inherently understand family businesses and the intricacies of expanding a business while adapting to the evolution of a family. Their investment-time horizon is longer than institutional private equity investors and in some cases they may accept a minority role, acting as a true partner to the founding family.

For a family business, private equity can be more attractive than other sources of capital.Unlike venture or angel capital, which is primarily interested in funding growth, private equity also can be used to satisfy the immediate and sometimes ongoing liquidity needs of shareholders. As opposed to bank financing, private equity strengthens the balance sheet of family companies, leaving open the possibility of future borrowing if needed. A private equity partner, particularly a family office type, can also offer assistance with strategy, acquisitions, management recruitment, and even provide further financial resources to the family business. Finally, a private equity partner can become a very useful agent of change. By partnering with the family, this new co-investor may bring financial discipline to the business and innovation in its management methods.

There are some drawbacks to private equity in a family company. First, such investors will not help solve diverging liquidity needs of shareholders and may sometimes limit the timing and opportunity for liquidity by the family. They may also infringe on family business control by their participation in management and their access to information.

In general, because the investment horizon of the family's patient capital will always be longer than the investment horizon of private equity investors, irrespective of their type, family business owners should view private equity as a source of transitional, not permanent, capital.Private equity is useful to effectuate a strategic or ownership transition. However, when inviting a private equity partner as an investor in the family business the family should plan the timing and method of their exit. Because private equity investors typically expect to double their investment before they exit, planning for such exit after the transition is completed is as important as attracting the right partner at the outset.

Consider a second-generation, Canada-based commercial real estate company. For 12 years, two branches of the family had battled over the strategy of the business – in particular over opportunities to develop hospitality properties in Florida. A series of animated board discussions among the two family factions resulted in stalling other burning business decisions. The showdown came when the reluctant faction expressed the desire to sell out. With the help of a financial adviser, the pro-growth faction identified potential private equity partners to provide funding for the buy out, while offering their experience and funds to assist in the Florida growth plans.

At the end of 2002, the company consummated its transaction with a private equity partner and began developing the properties in Florida. Three years later, the Florida project was so successful that the family was able to buy out the private equity partner with the proceeds of the sale of only one of the hotel properties.

With the growth and maturity of the private equity market, the alternatives for family businesses are multiplying every day. The question for many family businesses, therefore, is not whether, but how, to attract the right partner for your business. Here are some guidelines to help you determine whether the partner you're considering is the right one for you.

GENERAL DUE DILIGENCE

As is true of any partnership, a private equity relationship must be developed on the basis of mutual trust and respect. Conduct extensive research on the managers of the fund – their background, reputation and integrity.

Capital is not the only benefit you should derive from your private equity partners. They should also assist you in implementing your growth plans. Look for a partner who knows your industry and has contacts within it.

Ideally, you want a partner who understands and can relate to family business issues – shareholder liquidity and control, family governance, family culture and heritage, attachment to the community. Investigate and evaluate your potential partner's past investments in family companies.

Check out the private equity literature to get some idea of returns in the industry. Assess how your potential partner's track record compares with these statistics. Look behind the numbers; examine the quality of the firm's investments. What is its reputation in the investment world? You want to work with a fund that is in good standing with institutions and investors. A good partner is one that has been supportive of its investments, even when the financial performance has not been as expected.

STRUCTURE OF THE FUND

The fund should be small enough that its investment in your company is important to your partners. For instance, if you're looking for a $10 million investment, you don't want a $500 million fund. The firm will consider the amount it's investing in your company to be so small that no one will pay attention to you.

Similarly, the fund should not be too small. If you need more capital down the road, the investors should have sufficient resources to provide it. As a guideline, the fund's investment in your company should not represent less than 5% or more than 25% of its portfolio.

Most private equity funds consist of several professional investment partners and are managed by a general partner. It is important to understand who your contacts are going to be and how they plan to oversee their investment. You want someone who can pay attention to you at the senior level and provide continuity in dialogue with the family.

Not all private equity funds are the same. The type of investors in the fund will often dictate the degree of flexibility and the terms of the investment. For instance, private equity funds whose investors are multifamily offices or individuals will typically have the largest degree of flexibility regarding investment terms as well as timing and structure of their exit.

Examine what strategic guidance, board representation or industry networking contacts the partners can provide. Recently, we have formed a network of private equity investors, consultants and financial advisers called Business Growth Alliance who provide value-added and patient capital to family owned businesses.

TERMS

Do the investors expect their stake in your company to be in the form of common or preferred stock? What length of exit do they want? What kind of approvals would they require? What percent of your company will they expect in exchange for the funds they invest in your company? Remember: Transitional capital can be majority or minority capital. Will the deal come with control clauses that will allow the private equity fund to take control of your company if it doesn't perform at a certain level?

Private equity investors will require some liquidity down the road, which may result in the sale of the family company. If you have a sale, everyone benefits the same way. While the family may benefit from a financial point of view, it may not want to have it happen at the time the private equity firm does. So what are the family's recourses? Remember, the infusion of private equity does not need to end in the sale of the business if the terms are structured in the right way. The family may want to ensure that at the time the private equity firm wants to exit the investment, the family has the flexibility to buy them back or refinance with another private equity group. It's not necessary to leave control of the timing and the event to the private equity investors.

Find out how many board seats the investors will want, and how active will they will be on the board. What outsiders might they bring to the board in addition to one or two of their own representatives? What resources and experience – such as in technology or overseas contacts – do these outsiders bring to the table?

Because many private equity funds are competing for a finite number of investment opportunities, you can be very choosy. Look for someone who can bring you more than money. With careful due diligence and planning, you should have no trouble finding a private equity partner who can help you meet your business, family and liquidity goals. ■

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PREREQUISITED FOR A SUCCESSFUL TRANSACTION

Before seeking a private equity partner, your company must have a well thought-out business plan that describes how the capital will be used, and how that will translate into growth.

In structuring the transaction with the private equity partner, you should identify and provide for the immediate and ongoing liquidity needs of the family owners. The private equity partners will want to see all or most of their capital going to finance growth – not shareholder liquidity.

Before you bring in a private equity investor, ensure that your family governance structure is in place. Your board or shareholders' assembly can help crystallise the family's goals and provide a strong interface with your investors during the investment period.