PRIVILEGE PARTNERS

Private Equity for SMEs

Private Equity – Financing for SMEs

Small and Medium Enterprises (SMEs) which are considering an eventual sale of their business or requiring new equity capital, might want to consider working with a Private Equity (PE) firm. PE firms may offer an alternative to Strategic Buyers for suitable SMEs wishing to sell their business. This brochure shortly outlines the relevant aspects from the perspective of SME business owners with respect to a full or partial sale of their business to a Private Equity firm.

Private Equity funds manage money from institutional investors such as pensions funds, insurance companies and wealthy families. Every year around 5'500 enterprises are bought by private equity and venture capital investors in Europe of which are 80% SMEs. Financial investors such as PE firms seek financial returns and wish to enhance their equity value during their investment period. SME business owners need to present a well prepared investment case in order to convince the PE firm to invest. The better the story is developed, the better the purchase price.

A PE firm may not necessarily be the best buyer for any SME as the business owner will be asked to share or even hand over control over the business to the PE firm. In addition the SME has to meet the investment criteria of the PE fund. Therefore the Pros and Cons of selling to a PE firm need to be carefully evaluated.

The company's management team might consider that the Private Equity firm expects the company to operate in a more transparent way than family run businesses and require tracking key performance indicators on a regular basis. Normally there is a constant pressure for results as the PE firm needs to deliver on their investment case and expected financial performance. Nevertheless, Private Equity is an established form of financing and offers business owners of suitable SMEs another alternative to consider.

The SME business owner is well advised to be clear on his own objectives and to carefully evaluate if those can be achieved through a full or partial sale to a PE investor. Therefore, one has to thoroughly prepare an investment case before engaging in a more in-depth discussion with a PE firm. The SME firm should present itself in an open and transparent manner in order to create a professional basis for a future cooperation.

I wish you an interesting reading and will gladly assist you for any eventual questions or comments you might have.

Cyrill Haenni

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[1)] *Quelle: Investeurope 2014*

Choosing the Private Equity Firm

How Private Equity works?

- Private Equity firms professionally invest funds of institutional investors in privately held companies (mostly SMEs). This offers diversification and return benefits of the portfolios of such institutional investors, which normally consist of bonds and shares in publicly quoted companies.
- Therefore Private Equity firms search SMEs which can offer an attractive investment opportunity in form of buyouts, growth capital or restructurings.
- Private Equity firms may want to increase their returns by taking on additional leverage through financial debt.

Types of PE Funds

- Private Equity funds normally specialize to solve specific company problems:
  - Growth – PE firms which focus to finance growth strategies such as acquisitions or financing a larger capital expenditure.
  - Buyout – the company is acquired by the PE fund and a management team.
  - Distress – Special PE firms which focus on companies in distressed and turnaround situations.

Investment Criteria

- Investment criteria vary by PE fund depending on its scope defined in the bylaws as per geography, industry, size (revenues and EBITDA[2)]) and preferred company situation.
- The PE fund should not yet be fully invested.

A limited Term Investment

- As per the bylaws of the fund, PE investors normally target a holding period between 3–7 years in which the team focuses to execute the agreed strategy and develops the company further.
- At the end of the investment period the PE investor will want to sell the company again.

Majority or Minority Stake

- Most PE investors will only consider investing where they can get a controlling majority stake. A minority stake will be reserved for the management team to align interests.
- Only a few of the PE funds will invest in minority stakes. Such stakes need to be significant (typically between 25%-49%) and ensure significant shareholder participation and influence.

[2)] *EBITDA = Earnings before Interest, Taxes, Depreciation & Amortization*

Financial Considerations

The Story

- Each investment requires a solid investment thesis which allows to create shareholder value.
- PE firms may prefer investment stories where the capital goes into the company rather than paying out shareholders.
- PE firms require that the company presents a detailed business plan.
- The main challenge Private Equity investors are facing is that investment theses are presented or developed in a suboptimal way. A well-prepared investor story can lead to a better purchase price.

Exit Scenario

- The Private Equity firm needs to obtain comfort that the company can be sold again, otherwise the PE firm won't invest at all.
- Private Equity Investors will recheck their own exit scenario with respect to the following buyer groups:

  - Strategic buyers from the industry
  - Other Private Equity funds
  - Initial Public Offering
  - Sale to management (usually avoided)
  - Purchase by previous owner (usually avoided)

Profit Considerations

- PE funds have to promise their investors that they will deliver returns of minimum 20% IRR[3)] per investment.
- Such returns are only achievable with growth potential, operational improvements, a high degree of financial leverage and/or an attractive purchase price.

Valuation and Price

- The PE firm needs to justify each investment before its investment committee.
- Valuation considerations mostly base on EV/EBITDA industry multiples and on IRR analysis.

[3)] IRR = Internal Rate of Return

Corporate Management

Management

- The PE Investor requires a reliable management team to run the company on a daily basis. As investor the PE firm will focus on strategic matters and assume no operational responsibilities (except for certain turnaround situations).
- A good management team can lead to a better exit multiple (impact up to 0.5x EV/EBITDA) in addition to a better financial performance of the company.
- The management team might be changed in case the agreed objective cannot be achieved.

Corporate Governance

- A well functioning corporate governance framework is a must:
  - Risk Management
  - Internal Control
  - Compliance
  - Advisory board
- The basic pillars of such a corporate governance framework should already be implemented prior to a transaction.

Financial Reporting

- A Private Equity firm requires a higher degree of transparency than a family owned business. The firm mostly focuses on tracking key performance indicators of relevance to the company's value creation activities.
- Foreseeable information requirements might lead to the adjustment of the monthly or quarterly management reporting.
- A systematic budgeting process is needed to ensure the budget and the business plan is thoroughly reviewed by the company's board of directors.
- The better the quality of the presented investor materials to the PE firm, the more transparency and trust can be created as basis for a future cooperation.

Focus of Operational Improvements

- Improvement of the financial reporting framework
- Expansion of sales activities and internationalization strategy
- Management of working capital
- M&A – add-on acquisitions
- Focus on core competencies and divestment of the non-core business
- Major changes normally will be implemented within 100 days after the acquisition

Legal Aspects

Shareholder Participation Rights

- As minority investor, the PE firm will ask for certain shareholder participation rights:
  - Board participation
  - Mandatory approvals for larger capital and operating expenses
  - Veto rights for key management positions (CEO and CFO)
  - Rights to initiate the sale of the company
  - Mandatory approvals for the company's business plan and budget
  - Veto rights for add-on acquisitions
  - Additional approval rights in case of crisis

Shareholder Agreement

- The PE firm will normally require a shareholder agreement to pool the interests of all shareholders and to rule the settlement of potential conflicts of interests in advance:
  - Drag-along (co-sale obligation) und tag-along (co-sale right) clauses
  - Pre-emptive rights and anti-dilution provisions
  - Rules regarding the composition of the board of directors
  - Agreement on the intended exit route
  - Liquidation preference
  - Ruling regarding dividend payout

Acquisition Process

- The sales process of a SME to a Private Equity investor normally follows standard procedures:
  - Situation analysis and selling strategy
  - Preparing sales documentation (information memorandum)
  - Marketing of the opportunity and approaching investors
  - Indicative offer
  - Due diligence
  - Sales and purchase agreement
  - Closing

Pros and Cons of Private Equity Financing

Minority Stake

In addition to the offered price, the SME will evaluate the following aspects when considering Private Equity as financing option via a minority stake:

Pros	Cons
▪ Financing of expansion projects ▪ Strengthening of the company's capital base ▪ Allowing the exit of shareholders ▪ Enhancing company's debt capability ▪ No capital outflow in form of debt repayments and interests ▪ Professional investment structure enhances transparency and corporate governance ▪ Network and contacts ▪ Industry and management expertise ▪ PE firm adds additional credibility	▪ Loss of autonomy ▪ Strict contractual obligations ▪ Pressure for financial results ▪ Reporting requirements ▪ Potential conflicts of interests ▪ Investment period of 3-7 years only ▪ SME needs to fulfill investment criteria

Majority Stake

When buying a majority stake, the PE firm can fully decide what to do with the company. The seller thus mostly focuses on the sales price excepts he puts up certain conditions a PE firm cannot meet. PE firms which are using a high degree of financial leverage are able to adjust the sales price up, sometimes higher than Strategic Buyers which use a more conservative level of debt financing. However, if the Strategic Buyer can realize more synergies, it will become more difficult for the PE firm to increase its purchase price further. A PE firm also requires the presence of a reliable management team which can run the company.

Kontakt

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