10 Tips for Preparing for and Managing a Private Equity Investor Relationship

Financial Services

CHEAT SHEET

- ***The market.*** Before exploring a potential relationship with a private equity investor, consider the current market landscape and your position in it, as well as the potential risk exposure.
- ***Due diligence.*** Avoid potential issues by doing your own advance diligence on the front end of a sell-side process.
- ***Work together.*** For a successful relationship, manage expectations and maintain open communication.
- ***Pivot.*** Be flexible so you can adapt your business strategy as the market and other conditions change.

Private equity investment is an option that should be considered by any company looking to achieve growth capital or liquidity. Whether you are a founder-owned business looking for a first-time private equity investment or a company that has an existing private equity investor who is looking to exit in a recapitalization transaction, understanding the current private equity landscape is key to preparing for a transaction and managing the relationship on a go-forward basis. In this article, we outline five tips

for companies preparing for a private equity investment and five tips for managing a new private equity relationship post-transaction.

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Preparing for a private equity investment

Prior to launching a private equity sell-side process, it is important to get your financial, legal, and operational house in order. Understanding the current market, your position in the market and go-forward strategy, potential risk exposure, and the overall position of your current management team are key before exploring a relationship with a potential private equity investor. Below we discuss our top five tips for preparing your company for a private equity investment.

1. Understand your current market

What is the current market for your space? Are multiples trending up or down? Is the industry sector in which you operate new to private equity, or is it mature in terms of private equity investment? Where does your company fall within the market sector? Is your company poised to be a platform investment, or is it more likely suited as an add-on acquisition for an existing private equity platform? Will the founders have rollover equity in the go-forward business? What minority ownership protections and board protections are standard for your sector? What private equity firms have invested or are currently invested in your sector? What market intelligence is available regarding potential private equity firms you may be considering, and what references can they provide? Answering these questions will help you begin to understand and manage expectations in connection with a transaction.

To that end, it is important to research the current investment landscape in your industry sector prior to launching a sell-side process. A seasoned investment banking firm with experience in your industry may be a valuable resource in understanding your company's current market position. One thing to keep in mind is that most private equity firms are focused on growth. Understanding how your company is growing compared to the market is very important. Is your company growing faster than the market? Is your company growing faster than your competitors? Additionally, understanding how your company fits into the market can help facilitate a great dialog with a potential private equity partner.

2. Have a comprehensive business strategy

Most private equity investors have funds with defined life cycles that dictate the horizon for an investment and a return to their limited partners. Although holding periods for investments may vary and trend up from time to time, private equity investors typically look to exit an investment within a five-year period. In order to best position your company for an investment, it is important to have a developed business strategy that will allow you to demonstrate your ability to expand the business over the life cycle of the private equity investment. What is your current development pipeline? What are your key customer or acquisition targets? Do you have the ability to expand into additional service lines or ancillary businesses that complement your core business? What additional talent do

you need to recruit? What positions do you need to add or replace? Having a sound business strategy will allow you to enter your search for a private equity investor with a sense of confidence that will help you maximize enterprise value and best position your company for success post-transaction. Most private equity firms are not looking for detailed five-year strategic plans. In simple terms, private equity firms want to understand what your plan is to win. Think about a strategic plan as your playbook for the next several years. What actions will you take, what resources will you need, and what results will you deliver?

3. Understand your true financial position

Private equity transactions are typically priced based on an enterprise value calculated as a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA). This value generally is computed based on generally accepted accounting principles (GAAP). A threshold component of a private equity investor's diligence will be a quality of earnings (Q of E) assessment designed to validate the EBITDA number used to determine the overall enterprise value and multiple. The Q of E assessment typically is computed using the GAAP basis of accounting, regardless of whether the seller uses a cash basis of accounting, such that a cash to accrual conversion may be required. Typically, this financial diligence is the first diligence performed by a buyer, with legal diligence trailing behind by several weeks. Increasingly, sellers are performing their own Q of E assessment several months in advance of launching a sell-side auction process. If the seller engages a reputable third-party Q of E firm, this can help expedite buy-side diligence as the private equity investor may be willing to rely on the seller's Q of E or perform an expedited buy-side Q of E process. Performing sell-side Q of E also can help you begin to manage expectations regarding valuation and bridge any gaps between sell-side and buy-side expectations, particularly when a cash to accrual conversion is required.

4. Understand exposure to compliance risks

It is critical that a seller understand and be able to explain its compliance risks to potential buyers. Particularly in industries such as healthcare or fintech, compliance risks, including risks around billing and coding, can kill a deal. As part of their overall diligence, private equity investors will typically hire independent third-party consultants to assess risks in connection with privacy and security, information technology, the effectiveness of the seller's compliance program, and reimbursement, among others. Of course, as a seller, you do not want the first time you hear about a compliance issue to be from a potential buyer. Compliance issues identified during buyside diligence also can affect the ability of the buyer to obtain coverage under a representation and warranty insurance policy, which will result in increased exposure by a seller with respect to indemnification for these issues. To that end, many sellers are performing their own internal compliance assessments prior to going to market. Conducting this assessment early also gives a seller the ability not only to identify potential compliance issues but to address and remedy them prior to launching a process. You also should be prepared to have a candid conversation with a potential private equity partner around the qualifications of your team members who oversee compliance-related functions.

5. Evaluate your management's strengths and weaknesses

“Give me an average business and an excellent management team. I'll take that all day over an excellent business and an average management team.” This is a statement commonly made by private equity investors. It is true that private equity investors invest in the management team of a business as much or more than the business concept itself. It is important that the CEO of the

company be able to attract and retain top management talent. Understanding and assessing the strengths and weaknesses of your management team prior to going to market will prove beneficial when engaging in a dialogue with potential private equity investors. It is much better for a CEO to have identified management team members who may need to exit in connection with the transaction or positions that will need to be added post-transaction than to have these suggestions thrust upon him or her by a potential private equity investor in connection with the negotiation of a transaction. Come with a plan. By identifying these issues in advance, you can best position the seller to have a voice in terms of who stays and who goes.

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As important is the need to identify key employees and determine the compensation and equity ownership package that will be presented to them in connection with a transaction in order to properly incentivize them following a private equity investment. What, if any, ownership in the company is held by the management team? Does the management team expect to take any money off the table in connection with a transaction, and what percentage of their equity are they willing to roll over into the go-forward entity? What are expectations around go-forward salaries and bonuses (note that any upward adjustments prior to a transaction will impact pro form EBITDA and therefore the overall enterprise value)? What type of equity incentive plan will be required to motivate the management team post-transaction? Answering these questions is critical to ensuring the viability of the business on a go-forward basis as private equity investors will want to understand not only the identity of the key employees but their expectations around post-closing compensation and incentives.

Managing the private equity relationship

Now that you’ve closed on the investment, the real work begins. Although a private equity transaction may be heavily negotiated, once the deal is closed, you are locking arms with your private equity investor for at least the next several years. Understanding your private equity investor’s expectations and resources it brings to bear to the business, shifts in your strategy that may be required, transparency in communication with your private equity investor that will be required, and the long-term view of the overall business are key to managing a successful relationship with your private equity investor. Below we discuss our top five tips for managing a private equity relationship following an investment.

1. Understand your investor’s expectations

Like most businesses, private equity firms operate under certain rules and requirements that impact how they work with companies in which they invest. The individuals at the private equity firm are, in most cases, part of an investment advisor firm that is managing a fund made up of mostly other people’s money. Most of the time, the funds that they are administering come from wealthy individuals, investment firms, pension plans, insurance companies, family offices, and other qualified investors that provide capital to the private equity firm and in return receive a limited partnership interest in the investment fund. The private equity firm is charged with investing the fund and generating a return for its investors.

Additionally, most private equity firms are registered investment advisors and overseen by the SEC.

Why would this matter to how the private equity firm deals with companies in which it invests? First, because private equity firms have fiduciary obligations to the fund in which they have invested, they must ensure that their investments are reasonable and do not have unknown risks. Second, private equity firms have strict quarterly reporting requirements to their investors. This means that the private equity firm must have regular, timely reports on the operations and finances of your company. A private equity firm that fails to timely report the required information to its investors not only risks action by the investors, but also potential action by the SEC. How else does this impact the relationship? Private equity firms will spend significant time doing due diligence on their investments. At times it might seem like they are focusing on minor issues, however, the private equity firm must fully investigate the investment to make sure it fully understands the risks associated with the company and its market. Also, once the transaction is closed and the investment is made, the private equity firm will closely monitor the performance as part of its oversight role.

Once you have closed on a transaction with your private equity investor, set expectations early in the relationship. In addition to scheduled board meetings, how often does your private equity investor expect to receive routine communications? Will the board have active committees and, if so, how often will they meet? Should you have weekly or monthly check-in calls with key contacts at the private equity investor? Exactly how much will the private equity investor be involved in the day-to-day operations of the company? What types of issues should be vetted with the investor? Who will lead merger and acquisitions activity and de novo development efforts for the company? These and other questions may be best asked even prior to the closing of the transaction.

Given the resources they bring to bear and the high multiples that are being fetched in today's market, private equity investors are more involved in certain aspects of the business and the pursuit of the company's strategic initiatives today than they may have been historically. Provided that all parties are aligned, this can be a beneficial aspect of the relationship by allowing the company's management team more time to focus on the day-to-day operations of the business and the execution of the company's business strategy. That said, understanding the expectations of your private equity investor with respect to each of these items is important to a successful relationship over the life of the investment.

2. Be prepared to pivot

Even though you have developed a business strategy prior to launching your sell-side process, it is probable that your strategy will evolve as you grow your business and explore potential opportunities in connection with your private equity investor. Market conditions may change, and you may experience a loss of a customer relationship or a reduction in reimbursement that was unanticipated. You may be presented with an unexpected acquisition opportunity that is complementary to your core business and requires you to add ancillary services or capabilities. In order to navigate these catalysts of change successfully, it is important to be prepared to pivot your business strategy in response. It is possible that you will need to revisit and revise your business strategy multiple times over the life of a private equity investment. Being able to recognize the catalysts of change, inform your private equity investor of the challenges and opportunities that these catalysts present, and develop a plan to pivot your business strategy on a go-forward basis will best position your company for success in the wake of what may very well turn out to be an industry sea change.

3. Use investor resources

With multiple companies in their investment portfolio, private equity investors bring a number of resources to the table that can be valuable to the execution of your business strategy. Given their

networks and relationships, private equity investors may be able to secure advantageous pricing on items such as employee benefits, insurance, group purchasing, and other service providers. In addition, many private equity firms augment their investment teams with operating partners or advisory boards, comprised of seasoned industry executives who have successfully operated multiple companies in various sectors. These executives are able to draw upon their industry expertise to assist the company and may be willing to help fill vacant company positions on an interim or permanent basis. The members of the private equity firm and its advisors have large networks of service providers that its portfolio companies can tap. Private equity investors also may bring particular expertise around contracting matters, such as managed care contracting in the healthcare industry and government contracting in certain manufacturing industries. It is important to recognize these areas of expertise and be willing to take advantage of them in order to poise your company for the greatest likelihood of success in an ever-competitive environment.

4. Transparent communication is key

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Communicate, communicate, communicate. And, if you think you have over-communicated, communicate some more. Although you may have established board meetings and routine check-ins with your private equity investor, it is important to be transparent in your communications regarding the operations and financial position of the company. It is important to communicate bad news early and clearly. Don’t hold back information from your investor or attempt to sugarcoat a material business issue. This will only compound the problem down the road. Any material customer issue, lawsuit, government audit or investigation, or other financial issue should be communicated to your private equity investor in almost real-time fashion. It is inevitable that there will be twists and turns and ups and downs in the business over the course of a private equity investment. It is often not the issue itself that is the real problem but rather how the management team deals with it. That said, it is also important to apprise your private equity investor of the material “wins” in the business so that they have the most up-to-date information in connection with any discussions they may be having with lenders and other business partners. Although the private equity investor does not expect to be involved in all aspects of the day-to-day operations of the business, keeping the private equity investor apprised of the material developments in the business real-time will make for a smoother working relationship. This transparency in communication also will aid in further instilling the confidence of the private equity investor in the management team.

5. Take the long view

Although a private equity investment may be short-term in the entire life cycle of the business, it is important that you take the long view of the business and operate the business in a manner that consists of “doing what’s right” for the overall business in the long term. Even if a decision might result in a dip in the financial performance of the company on a short-term basis, don’t shy away making key investments and changes in the business that will yield the best results for the business in the long run. This likely will involve ongoing candid discussions with your private equity investor as you evaluate and re-evaluate your business strategy. At the end of the day, the right business strategy ultimately will yield the highest returns for all concerned. And, upon an exit, any one-time business decisions can be explained. This also can result in pro forma value being attributed to the business as a result of these decisions. By taking the long view of the business and having an

ongoing discussion with your investor, you will ensure the long-term viability of the business while maximizing returns for your private equity investor.

With private equity investment at an all-time high, there is a lot of competition among private equity investors for investment opportunities. Understanding the current market landscape and your position in the market, as well as your go-forward strategy, potential risk exposure, and overall position of your current management team are key factors to consider before exploring a potential relationship with a private equity investor. By doing your own advance diligence on the front end of a sell-side process, you can head off potential issues and best position your company for a successful transaction.

But finding your private equity partner is just the beginning. It is important to level set with your private equity investor at the outset of your relationship. Understanding your investor's expectations is key to the start of a successful relationship. By understanding and managing expectations, being prepared to pivot your business strategy as market and other conditions change, utilizing the resources your private equity investor brings to the table, maintaining an open line of transparency in communication, and taking the long view on the overall business, you can ensure your company's long-term success. Some of the best relationships are those in which the management team and the private equity firm have a successful exit and go on to do it again — together

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Private Equity in Australia InfoPak (Feb. 2017).

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