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Negotiating with the Private Equity Buyer

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What Is Private Equity (“PE”)?

- Broadly considered as a group of investors who like the business’s prospects and want to profit from the growth – sometimes called “financial buyers”
- Contrast with “strategic buyers” – generally existing businesses wanting to expand geographically or by business lines

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Negotiation Structure

- Three party negotiations: PE, sellers, managers
- Two deals:
  - Sale of business – exit by sellers
  - Engage managers – continuation of management
- Negotiation paths
  - Should be simultaneous
  - Simultaneous negotiations difficult to manage
  - Sequential negotiations are usually detrimental to management

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Suggestions for Seller

1. PE perspective – financial buyer
2. Due diligence on PE firm
3. PE adds capital, needs management
4. PE investment criteria
5. PE's ability to fund
6. Negotiating with PE
7. Deal structure

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1. Financial Buyers

- Consequences of negotiating with financial buyers:
  - – Nonfinancial benefits are irrelevant – e.g., will not pay for synergy
  - – Purchase price is driven by the numbers, especially ratios
  - – Will seek best deal across multiple industries
  - – Will use uncommon deal structures to enhance financial ratios

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2. Due Diligence on PE Firm

- Seller needs to perform due diligence on PE firm
- Examine PE’s portfolio of companies
- Examine investors in PE’s fund
- Learn from negotiating experiences of other sellers

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3. PE Adds Capital, Needs Management

- Business needs:
  - Idea
  - Capital
  - Management
- PE has capital and buys the idea and management

4. PE's Investment Criteria

- PE usually a fund
- Fund composed of multiple other investors
- Fund makes promises to investors:
  - Types and size of companies
  - Return
  - Duration
- Promises to investors drive the PE's decisions

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5. PE’s Ability to Fund

- Bank approval – PE needs bank debt to achieve returns
- Cash on hand or PE “calls” for funding
- Mandatory or discretionary “calls” – investor approval

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6. Negotiating with PE

- Fund cycle
- PE's next fund and fund-raising
- Reputation
- Mix of investors in fund

7. Deal Structure

- Financial warranties
- Business warranties
- Escrows
- Holdbacks
- Earn-outs
- Noncompetition covenants

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Suggestions for Management

1. Management’s negotiations with PE
2. PE’s role in business strategy and operations
3. PE approaches to management compensation

1. Negotiating with PE

- Need for continuity of management
- Management's shifting bargaining power
- Skin-in-the-game and future incentives
- Need for follow-on equity
- Due diligence of PE's portfolio companies and PE's attitude as owner

2. Business Strategy and Operations

- PE focus on revenue growth
- Use financial and not business targets
- Management's relations with PE
  - New bond
  - New financial demands
- Management team changes, especially finance
- Effect of PE fund cycle on management choices

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3. Management Compensation

- Performance-based compensation
- Financially driven compensation
- Management’s equity rights restricted
- Compensation affected by:
  - PE investment structure
  - PE fees
  - Repayment of PE equity

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Summary: Differing Perspectives

- Three party negotiations: PE, sellers, managers
- Different time horizons of sellers, PE and management
- Two parallel and diverging negotiations: exiting sellers and continuing managers
- Financially driven, not business driven

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