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The Elusive Silent Partner

Taking on a partner can be more difficult than selling your business.

by Mark D. Working

It appears to us that the economic downturn has had an impact on the mindset of a growing number of private business owners by feeding a heightened perception of business risk. Even those with businesses that have performed well in this environment have observed the plight of others, including otherwise competitive firms prior to the onslaught.

The private equity industry also remains largely committed to leverage as a tool to combine business risk and financial risk to enhance equity returns. An equity fund manager's job is to create investments that match the risk objectives of its investors.

The tough 2008-2009 environment has cast a brighter light on the downside effect of unpredictable external events, and the amplified damage caused by leverage. The desire to reduce the number of eggs in a single basket and bolster business balance sheets make the prospects of an investment partner look more attractive. Matching an entrepreneurial owner/manager with a capital partner is a complex equation that includes far more than price.

The business owner that has decided that a partner could be desirable, confronts a capital market designed to provide liquidity in accordance with the golden rule, meaning that those with the gold, rule. A corporation with strategic interest is not a partner; it is a buyer. A strategic buyer's interest in a transaction is driven solely by its own internal business purposes. The private equity world, although now far more diverse than its LBO origins, is still dominated by change of control transactions, either 100% buyouts, or majority-controlled recapitalizations.

PRIVATE EQUITY AND RISK

The private equity industry also remains largely committed to leverage as a tool to combine business risk and financial risk to enhance equity returns. An equity fund manager's job is to create investments that match the risk objectives of its investors. Historically, the private equity value proposition has been to use leverage to deliver higher return and risk investments as part of a broader investment portfolio strategy. The problem is that business owners contemplating transactions to deleverage the business, sell a partial interest, and/or support growth may not share the same tolerance for risk as an investor managing a diverse portfolio, where the financial risk of any particular transaction is but a small component. In other words, if the business owner's motivation for seeking a partner is to reduce risk, he is likely to be disinclined to add financial risk (leverage) to the equation.

Frustrated by anemic investment opportunity flow, a growing number of private equity investors express interest in minority equity investments, but most remain steadfast in their desire to employ leverage to boost returns. Some have concluded that a minority position in a modestly levered private business with growth opportunities can be an attractive investment. These investors are gaining comfort with lower returns when combined with the reduction or elimination of financial risk.

MATCHING THE RIGHT INVESTOR

The recent purchase of a minority stake in Pacific Market International ("PMI") by the Joshua Green Corporation illustrates the challenges of properly matching an investor with a dynamic entrepreneur-led business. Headquartered in Seattle, Washington, PMI is a very successful business that designs, contracts for manufacture, imports, and distributes beverage and food containers in retail channels on four continents. Although its Stanley® and Aladdin® products can be found in large retail chains such as Target and WalMart, PMI originally gained renown as the supplier of insulated coffee mugs to Starbucks, allowing its customers to enjoy their favorite beverage on the road. The business is growing rapidly and is considering a number of interesting opportunities. In order to realize PMI's potential, more capital will be required, thereby posing an interesting dilemma for ownership. As a private owner, Rob Harris considered the various options of borrowing money from the company's lenders and moving forward, or taking on an investment partner that could help fund the company's growth and share the load of critical strategic decisions. He chose the latter.

Rob's criteria for a partner were stringent. The partner had to respect the company's culture and the strong corporate values of the owner. Second, the partner needed to have confidence in the incumbent management team. Third, the partner had to accept a supporting role and take on a minority and non-controlling ownership position. The partner had to be comfortable with the basic returns of the business without having to add financial leverage to the equation, and it had to have a long-term investment horizon to assure sufficient time for the business to fulfill its potential. Lastly, there needed to be evidence of organizational stability and longevity.

Whereas the dominant criterion for measuring proposals to purchase a business is value, that criterion often takes a lower priority when choosing a partner. Instead, compatibility of business vision and principles are often the preeminent concerns.

Rob Harris had many options to choose from to gain an equity partner, but settled on the Joshua Green Corporation ("JGC"), a family-owned investment company that has been in existence in the Pacific Northwest since the late 1800's. JGC, of course, had its own requirements, the most important being that a priority in decision making had to favor the interests of the business over those of individuals. The duo came up with a highly com-

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petent board of directors charged with providing expert guidance and input. Together, a formidable team has coalesced and is geared to face future challenges and take advantage of opportunities.

A MORE COMPLEX TRANSACTION

Although PMI and JGC meshed quickly and well, duplication of their success is by no means guaranteed for others. Taking on a partner is a complex and often more difficult decision than selling a business. Whereas the dominant criterion for measuring proposals to purchase a business is value, that criterion often takes a lower priority when choosing a partner. Instead, compatibility of business vision and principles are often the preeminent concerns. Much of what will be created in the future depends upon being able to lock arms and move forward together. It is important that the owner and investor are aligned in their business thinking and goals. Not every future day will be met with success, so having a partner that is supportive and confident of the business over the long term, and possesses the stamina for the trip, is invaluable. Business owners contemplating joining forces with an equity source need to carefully think past the transaction details and consider the specific characteristics that are important for the longer haul. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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