Zachary Scott
INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
FALL 2012

Private Equity Diversity

Before approaching a private equity group, understand that PEGs are not all alike.

by Jay Schembs

Jerry Kohlberg and other industry pioneers developed the original mission of private equity: help privately held business owners achieve liquidity and, when necessary, improve the operations through their experience and connections. After decades of proliferation, private equity groups (PEGs) now mirror the vast differences among businesses and entrepreneurs and represent the least fungible source of capital in the private capital markets. Private business owners must understand the selectivity and diversity of investment criteria among PEGs before accessing this market.

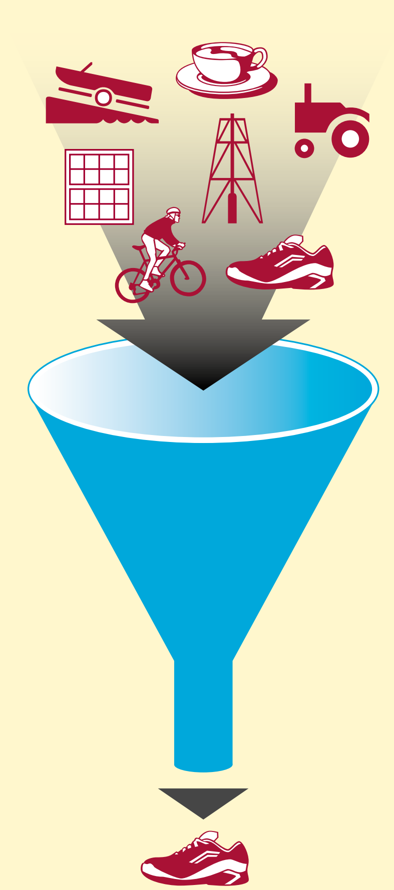
When Zachary Scott began advising companies over 20 years ago, private equity investors were a rarity. Today, private equity has evolved into a substantial source of risk capital for private businesses. Private equity activity data suggests that nearly 30% of private businesses in the U.S. have or have had PEG investments. Pacific Northwest firms are no exception. According to Pitchbook, more than 270 private equity investments have been made in the Pacific Northwest since 2008, drawn from a universe of approximately 2,600 PEGs headquartered throughout the U.S.

INVESTMENT SELECTIVITY

Perhaps the least understood dynamic of the private equity market is the ratio of opportunities evaluated by each firm relative to the investments actually made. Our experience shows that private equity groups sort through numerous opportunities and have very selective criteria in choosing a company in which to invest. The available data indicates that the median middle-market PEG reviews more than 500 potential investments in a given year. Only 50 of these opportunities sufficiently pique the PEG's interest to submit a preliminary indication of interest. Thereafter, a mere ten candidates advance to the more serious stage of a letter of intent. In total, the median PEG closes four transactions each year, representing less than 1% of the opportunities reviewed and considered. The private equity process of selection is a two-sided equation. The process creates a daunting environment for the novice trying to access this market. Investors in private equity funds, however, view such selectivity as an effective determinant of high returns on capital. Much like the model of elite private colleges, private equity turns down most candidates they review and use these statistics to promote their "selectivity."

Business transactions that initially interest a PEG frequently turn into dead ends upon deeper investigation. An inability or unwillingness to grasp the business model or value proposition, questionable accounting records, customer concentration, insufficient management bench strength, unresolved environmental issues, personalities, or value expectation differences are all factors that can quickly end deal negotiations. Many of these factors only emerge as issues after the due diligence process begins to unfold. Business owners with serious intentions of approaching the private equity market need to realize that the myriad potential variables put the odds against a deal closing with a specific PEG. For that reason, a seller should approach the market in a manner that will increase the probability of a successful outcome.

The median PEG closes four transactions each year, representing less than 1% of the opportunities reviewed.



As the private equity market has matured, it has fragmented into various specialties. A wide range of criteria differentiate the specific interests of middle-market PEGs, including the acquisition target's location, size, industry, and operating health. For example, Dallas-based Valesco Industries focuses on manufacturing and distribution businesses generating up to $75 million in revenue with EBITDA margins in excess of 10%. Heritage Partners, out of Boston, will only invest minority stakes in companies valued greater than $30 million. J.F. Lehman, headquartered in New York City, focuses exclusively on defense, aerospace, and maritime businesses. These simple examples offer just a glimpse of the diversity of PEG investment preferences. Screening PEGs according to criteria that are important to the company requires an organized process. Some of the important criteria are discussed herein.

APPROACH TO LEVERAGE

PEGs are often portrayed as "manufacturing returns" by adding excessive levels of debt to magnify equity returns. The approach to leverage will differ among PEGs, industry, and stability of the company's market position. Nevertheless, leverage might or might not conflict with the future course of the business, the degree of operational flexibility required, and/or the risk tolerance of the operating partners and rollover investors.

CORPORATE GOVERNANCE

PEGs have diverse preferences on whether they demand full ownership, majority control, or minority interests, as well as how they view the degree of control over a broad range of operational, strategic, capitalization, and exit decisions.

(continued p. 2)

PHILOSOPHICAL APPROACH

The level of engagement and oversight PEGs require also differ greatly. Some firms take a very hands-on approach, oftentimes bringing in industry veterans to participate in a board role, as the new CEO, or in a critical operational capacity. Others remain passive, allowing the managers to run the business with minimal interference. As a result, business owners need to recognize the demands placed upon them may vary substantially depending on the private equity group.

ACCESS TO CAPITAL

Most PEGs have access to a contractually committed pool of capital with investment decisions left entirely to the PEG managers. However, not all PEGs have control of the purse strings, implying the involvement of other decision makers. Hundreds of firms throughout the country operate as pledge funds, which work to find and tie up a prospective investment, typically with a signed letter of intent granting exclusivity. Once accomplished, the PEG works behind the scenes with pledge investors to win approval and funding. While this does not mean pledge funds should be ruled out when shopping the private equity capital market, owners must recognize the additional element of risk that pledge funds present to closing a deal.

> **The degree of differentiation makes it prudent to carefully qualify multiple prospective PEG buyers prior to engaging in a sale process to ensure that the best combination of value, structure, and philosophical alignment is achieved in a transaction.**

Over the past four decades, private equity has become a predominant source of capital for private businesses. Business owners looking to approach this market for incremental capital to fund growth or a liquidity event should recognize that private equity firms come in a vast array of shapes and sizes, and no two are alike. The degree of differentiation makes it prudent to carefully qualify multiple prospective PEG buyers prior to engaging in a sale process to ensure that the best combination of value, structure, and philosophical alignment is achieved in a transaction. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Michael J. Black
206.838.5526
mblack@zacharyscott.com