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INVESTMENT BANKERS

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Minority Equity: Structural Considerations

To succeed at fund raising when banks won't help, you need to understand private equity investors.

by Mark D. Working

A burgeoning economic climate has created an attractive opportunity to expand your business, but your banker can't fill the funding gap. Ideally, a "silent partner" who will provide the needed capital would be just the ticket. This would allow you to continue to drive the business forward unfettered.

We've seen this scenario arise regularly. Unfortunately, this is not a set of conditions that attracts professional investors, a group that represents the greatest source of equity capital available to business owners. For those owners facing a funding need, it is important to understand the motives and practices of private equity investors so that fundraising can be successful.

WHAT IS "INSTITUTIONAL PRIVATE EQUITY"?

An enormous amount of institutional private equity capital is raised every year by professional managers and is targeted toward investments in private companies. Local examples include Vulcan Capital (Paul Allen's investment vehicle), Endeavour Capital (a $250MM fund headquartered in Portland), Evergreen Pacific Partners (a brand new $275MM Seattle-based equity fund), and Northwest Capital Appreciation (also based in Seattle). Depending on the nature of the business, industry, and degree of financial leverage, these investors are seeking investment returns ranging from 20% to above 30% per annum.

The greatest concern facing a private equity investor is that individuals and/or family owners might sacrifice economic return for other benefits, such as status, employment, continuity, or lifestyle considerations.

Insitutional private equity managers have promised their investors that they will invest only in circumstances where they can control or influence the primary factors affecting the success of the investment.

RISK FACTORS	CONTROL OBJECTIVE	TOOL
Management	▪ Assure that management will be evaluated objectively ▪ Power to make changes in the best interest of the business	▪ Outright Board control ▪ Board control in the hands of economically minded parties ▪ "Springing Control" based on performance triggers
Business Strategy	▪ Ability to control/approve the direction of the business and the parameters for allocating the firm's resources	▪ Outright Board control ▪ Board control in the hands of economically minded parties ▪ Approval of annual operating budget
Capital Structure and Investments	▪ Control financial risk (leverage) ▪ Control/approve investments of the company's capital	▪ Outright Board control ▪ Board control in the hands of economically minded parties ▪ Super majority approval of changes in structure (new capital) or terms of existing capital ▪ Approval of annual capital expenditure budget
Exit Timing and Tactics	▪ Make the determination of when and to whom the business is sold and the return to be realized	▪ Control over sale events (timing and terms) ▪ Approval/veto of any suggested transactions ▪ "Put" or right to force liquidity event after a specified time

The greatest concern facing a private equity investor is that individuals and/or family owners might sacrifice economic return for other benefits, such as status, employment, continuity, or lifestyle considerations. A private equity investor making the same choices would violate its fiduciary responsibility to maximize the return on its investors' money. Aligning the potentially conflicting interests of institutional and family owners, and providing protection for both, is the most challenging aspect to structuring an investment in a privately held company.

STRUCTURAL STRATEGIES

Institutional private equity investors have a few tools to help control the factors influencing risk and investment return. The table above summarizes the potential range of actions institutional investors typically demand to protect their investment.

The tradeoff between the current owners' desire to retain independence and the investor's need to protect its investment leaves two possible options for the company desiring external private equity. Either the existing owners can cede control over certain issues, or the investor can be offered economic priority. Often, in exchange for receiving a less-risky position than the existing owners, the investor can be more lenient with regard to "control" issues. Generally, as the two parties' relative ownership approaches equality and there is a common purpose and investment horizon, negotiation of control provisions is emphasized.

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When the ownership position of the outside investor becomes disproportionately small and investment horizons diverge, economic priority is a more customary avenue to align the parties' interests. Economic priority is typically achieved by tiering the equity structure. The new capital can be structured as convertible preferred stock, with a "put" option. This assures that the investor's capital

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and a portion of its return will have priority over the other owner(s) and that the investor will have a measure of control over the timing of its exit.

The point of all of this is that when there is economic opportunity that requires external capital, a financial partner can provide the fuel to grow the business. The challenge is to customize an investment structure to meet the objectives and fit the constraints of all parties. With a full understanding of the variables and alternatives, a structure can be developed that allows all parties to achieve their goals, and frees the business to realize the opportunities presented. ❖

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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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