



TOOLBOX: PRIVATE EQUITY FOR MIDDLE-MARKET FIRMS

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"Private equity," frequently in the news because of presidential politics, has an ominous, even foreboding connotation for many who do not live in the world of mergers and acquisitions or finance. It connotes the book and movie "Barbarians at the Gate," which tell the story of the infamous 1988 hostile takeover of publicly-held RJR Nabisco by KKR, the private equity firm formerly known as Kohlberg Kravis Roberts.

Yet "Barbarians," with its high-profile, rarified players battling a hostile takeover, is not the world of private equity in which most of us are active. We work in a world not of multibillion-dollar companies like RJR Nabisco but of middle-market companies that generate revenues of \$5 million to \$1 billion.

Long Island middle-market business owners ought to know more about private equity. It can be an effective alternative to traditional options when seeking ways of expanding a successful business, turning around troubled operations, or simply exiting the business or retiring.

Shedding light on private equity for business owners is the subject of a March 22 panel discussion sponsored by ACG New York, an association of deal-making professionals, in Farmingdale.

What is private equity? Private equity transactions are investments – made typically by private equity firms (also known as financial sponsors) in the equity securities of operating companies that are not publicly traded on a stock exchange. These investment managers use pools of capital raised from investors, also known as limited partners.

What should business owners know about private equity firms? Like people, all financial sponsors are not the same. Typically, these financial buyers need to retain existing management as a resource to transition the seller's business to their ownership. Some private equity firms look to partner with existing management and create a team approach for the life of their investment. Others will look to replace management shortly after the acquisition. Business owners are advised to investigate each private equity firm to determine its objectives and operating style.

Private equity firms are financial buyers that make investments to earn a return. The plan typically is to exit the investment within three to five years. If the seller retains an interest in the company after acquisition (a "co-investment"), the seller has the opportunity to make money a second time when the private equity firm makes its exit.

What is the role of special counsel in these situations? Often overlooked in these transactions is the need for special legal counsel to the business that is being sold. The dynamics of the transactions require nurturing by experienced professionals – advisers who have ideally worked on both the buy and sell sides – who understand the pitfalls and nuances of the deal (including the seller's emotional attachment to the business). Sale transactions are not easy for the owners and operators of middle-market companies, not only because they are not in the business of doing mergers and acquisitions, but also because typically the enterprise has not been run with an exit in mind. The owners therefore need to be guided through the entire sale process, from the financial adviser's initial due diligence of the target getting the deal consummated.

Because these acquisitions frequently contemplate that existing management continue with the operation of the business for at least a year or two if not until the private equity firm is able to make its exit, the transaction's advisers on both sides of the table, especially the seller's side, must help to keep the relationship positive between the selling company's executives and the financial sponsor so that after the deal is consummated, the seller who continues with the company starts off on the right foot rather than one that begins with distrust and animosity.

With real understanding of how private equity works and with good advice from skilled advisers, these transactions can be of great benefit to middle-market businesses.

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