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No More Deal or No Deal

How a hungry private equity market has created more liquidity alternatives for company owners

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Competition is driving big changes in the kinds of investments institutional private equity funds are willing to make, and private company founders and shareholders are reaping the benefits.

A long-held principle of the private equity business was that PE funds would only invest in companies if they could buy control stakes. Most funds are designed to have a three- to five-year investment horizon, and owning control of a portfolio company ensured that fund managers could make the decisions they thought were necessary to acquire, grow and exit an investment within that time frame.

But over the last several years, the number of funds willing to make minority investments in attractive private companies has mushroomed. Transaction data service S&P Capital IQ shows a 58 percent increase in the number of minority PE deals over the last five years—a time during which, counterintuitively, the number of traditional majority PE deals has actually shrunk 16.8 percent.

The shift is creating dramatically expanded choices for private company owners and fueling the pace of PE deals across multiple industries.

Owners Benefitting from Fund Competition

The previously binary nature of the control issue meant that if founders or family member owners weren't willing to give up control of their company, the path for monetizing their holdings was difficult and limited. They could sell off small stakes to individual investors, which was both time-consuming and fraught with problems, or try to engineer bank-led debt recapitalizations, which could severely crimp a company's financial flexibility and growth profile.

But the U.S. private equity industry has become cutthroat competitive, with the number of institutional funds more than doubling since 2000 to more than 3,500 today as investors seek returns outside public markets. And as with any other asset class, this search for yield has required greater risk tolerance. In the PE market, that's led funds to an increased willingness to shed the perceived safety (and liquidity options) of majority ownership and control.

Control Premiums a Thing of the Past?

The few PE funds that may have been willing to consider making minority investments in past years generally got to take advantage of discounted valuation. The notion of a control premium prevailed, driven by the idea that it was the path to higher returns.

But what's emerging in middle-market M&A today is a realization that entrepreneurs who are more heavily invested in the success of their companies often represent better bets than those who take most of their chips off the table but still run their company for a majority buyer.

The upshot: Valuations are evening out between control and non-control transactions.

Strings Attached

None of this means that money's being thrown at private company owners with no strings attached. The structure of these minority purchase transactions shares many characteristics of a venture capital funding deal. In most PE control deals where sellers hold on to a minority stake, the fund and the sellers are left holding the same class of equity.

But when PE funds make minority investments—something venture funds do every day—they're often in the form of securities that give the non-control minority investors several forms of protection and preference over control shareholders. Those generally include:

- Liquidation preferences (last money in is first money out if the company is later sold).
- A guaranteed minimum return for the minority investors before others get future sale proceeds.
- Blocking or veto rights on major decisions affecting the company, such as making fundamental changes to the scope of the business, bringing in additional capital, making acquisitions, hiring and firing key executives, or selling the company.
- A governance role in the company, generally in the form of a number of board seats proportional to their ownership.

Meaningful Stakes in the Right Kinds of Companies

That doesn't mean that institutional PE funds are chipping off tiny stakes in every kind of private company. In most cases, funds aren't willing to own less than 20 percent of a company's equity, and the characteristics that funds look for are no different than those they seek in control investments.

That means they like companies with recurring revenue business models and without huge customer concentration issues. They look for defensible market positions with meaningful barriers to entry for any new competitors. They don't like the business to depend on a single key executive or founder. Because they don't have full control, they rely even more on the fundamentals of the business to justify the valuation they're paying for their ownership stake.

Since this phenomenon is driven by a search for returns, PE investors will value growth opportunities over highly stable, slower-growing companies. And as for target company sizes, the market for minority stakes extends to companies as small as $30 million in enterprise value.

Finally, there's been a noticeable shift among many PE funds away from the notion that making a minority investment is more risky for them. These preferred stock minority investments can in many ways offer the funds downside protection that makes their investment less volatile than a traditional common stock control deal.

Life with a Minority Shareholder

For well-run companies, life with a minority shareholder may not be wildly different from life as a closely held private company. Minority investors seem somewhat less likely to be as heavily involved as control investors usually are. While some funds may seek an active role in setting the direction of their minority portfolio investments, others don't. And as for reporting requirements and information flows, they're not generally different from what the company's lenders would require.

The minority shareholder will often have a "put" right after four to six years, under which the company can be required to buy back the fund's shares. There's generally a pre-determined formula or a fair market value assessment process outlined in the share purchase agreement. That means PE minority investments sit somewhere short of permanent capital, and as with any major transaction for a company, prospective sellers need to go in with their eyes wide open and capable advisers at their sides.

Making It Happen

The process for seeking minority private equity investors is pretty much the same as for selling a control stake in a company. Most companies will retain an investment bank to present the company in the best light to investors whose preferences and cultures are a good fit with the company's.

Company owners don't have to be definitive about their preferences for selling a minority versus majority stake. Ambivalence often can work in the seller's favor, increasing the number and clarity of choices they're offered for a path forward.

The increasing willingness of private equity funds to make minority investments in strong private companies is opening a whole new world of optionality and liquidity for the shareholders of those companies, and giving funds a whole new world of targets for the deployment of their capital.

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