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Wealth Planning Update

Private equity group vs. strategic buyer

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Key takeaways:

- Selling your business to a private equity group (PEG) usually requires you to stay invested and active in the business for an indeterminate period of time but with the goal of generating a second liquidity event after the PEG grows and then resells the business.
- Selling to a strategic buyer usually allows you to sell your entire company at once and receive most or all of the cash up front with your continued involvement only required for a short period of time.

What this may mean for you:

- Understanding all of your options for transitioning your business is critical in helping you decide how to proceed. If you are interested in helping to enhance the price you receive for your company, you may want to consider selling to a PEG or a strategic buyer.

It can be overwhelming to think about selling your business. One way to gain some control is to be informed about your alternatives so you better understand what is best for you, your family and, your company. While buyers come in all shapes and sizes, perhaps the most sophisticated buyers are private equity groups (PEGs) and strategic buyers. What are these buyers, and what can you expect from them?

Traditional private equity group

A private equity group is a firm made up of financial professionals who have raised a pool of money (a fund) to buy — and eventually sell — companies. Their goal is to make profitable returns for their investors. Most PEGs are looking for effective management teams running highly profitable businesses with strong growth prospects.

Here are some common traits of traditional PEGs:

- The purchase typically occurs quickly, as they are seasoned acquirers in the business of buying companies
- Valuations tend to be predictable and are based on multiples of profits/cash flow
- The multiple they pay will depend on their negotiating leverage — PEGs will pay more if necessary
- They will buy a company for cash — however, they usually require the roll over (when you reinvest proceeds back into the company alongside the buyer) of equity to demonstrate a continued commitment to the company
- PEGs may back existing management teams, so you and your team may be asked to stay on
- They typically look to double or triple the profits of the company during their holding period
- Generally, debt is used to fund the transaction to increase their (and your) equity returns
- They may use an earnout (future payment from a buyer that can vary with future results) but mostly rely on your minority interest to encourage you to continue to grow the company
- The goal of a PEG is to sell the company to realize their returns — this can result in a longer timeline for you to exit

Key considerations when selling to a private equity group: It is important to consider your financial and timing goals to determine if a PEG sale is a fit. Your continued involvement will be based on your current role in the company. Are you comfortable running the company with another majority owner? PEGs usually target a three-to-five year holding period. And while the second sale of the company (in which you completely exit) can be lucrative, it is uncertain.

Because you don't know who will be the next buyer of the company, your legacy and that of your company in the community is also at risk. PEGs typically leverage existing management teams, so there can be good opportunity for your key leaders. Usually, a PEG increases profitability by growing the company rather than cutting expenses. So what happens when you sell to a PEG? First, consider that second sale of the company. As a simple example, assume you sell your business to a PEG for $1,000. Assume also that they fund the transaction with $500 debt and $500 equity and ask you to roll over $100 to own a 20% equity interest. Your existing management —– and likely you — will be tasked with growing the business while paying down the debt. Remember, their goal is usually doubling or tripling the profitability of the company during the holding period.

Now, assume all goes well and you double the profits while completely paying off the debt and then the business is sold — maybe to another PEG. Assuming the same valuation multiple of profit/cash flow, the business would be valued at $2,000 and you would get 20%, or $400, for your $100 investment because all debt was paid off. In some cases, the same company may be resold several times to different PEGs, providing increasingly lucrative liquidity events for management owners.

Risks in selling to a private equity group: Of course, there is no guarantee that the business will grow while paying down its debt or that it will then sell on favorable terms. In the meantime, you will have a majority owner who is looking to exit in a few years, so their goals may not align with yours. When considering a PEG, you want to be comfortable with their level of involvement in the running of the company and how decisions will be made.

Many PEGs will also bring administrative, financial, and operational expertise to bear as well as board-level advisors who can help the company grow and prosper. PEGs will back a management team in a platform acquisition and then use add-on acquisitions to add scale and diversification. Purchase price multiples for platform acquisitions tend to be higher than those for the smaller add-on transactions.

Strategic buyers

A strategic buyer is usually a company in the same or related industry that has some overlap or synergy that would result in incremental savings or revenue if they bought your company. Strategic buyers are interested in buying companies that they believe will fit into their strategic growth plans; these plans change over time, so it is important to maintain familiarity with strategic buyers in your industry.

Here are some common traits of strategic buyers:

- They move at their own pace, as acquisitions are not their primary focus
- Valuations are less predictable and are based what they think you mean to them
- While they may derive the most value from your company, they may be conservative when making their offer
- They usually buy 100% of a company using their existing cash or in some cases their stock
- There may be a risk of job loss to your managers depending on overlap with their team
- An earnout may be used if there is a difference of opinion on your future growth
- They will look to integrate your company and hold it indefinitely so you can exit sooner

Key considerations when selling to a strategic buyer: Is there an industry player with some synergy that would make your company more valuable to them? Your company may be absorbed in a strategic sale, which is important to consider if you value legacy. There may be a heightened risk for job loss, especially among senior leaders, as your team may overlap with that of the buyer.

The flip side is that you may find it easier to walk away after a strategic sale, and if they paid cash, there is usually less ongoing risk for you. If the transaction was paid in buyer's stock, then you have to understand the risk of that investment and how you can liquidate and diversify.

So what happens when you sell to a strategic buyer?

Unlike a PEG, you will not be asked to reinvest in the company, and depending on your current role, you may only be involved in a transition period of a few months. What happens to your management team and the rest of your workforce depends on the overlap with the buyer and their strategic direction. Unless there is an earnout, you have much more certainty of payment.

	Private equity group	
Speed of transaction	Often fast — buying is their business	Move at their own pace
Deal pricing	Market price — multiple of profit	Often highest, but each buyer is different
Financial goals and deal structure	Continued investment requires ongoing involvement and potential second liquidity event	Usually a single 100% sale
Company/community legacy	Uncertain as company will be resold later	Company likely to be absorbed
Employee security	They rely on your team	More risk of job loss for leaders
Retained risk	Some cash at time of sale, some at next transaction	More certainty with a single deal if it was for cash
Holding period	Three to five years	Indefinite
What draws interest	Management, growth, margin	Fit with their business and goals

Risks in selling to a strategic buyer: If you are paid in the acquiring company's stock, you need to consider the risk of owning that much of one security. If the buyer is a public company, you may be able to sell that stock and diversify over time, but that can be delayed if the stock is restricted. In the case of restricted stock, you can be prohibited from selling the shares until after a vesting period or certain conditions are met.

If the buyer pays with private company stock, then you need to know your path to liquidity, such as how and when you can monetize your investment. Until you do so, you will own shares in a larger company you no longer control, and it likely represents a large percentage of your personal assets.

Understanding earnouts: An earnout is used to bridge the valuation gap between what a seller wants and what a buyer is willing to pay. This difference can be due to the uncertainty of future results, like a new revenue source. In these cases, there are additional payments to you upon hitting revenue targets.

An earnout often works best when you are involved in the company after the sale so you can influence future performance. Of course, this introduces payment risk, but it can be a way of bridging a valuation gap. It is important for you to understand how decisions will be made and how that may affect your ability to potentially enhance earnout payments.

Next steps: Transitioning your ownership of the company is more complex than a typical retirement, but it's less daunting if you understand your options. If you decide on a third-party sale, consider hiring a merger and acquisition advisor to represent you in that transaction. Your Wells Fargo team can help you navigate as you consider what the most suitable approach may be for you and your company.

Appendix:

Terminology

- Private equity group (PEG): financial professionals who have raised a pool of money (a fund) to buy — and eventually sell — companies
- Strategic buyer: a buyer in the same or related industry who has some overlap or synergy that could result in cost savings or revenue enhancements if they bought your company
- Financial buyer: category of buyers that includes PEGs but also family offices, fundless private equity, and individual investors
- Deal structure: what you are selling along with payment terms and timing
- Earnout: future payment from a buyer that can vary with future results
- Transaction currency: what you get from the buyer (for example, cash, note, buyer stock)
- Rollover: when you reinvest proceeds back into the company alongside the buyer
- Leverage: non-equity capital used to help the buyer fund the transaction (in other words, debt)
- Platform: a PEG's initial acquisition in an industry or sector
- Add-on: a PEG's follow-up acquisition that adds scale and capabilities to its platform
- Intended holding period: the amount of time the buyer plans to own your company

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