Five Reasons to Consider Private Equity

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Private equity is an exit alternative that has only been available to engineering and construction companies in recent years. The prolonged economic boom of the late nineties and the unprecedented financial success of many companies in our industry caused private equity investors to gain substantial interest in the engineering and construction industry. As the economy has slowed, many firms in our industry have continued to prosper, which has only furthered the interest of outside investors. Private equity firms make investments in operating companies for three to seven years with capital they raise through institutions, businesses, and wealthy individuals. Private equity can be an excellent interim step for an owner who is not ready to sell his business yet, but may be ready to sell in the next five years. Outlined below are five reasons for owners to consider private equity as an exit alternative.

Reason #1 - Substantial Liquidity

Private equity transactions are an excellent way for owners wanting to remain private to obtain significant liquidity at an attractive valuation without having to transact an outright sale. Most private equity firms prefer to purchase over 50% of the equity in a typical transaction. This can generate substantial liquidity for the owners to "take some chips off the table" and diversify their net worth, while maintaining significant ongoing ownership, providing for new ownership opportunities for the next generation and retaining day-to-day operational control.

Reason #2 - Growth Capital

In addition to providing liquidity for the selling shareholders, private equity firms will provide additional debt and equity capital for internal and external growth opportunities. In many businesses, the management team has excellent growth plans but does not have the capital or is not willing to "bet the farm" to execute a given strategy. This could include opening branch offices, entering a new product or service line or making select acquisitions of marketplace competitors. Private equity investors are more than willing to provide the capital necessary to execute growth plans that make strategic sense.

Reason #3 - Eliminate Personal Guarantees and Retain Operational Control

Many owners have created substantial personal wealth and are looking to eliminate personal guarantees to the bonding companies and banks. In the past, this was difficult to do without selling the business to a competitor and giving up control to a larger company. In a typical private equity transaction, all shareholder guarantees are eliminated and day-to-day control remains with the management team. While most investors prefer to purchase over 50% of the equity, they have no interest in running the business on a daily basis. Private equity firms will have approval rights on major issues such as new acquisitions, capital raises, strategic plans, and future liquidity events but investors will leave the daily operation of the business in the hands of the management team.

Reason #4 - Obtain a Strong Partner with Aligned Goals

Private equity professionals not only bring financial strength to help finance the business, they traditionally possess relationships and contacts that can help generate new customers and new supplier relationships. The investors will participate in the business at the Board of Directors level and many possess significant operational expertise and have extensive merger and acquisition experience. The investors also have many other portfolio companies that could be facing similar growth issues or could provide a complementary service or customer or supplier relationship. Furthermore, the goal of a private equity investor is to maximize the value of their investment in the company which in-turn maximizes the management's ownership interest in the company.

Reason #5 - "Second Bite at the Apple"

In a typical private equity transaction, the management team will still own a large percentage of the business (10% to 50%) through a combination of retained ownership and new stock options granted by the investor. Therefore, in three to seven years when the outside investor is ready to exit their investment, the management team will receive substantial additional value for the business. Hopefully, since the initial investment, the business will have grown and retired debt and will be worth much more than the original valuation. In many instances, owners can receive more money from the "second bite at the apple" than from the first.

While private equity transactions provide very attractive exit alternatives, they are not for every company. Upon investment in a company the equity investor typically supplements the equity investment with senior and subordinated debt. Given the debt load associated with these transactions, companies must meet very specific criteria for this alternative. Some of the criteria include:

· A compelling story;

· Predictability of earnings and lack of dependence on new construction;

· Exceptional management team;

· Defensible market position;

· Strong growth potential;

· Exceptional profitability; and

· Favorable industry trends.

The level of importance of each of these characteristics differs depending on the industry sector and trends. However, it is important to remember that one of the primary ways in which private equity firms make money on their investments is through the use of debt. Thus, a stable and predictable earnings stream is one of the most important characteristics for this alternative. If a company's earnings stream is highly volatile, it may have difficulty servicing a large debt load. Furthermore, if the company is not very profitable, banks will not be willing to loan much to the business, which makes the economics for the private equity investor less appealing.

While we believe a private equity transaction can be an ideal alternative for many owners, there are also some disadvantages associated with these transactions. A few of them are outlined below.

Disadvantage #1 - Debt Burden

The most obvious disadvantage is the significant level of debt typically associated with these transactions. This debt must be serviced monthly and therefore has a large drain on the earnings of the business. If operations falter, the business runs the risk of default and it may change the way management makes decisions moving forward.

Disadvantage #2 - Board Seats

Regardless of whether the equity investors make a majority or minority investment in the business, they will want board seats to closely monitor their investment. As mentioned above, this can generally be a very favorable situation, it is however, for some owners, the first time they will have had to share executive decision making with a third party.

Disadvantage #3 - Required Exit Strategy

Since equity investors must pay back their investors over a five to seven year horizon, they must exit their investments in their portfolio companies within a similar time horizon. Consequently, when owners agree to partner with private equity investors, they need to be prepared for the fact that the investor will want to sell the business or take it public within three to seven years.

As mentioned earlier, the engineering and construction industry has held up surprisingly well through the current recession. For many owners this phenomenon is generating tremendous opportunities to achieve maximum value for the businesses they have built. If your firm meets a majority of the criteria above, a sale to a private equity investor can be an ideal way to transfer ownership, achieve significant liquidity, and remain involved in day-to-day operations.

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About FMI

Founded in 1953 by Dr. Emol Fails, FMI provides management consulting, training, and capital services for the worldwide construction industry.

FMI delivers innovative, customized solutions to contractors,engineers, architects, environmental firms; manufacturers and suppliers of building products and construction equipment; construction materials producers; private owners, government agencies, utility companies; surety companies; and trade associations.

FMI's experienced consultants can assist your business with compensation planning, leader and organizational development, business development, strategic market information, acquisition integration, mergers and acquisitions, ownership transition, private equity financing, project delivery improvement, management and field-level training, strategic planning, strategic sourcing, and productivity improvement.