GUIDE TO PRIVATE EQUITY

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ADWEEK BRANDWEEK INSIGHTS
RESEARCH AND WHITE PAPERS

IN COLLABORATION WITH

BERINGER CAPITAL

TABLE OF CONTENTS

» 4 AREAS COVERED IN THIS REPORT «

1

How the PE industry works

2

How PE creates value

3

How to design your business to be attractive to PE

4

What you need to know to be successful working with PE funds

METHODOLOGY

As more and more companies in the Adweek/ Brandweek ecosystem are being acquired by private equity (PE) funds, we at Adweek/ Brandweek Insights are increasingly hearing questions from business owners and executives about how these funds operate and what it takes to be successful working with them.

To answer those questions, we conducted an extensive proprietary research study on this topic. Our approach included secondary research, quantitative surveys and dozens of one-on-one interviews with private equity fund executives. Some of these funds are household names, such as Blackstone and KKR. Others may be lesser known, but they still manage hundreds of millions, if not billions, of dollars of capital, acquiring businesses and working with accomplished founders and management teams to create value. We also spoke with current and former executives who have worked in PE-backed businesses as well as numerous professional service advisors who support PE firms in their deals.

This report summarizes our findings.

Adweek/Brandweek Insights Group is pleased to collaborate on this report with our parent company, Beringer Capital, a private equity firm, headquartered in New York and Toronto, that partners with the founders of growing companies.

FOREWORD

by Tony Robbins, Entrepreneur, Investor, New York Times Bestselling Author, Philanthropist and the World's No. 1 Life and Business Strategist

I HAVE TRAINED HUNDREDS OF THOUSANDS OF BUSINESS OWNERS AND SENIOR EXECUTIVES

all over the world through our global business training programs. I'm consistently inspired by the dedication, drive and ingenuity they exhibit to achieve their dreams.

However, I always draw the distinction between someone who is self-employed versus a business owner. Someone who is self-employed works for a business and draws a paycheck. They may be the boss, but in all other respects, they trade their time for income. A business owner, on the other hand, is building their business to create massive value for themselves and their team. But to fully realize that opportunity, they need to build a business that someone will want to purchase.

And do you know who purchases more businesses than anyone? Private equity firms. The good ones have mastered the science of optimizing businesses to maximize their potential. The best understand that developing leaders in their portfolio companies is the key to unlocking exponential value. It is the opportunity to impact business at this fundamental human level that has interested me in private equity and led to my joining Beringer Capital (the investment group that owns Adweek/Brandweek).

To anyone reading this guidebook, you probably find yourself at the starting point of one of the most exciting journeys you'll take in your career. Armed with the right knowledge and insights and strengthened by the determination that's gotten you this far, your ability to reach your true potential is within your grasp, and private equity can be a major springboard. This guide is an important step on that path.

Tony Robbins

INTRODUCTION

Perhaps you're an entrepreneur who has built a business and you've started mulling the possibility of an exit. With private equity firms being the largest purchasers of independent businesses, they are obvious contenders. Some may have expressed interest in your business already. So how do you navigate the private equity world? How do you decide which firm is right for you?

Or you may be a senior executive at a corporation. A number of PE firms may have signaled their potential interest in the company you're working at, or one of them has already bought the company. What now? What does this mean for your career? Do you have a chance of a significant financial exit yourself? What will it be like to work with the new owners?

Or maybe you work in management at a large company and a private equity firm wants to recruit you to lead one of their portfolio companies. Or perhaps, you want to get recruited: Does such a move make sense for you?

If you are either an entrepreneur or an executive in such a position, this is addressed to you. Private equity is often discussed with needless complexity, but the essence of the process is straightforward. We will keep it simple and concise. You will be able to understand, and it will be worth the effort.

This guidebook explains how private equity works, what factors to weigh when deciding which firm to work with, what questions to ask, how to make your company desirable to a PE firm and how to work with their team successfully, whether you're the founder or part of senior management.

OUR FOCUS

This book does not cover venture capital firms, which invest in startups, or hedge funds, which can invest in all sorts of things and can hold those investments for as little as a day. Our focus is private equity firms, which are interested in buying companies in the sweet spot of $20 million to $1 billion in revenue, increasing their value rapidly—in three to five years—and selling them, returning the proceeds of the sale to their investors, called limited partners or LPs.

CHAPTER 1
WHAT YOU NEED TO KNOW ABOUT THE PRIVATE EQUITY INDUSTRY

KEY STAT

There are some 3,000 PE funds in the U.S., with assets under management of about $1 trillion.

A HIGHLY SIGNIFICANT SECTOR OF THE ECONOMY

Private equity, as a trillion-dollar asset class, is a major economic driver of the U.S. economy, creating millions of jobs and funding the future needs of pensioners, academic institutions and charitable foundations. It is also the primary market through which business owners can exit the companies they've built.

In essence, private equity is an asset class that consists of pools of capital raised by private investors and managed by a team of professionals. The goal is to buy, or make significant financial investments in, companies and increase their value to a future investor in the course of three to five years.

When the PE firm judges the moment is right to sell a company in its portfolio, it seeks an exit. This could mean selling the company to yet another private equity firm or to a strategic buyer, such as a large corporation in the same industry. Some large PE firms that buy bigger companies might take a company public through an initial public offering (IPO) on a stock exchange. In any of these cases, the PE firm returns capital plus gains to its investors, with the private equity fund retaining some upside.

What is the scale of the private equity industry? There are approximately 3,000 PE firms in the U.S. alone, with assets under management in the trillion-dollar range. To put that into perspective, the private equity sector as a whole (including some 8,000 PE-backed companies in the U.S.) is the largest employer in the U.S., with an estimated 11 million workers, according to the Washington Post. (For comparison, Walmart employs 1.5 million.) As such, it is a major source of potential employment growth.

Private equity is also a major avenue by which entrepreneurs who have built businesses can realize value and opportunity for their team. It provides a way for small businesses to grow—quickly—and for their managers to realize their full potential as business leaders and as people.

CASE STUDY

ADWEEK EMBRACES EVENTFUL FUTURE

Since Beringer Capital acquired Adweek, it has invested heavily in building a fast-growing and highly profitable events business, including the revitalization of Brandweek as an annual event franchise for brand marketers. The company has also found new revenue streams such as online education, custom content and corporate subscriptions. These initiatives have not only helped grow the company's revenue and profit, but they have also boosted the value of the company by increasing its exposure to attractive business models, beyond traditional media, that are highly prized by strategic and financial investors alike.

ADWEEK

WHO INVESTS IN PRIVATE EQUITY AND WHY

Private equity investors (or "limited partners") can be institutions charged with managing assets on behalf of a public or private entity or high net worth individuals or family offices. They invest in private equity because it provides diversification from the public markets and offers among the highest rates of return of any asset class.

Investors in private equity are called limited partners (LPs) versus the general partners (GPs), who manage the funds. Limited partners include institutions such as public or private pension funds, non-profit endowments and universities. Examples include California Public Employees' Retirement System, the Ford Foundation and Yale, respectively. In fact, nine out of ten pensions invest in private equity, and the returns lead all asset classes. So private equity is an important engine of financial growth that helps secure the futures of teachers and other workers in labor unions, as well as helping fund important charities and scientific research.

Another investor class includes high net worth individuals or family offices, which are self-managed or managed by an institution such as Goldman Sachs. A third class includes financial institution "funds of funds," which invest in a diverse portfolio of private equity, hedge funds and venture capital.

The average PE fund size is $500 million, and the usual life of a private equity fund—PE firms may run several funds at once—is seven to ten years. So these investments are highly illiquid. An investor is committing capital for a significant period and cannot withdraw this money on demand.

Limited partners invest because they are seeking diversification across industries and asset classes, as well as higher returns. Over the last 15 years, private equity has been among the highest-yielding asset classes, returning on average about 14% a year. (By comparison the S&P 500 returned about 7% over the same period.) But the main reason private equity delivers higher returns than other asset classes is simply that PE firms optimize the businesses they purchase. So designing your company to be attractive to private equity is just good for your business, whether you end up selling it or not.

DID YOU KNOW?

Private equity is the highest-performing asset class in the investment world, including stocks, hedge funds, venture funds, etc.

"Massachusetts Pension Reserve Investment Management private equity program has consistently performed extremely well for the 300,000 state and municipal employees, teachers, retirees and others that count on us to deliver strong investment returns on their pension assets."

Michael Trotsky, Executive Director and Chief Investment Officer, Massachusettes Pension Reserve Investment Management Board

Private equity has been performing so well as an asset class that investors are willing to commit more and more money to it. This means more cash that PE fund managers are looking to invest in companies.

DRY POWDER HAS BEEN ACCUMULATING, SETTING A RECORD IN 2018

TERMINOLOGY

Dry Powder: Cash held in reserve by PE funds, used both to buy new companies and to invest in existing portfolio companies.

2014 $441 2015 $475 2016 $516 2017 $602 2018 $692

GLOBAL DRY POWDER AMONG BUYOUT FUNDS AS OF YEAR-END, IN BILLIONS

SOURCE: PREQIN

HOW A PRIVATE EQUITY FIRM WORKS

The general partners manage the money invested in the fund by acquiring businesses that meet their investment criteria and keeping a portion of the upside from the sale. Funds range the gamut in terms of size, investment style and strategies employed.

The general partners actually run the private equity fund, raising the money from limited partners, making the investments and working with the portfolio companies. The organization includes partners of the firm as well as various middle layers of principals, vice presidents, associates and analysts, who work on much of the day-to-day activity, especially the financial analysis and deal due diligence. The general partners who guide the strategy of the fund report on its progress to the limited partners, holding an annual meeting with them to discuss their platform companies, strategies and exit prospects.

The general partners decide what to invest in, but they are typically bound by the fund's prospectus (called a Private Placement Memorandum), which lays out guidelines in terms of types of sectors, investment size or profitability of the companies in which the fund will invest. To deviate from this substantially, the GPs may need to get permission from the LPs.

The general partners are generally compensated according to what's known as a "two and twenty" structure: The two is the 2% annual management fee based on the amount committed to/invested in the fund. The twenty (also called carried interest) is the 20% upside they get on the profit of the investment after the capital is returned. Typically, this 20% kicks in only after the LPs have received a preferred return on their investment, usually around 8% or so. The GPs share the carried interest according to their own respective share in the firm's equity.

There are many different types of private equity firms. They vary greatly in size, from giants like Blackstone or KKR, with individual fund sizes in the tens of billions of dollars, to smaller firms running funds in the hundreds or even tens of millions. Most try to differentiate themselves from other PE firms in some way. Some will tout their industry specialization or expertise in executing certain investment strategies.

Some firms specialize in taking substantial but minority stakes in fast-growing companies, as opposed to traditional buyout firms (so-called growth equity). Some are more "hands on" in style, others more "hands off." And they vary in their preferred strategies: Some like to do roll-ups—buying several small companies in the same industry and merging them together for economies of scale—some focus on financial engineering, and others seek organic growth through the development of new products, untapped markets or better processes.

GPs

GENERAL PARTNERS

- Raise money from limited partners
- Make the investments
- Work with portfolio companies

LPs

LIMITED PARTNERS

- Are often institutions, such as pension funds
- Are willing to commit capital for a period of years to seek high returns

CHAPTER 2
HOW PRIVATE EQUITY CREATES VALUE

THE USE OF LEVERAGE

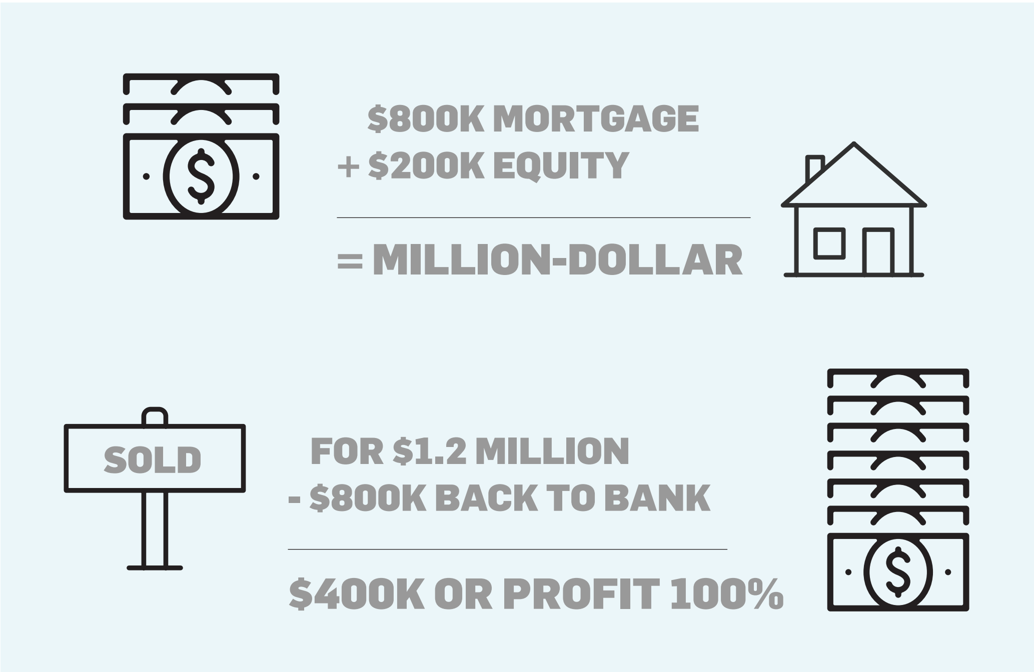
PE funds are able to take advantage of debt financing of acquisitions. This further augments returns by limiting the initial cash outlay for the business, while writing off interest on the debt to minimize tax liabilities.

PE firms will usually buy a company using mostly cash, but they also use bank debt (or leverage), with interest payments covered by the purchased company's cash flow. Hence, this is known as a "leveraged buyout." When the (hopefully more valuable) company is sold again in a few years, the debt is paid off, and the remaining profit is used to pay the investors (limited partners), the general partners in the PE firm and the company's top management.

This extensive use of leverage is one reason private equity tends to deliver high returns. It also allows the fund to keep more cash in reserve (known as "dry powder").

ILLUSTRATION

The use of leverage in PE is similar to using a mortgage to buy a house: It allows you to buy a lot more house than you could otherwise afford, and the leverage vastly increases your return on your investment. Let's say you take out an $800,000 mortgage to buy a million-dollar house, then sell that house for $1.2 million. You pay back the bank and keep the $200,000 profit as well as the $200,000 in equity you kicked in. The return on the entire $1 million the house cost is 20%, but the return on your $200,000 down payment is 100%—you've doubled your money!



THE RELATIONSHIP BETWEEN EBITDA AND VALUATION

EBITDA, or earnings before interest, taxes, depreciation and amortization, is the primary metric used by private equity to measure profitability. Because valuations are calculated using a multiple of EBITDA, this figure is tracked very closely, with attention put on maximizing its output on an annual basis for PE-backed companies.

EBITDA is essentially net profit or earnings with interest, taxes, depreciation and amortization added back. Because EBITDA normalizes the effects of bank financing, tax rates and capital expenditures (which can be unique to every individual business), it is a useful way to compare the profitability of companies on an apples-to-apples basis. That's why investors, such as private equity firms, use EBITDA to measure the profitability of a business.

There's an old saying in business: Cash is king. And while it's true that the cash flow of a business is the only thing that can line your pockets as an owner drawing dividends, in private equity, EBITDA is the central number that determines a company's value.

Valuations are generally a function of the company's EBITDA times some multiple of that figure based on a number of business factors, such as sector growth rate and company size. So, if a private equity fund can increase either the profitability of the business or the factors that boost the "valuation multiple"—preferably both—during its hold period, it creates economic value and thereby a positive return to investors. That is why maximizing against EBITDA is so vital.

The ability to drive EBITDA comes with a force-multiplier effect. Say companies in your industry trade at a multiple of eight times EBITDA: Then every new dollar of EBITDA creates $8 in new shareholder value. This puts a very different lens on every incremental dollar spent or earned.

WHAT'S YOUR VALUATION MULTIPLE?

Any given industry tends to have a range of EBITDA multiples. A number of factors—such as growth rate, margins and exposure to various potential risks—will affect where a company's multiple lies.

Illustrative Industry Multiples

Technology	10-15x
Consumer	8-12x
Media	8-10x
Manufacturing	5-7x

PULLING THE VALUE LEVERS

On the path to maximizing EBITDA, many PE funds are known to aggressively cut costs (including employee benefits and salaries) or conduct other balance sheet restructuring, like capitalizing certain expenses such as equipment leases or even restructuring companies to lower the liabilities on their books. Other funds will be more focused on building and driving profitability by increasing revenues faster than the rate of costs go up.

Generally, cost-cutting and balance sheet restructuring can be done only a limited number of times in the hold period of a private equity fund, and no one has ever “cut costs to greatness.” (3G Capital recently learned this hard lesson: After four years of cost-cutting at Kraft Heinz—all while failing to properly support its biggest brands, Kraft and Oscar Mayer—3G had to write down the value of key assets, especially those brands, by some $15 billion. The stock dropped by 27% in a single day.)

Therefore, organic growth (the ability of a business to grow its top line on its own steam, without acquiring or merging with another company) is essential, as it is the only path to sustainable EBITDA increases. It generally comes down to executing against one of three ways to grow a business, according to renowned strategic consultant Jay Abraham: (1) increase the number of clients (get more new prospects to become paying customers); (2) increase the average transaction (get each client to buy more at each purchase); or (3) increase the frequency that the average client buys from you (get each customer to buy from you more often).

Identifying organic growth opportunities can be straightforward enough. The downside is that organic growth tends to be a slow process, and in private equity, time is not your friend. Some PE firms tend to underplay organic growth for this reason.

Another essential value lever is increasing the efficiency of the company, thereby delivering more profit to the company’s bottom line. This is where real strategic thinking comes into play and figuring out how to build a better, more efficient mousetrap: getting more out of your existing resources, finding ways to lower excess capacity, in-sourcing external spend or investing in technology or machinery to offset time and materials expense. Unlike increasing revenue, which usually comes with an associated marginal increase in cost of goods, focusing on margin tends to have an outsized impact on EBITDA. That’s because any incremental dollar retained drops fully to the bottom line.

A PE firm can help with all this. After all, it’s not easy to disrupt yourself and reexamine every facet of how you run your business, especially when you’re running it as fast as you can. The GPs will ensure that no possible untapped source of value is overlooked. They will insist on rigorous benchmarking. They will set targets. They will do all they can to keep you on track.

The partners at the PE firm will also make sure you have the right resources when you need them. These resources could be professional advisors—consultants, recruiters or lawyers—that can help you tackle specific challenges in the business; they could be introductions to potential sources of new revenue, talent or important influencers in government or industry that can help you open new areas of opportunity domestically, or even in international markets where you have never played before. That’s part of the network effect of working with partners in a fund worth several hundred million dollars—these people have a high-powered Rolodex that could be at your disposal and the know-how of whom to call and when.

PE FUND STYLES «

FUND SIZE BY MARKET SEGMENT

- Large cap $5B and up
- Upper middle market $500M-$5B
- Lower middle market $100M-$500M

MANAGEMENT STYLE

- Hands-on
- Hands-off

FUND FOCUS

- Industry specialty
- Investment theme, e.g., roll-ups, financial engineering, organic growth

THE MERGERS AND ACQUISITIONS (M&A) FAST-TRACK

Mergers and acquisitions (or M&A) can fast-track the company's growth while increasing the value of the business. Acquisitions also have the potential to magnify the return on investment in the acquiring PE-backed company, to the extent the acquisitions are financed, at least partially, through debt.

The fastest way to grow a business is to create a platform company that the PE firm can build upon, buying other companies and integrating them. For private equity, the key aspect is speed. Adding on new companies can lead to rapid growth, and most of this is done with debt financing. Besides achieving absolute growth, increasing the size of a company tends to boost its valuation multiple since larger companies can take advantage of economies of scale.

This is a prime example of how partnering with a PE firm can be beneficial, thanks to the experience, skill sets, connections and propensity for big-picture thinking the general partners bring to the table.

THE TICKING CLOCK

By shortening the timeline by which capital plus profit on the sale of the business is returned to investors, the rate of return is accelerated.

Value is a function of time, and time is an especially urgent concern in private equity. If you double the value of your investment in one year, that's very different from doubling it in 100 years. The time horizon for optimizing and reselling a company is typically within five years for PE firms. But a quicker turnaround means higher annualized returns for investors.

So you need to accelerate the value that you can create, which means avoiding mistakes. It also means identifying what's going to move the needle and getting there as quickly as possible, because you have the right insights, the right know-how, the right support, the right network. Anybody who thinks that they can do that on their own, run the day-to-day operations, make sure that HR is working and so forth is fooling themselves.

Ideally, when you work with a PE firm, the ticking clock should keep everyone focused enough to not waste any time or energy. Not only do you need the capital, connections and insights the firm can supply, but you also need the general partners' strategic and operational expertise to help realize the vision for the company with greater speed and certainty. The board should monitor your progress against key outcomes every quarter to keep things on track.

However, the reality is that many board members, advisors and individual investors say they will add value but don't. Many quarterly board meetings are a waste of time for the executives running the business. And not many general partners, for all their financial acumen and experience as investors, are positioned to help operators become the types of leaders that make transformational change in the business occur.

IDEALLY, WHEN YOU WORK WITH A PE FIRM, THE TICKING CLOCK SHOULD KEEP EVERYONE FOCUSED ENOUGH TO NOT WASTE ANY TIME OR ENERGY.

PRIVATE EQUITY TERMINOLOGY

1. **Leveraged buyout:** Use of borrowed money to acquire a company. The company's assets are used as collateral for the debt, and interest payments are made from its cash flows.

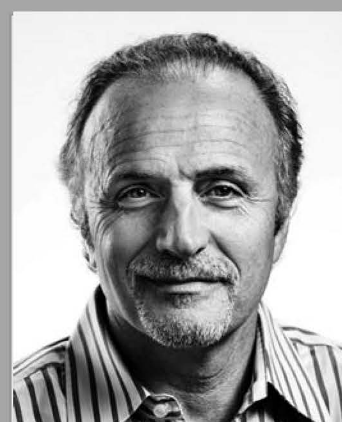
2. **Internal rate of return (IRR):** A measure of the net return to limited partners over a particular time period. The rate of return matters greatly to limited partners because their capital is tied up for a long time, so they want a higher return than they could get with, say, a broad stock market index fund. A good IRR is in the mid-teens.

3. **Return on invested capital:** The return divided by invested capital. This is the cash return, but it doesn't consider the time period of the investment. A good return that LPs would be satisfied with is around two times their money in five years. Of course, the faster the timeframe, the higher the IRR.

4. **EBITDA:** EBITDA is essentially net income (or earnings) with interest, taxes, depreciation and amortization added back. EBITDA can be used to analyze and compare profitability among companies and industries, as it eliminates the effects of financing and capital expenditures, thus enabling comparison on a more "apples-to-apples" basis. EBITDA is often used in valuation ratios and can be compared to enterprise value and revenue.

5. **Adjusted EBITDA:** EBITDA plus non-routine or one-time expenses, such as excessive owner's compensation or a one-off consulting project or severance payout. The adjustment can also be a subtraction when EBITDA doesn't represent the business as an ongoing concern, for example, salaries for necessary headcount in a company that is understaffed.

6. **Confidential Information Memorandum (CIM):** A document, usually created by an investment banker and sent to potential buyers, that helps prepare a company for sale. It includes a description of the business, its top management and financials as well as an assessment of growth opportunities and barriers to entry in the industry.



"I've spent over 20 years as an operator and investor, working in the trenches to build successful businesses. That experience has not only afforded me first-hand insight into various processes, but also the difficult decisions that entrepreneurs must make as they navigate their business journey.

Most entrepreneurs reach a critical juncture at one point or another: whether they're facing a significant business disruption, hoping to establish a viable succession plan, or simply looking to take their company to the next level. Each of these scenarios can feel daunting, and it might be tempting to bury your head in the sand, but we extend the gentle reminder: "Hope is not a strategy." However, having the right partners in place can offer meaningful hope in the form of a solid roadmap for the future and value creation for subsequent generations. Take the time to get to know a prospective private equity partner, assessing the relevant experience and skills they can bring to the table, as well as how they plan to be involved day to day. Remember, it's not just about boosting your bottom line—you want to work with someone whose core values complement your own."

Perry Miele, Chairman, Beringer Capital

AS THE LEADER GROWS, SO GROWS THE BUSINESS

One truly differentiated approach to create value through private equity ownership is to focus on the human element of the business. That means personal and professional development of the executive talent using human analytics and mentorship to help them become leaders that can more effectively unlock opportunity in the business. This approach is not for everyone, but anyone can benefit from it.

The traditional method for PE firms has focused on the “Seven Principles of Private Equity Value Creation” gleaned from the research for this piece (see page 18). Although still valid, those approaches have become so common that it is hard to differentiate amongst the thousands of PE firms in the market, outside of their sector focus, investment criteria and fund size. But there is another method, and that way is to transform how the businesses are managed and their orientation to growth and excellence. This is, incidentally, the approach taken by Beringer Capital, the PE fund that backed Adweek/Brandweek.

> ALL BUSINESSES ARE BUILT AND RUN BY PEOPLE, AND LIKE EVERYONE ELSE, ALL BUSINESS LEADERS HAVE THEIR LIMITATIONS AND BLIND SPOTS.

It is critical to bear in mind that all businesses are built and run by people, and like everyone else, all business leaders have their limitations and blind spots. Often a business grows to a point where the founding entrepreneur, essential to the company in its early years, becomes the choke point for further growth because of these limitations.

Private equity can help you take a step back and expand your vision. There might be an opportunity you didn’t realize you had because you’re working deep in the trenches, while the PE partners are looking at the market, what other companies are doing, what transactions are occurring. Perhaps you could shift operations in such a way as to boost profits, but this will require a change in the culture, one in which you will need to lead by example. It could require a senior leadership change or getting more out of the team you already have. Helping you see that, and capitalize upon it, is part of helping you grow as a leader.

One area that is rapidly growing is that of human analytics—existing, proven tools, such as scientifically backed behavioral assessments, that can provide an understanding of what drives people, how they deal with situations and how they can be better positioned for success given their nature. The other is deep mentorship—working with partners who have a history of nurturing success in others, and who have valuable skills, knowledge and contacts.

"You have got typically four to five years max to get to the right level of return. So there's a sense of urgency, really moving very fast to drive your strategy, make the organizational changes you need. Once you figure that out and you're comfortable being decisive, it's actually a very fun environment to work in. And you can make a lot of money in a short time.

Make sure you align with the style of the PE professionals you'll be working with. You're aligned around the strategy, how you're going to communicate, what they're going to do, what you can do independently. Being very proactive in your communication is really important. They're under pressure from their investors. So you've got to get that communication cadence and help them along the way."

Sharon Rowlands, CEO and President, Web.com

This model of mentorship is like working with a personal trainer. It's up to you to do the work, but that partner is there every day to assist on the long- and short-term challenges of the business, pushing you but also supporting and teaching you, and holding you accountable. Over time, you become stronger, you expand your range and toolkit, you develop good habits, you move beyond your personal and professional plateaus. Eventually, this filters down to your direct reports and then further down through the business.

The key factor here is a willingness to genuinely consider new perspectives, and some people are not ready for that. You have to be open, and you have to be hungry enough to want to make those internal changes and improve yourself. This is not just a matter of one or two sessions but something you work on and reinforce regularly. Even small shifts in your thinking and behavior can make a big difference if they infuse your actions day to day.

This is simply a matter of constant learning and never-ending improvement. After all, the most effective learning environments are immersive. The quickest way to learn a new language is to immerse yourself in that language community. If you partner with a PE firm that has this type of focus, you will be fully immersed for at least three years. You will develop as a leader, and this skill set will make you more effective for the rest of your career, whatever challenges you undertake.

7 PRINCIPLES OF PRIVATE EQUITY VALUE CREATION

Based on the extensive research conducted for this report, we asked a simple question: "How does private equity add value?" The answers can be synthesized into these seven principles.

1. **Access to Capital** PE general partners access capital through the funds they raise. This capital attracts owners of quality businesses who are seeking a liquidity event (or "exit"). It can also be invested in a purchased business to drive revenue or profit growth.

2. **Use of Leverage** PE firms usually acquire companies through what is called a "leveraged buyout": Most of the purchase price is paid in cash, but a significant amount is financed through bank debt (or "leverage"). Use of leverage to acquire businesses results in higher returns on equity invested.

3. **Financial Rigor** Most privately held businesses are not managed to maximize the most important metric in defining the economic value of the business—the pretax profits, or EBITDA. PE firms set up rigorous financial controls to help drive decisions that can positively affect EBITDA growth.

4. **Access and Introductions** Executives are focused on their roles at the company and often do not have access to senior industry thought leaders or the best professional services providers (e.g., consultants, investment bankers or lawyers), who can make significant contributions during key events.

5. **Mergers & Acquisitions** Through access to capital, market knowledge and the skill set to acquire other, complementary businesses, PE funds can dramatically increase the size of their portfolio companies and/or their value.

6. **Speed/Focus** The returns PE earns depend on the dollar amount of those returns as well as how long it took to generate them. This means that the value PE helps create must occur as rapidly as possible.

7. **Alignment of Incentives** By creating management incentive plans, PE can provide the management of the companies they purchase a significant financial upside when the asset is sold. For former owners of the business who are still working at the company and have retained a significant portion of their equity as part of the transaction, their gain may even be larger when the business is sold again to another investor.

» IS YOUR BUSINESS RIGHT FOR PRIVATE EQUITY?

From these seven principles we can derive the seven elements that make your company desirable to private equity.

Vision for Strategic Growth A desirable company has a vision for how to deploy the capital that private equity can supply—a plan for strategic growth and how to achieve it. What category can you create? Will you grow by creating new products and/or via acquisitions? **1**

Profitability Your company must be profitable—or, at the very least, have a clear path to profitability—or banks will not lend money to finance the buyout. **2**

Clear Financial Systems and Data Your company should have all relevant data (e.g., customer information, employee information) organized and accessible. There should be clear lines of financial authority, a detailed budget and realistic financial projections. They will ask you to fill a data room, be prepared to fill it. **3**

A Growth Mindset You and your company's management team need to have a growth mindset and be open to accepting advice, help and new perspectives in order to achieve that growth. A PE firm won't provide access and introductions—a hugely valuable resource—if you're going to give these contacts the brush-off and ignore advice. **4**

Open, Appealing Culture If you intend to grow via M&A, your company must have the sort of culture that's able to absorb other companies. This means an open, inclusive staff that's willing to work with new people and integrate them into the firm, as well as to share information—if your company is riddled with silos, that's a problem. The workplace environment must also be appealing so employees of the acquired company don't flee. **5**

Plan for Fast Growth In the same way that it takes multiple columns to hold up the Parthenon, it takes multiple areas of potential growth to really get a private equity firm excited. You should have a list of priorities and a sense of urgency and be willing to leverage the help and access the PE firm offers. **6**

Motivated Leadership The PE firm will arrange incentives, but you must be willing to bet on yourself. Private equity wants hungry, motivated management with skin in the game. The second bite of this apple should be at least as important to you as the first. If you are not motivated, then you should be willing to step aside. **7**

CHAPTER 3
THE DEAL CYCLE

THE SALES PROCESS

Selling a company is a structured process that may involve intermediaries who represent the business in the sale process. The due diligence conducted by private equity buyers is usually thorough, and owners are well-advised to prepare for this process in advance to increase the certainty of a sale at a good price.

Once an entrepreneur decides to sell a company, the first step is usually to bring in an investment banker, who helps prepare the company for sale by creating a Confidential Information Memorandum (CIM), which includes a description of the business, its top management and its financials as well as an assessment of growth opportunities and barriers to entry in the industry. The investment banker represents the company for sale and may send the CIM to a group of potential buyers (it could be a dozen or even a hundred, depending on the marketing strategy employed by the investment banker) to solicit multiple bids. Generally, it takes four to eight months to close a deal.

Many candidate companies are brought to PE firms by investment bankers. However, PE firms may also cultivate a proprietary deal flow, essentially by knocking on doors of companies that have caught their eye and that may not be for sale—at least not yet. Entering into such a deal can have advantages for a target company, as the deal could be concluded relatively quickly, without much disruption to the management team. So if the PE firm seems like a good fit and the price is right, it's worth considering.

Once you've selected a buyer, due diligence will begin. It will involve various types of scrutiny: financial and taxation due diligence, legal due diligence, an evaluation of the company's market size, growth prospects, client relationships, etc. This process may be taxing, but the PE firm has a fiduciary obligation to its investors to ensure the business is on solid footing and identify any discernible material risks.

In fact, Sean Mooney, who spent a couple of decades working in PE firms before founding BluWave, which connects private equity firms and their portfolio companies with top resources for due diligence and execution, believes business owners should start preparing for a sale well in advance, ideally about two years before, by doing due diligence on their own companies: "What business owners need to know is, do they have accurate numbers? They may need to have a third party come in to verify their numbers.

"And they need to really know the size of their market, their market share versus their competitors," Mooney adds. "They need to know their revenue by customers, profitability by customers, by product lines. They need to tie all that into a projection that goes out five years.

"It's a lot of work, but the more prepared they are, the better outcome they're going to have. If they're not prepared, investors will perceive higher risk and offer a lower price."

THE CONTRACT PHASE

Standard in any deal will be various legal agreements that govern everything from the terms of the transaction itself to a new employment contract with the owner and key executives, to how money is distributed post-exit.

At some point during the due diligence process, when the parties are fairly certain the deal will get done, the contracting phase will begin. A well-reputed M&A lawyer is essential to this part of the process. You may be dealing with a purchase contract, a shareholder agreement and an employment agreement if you're rolling over part of your proceeds and staying to run the business. If you're an executive being recruited to join a portfolio company, you'll negotiate an employment contract, and possibly an incentive equity agreement and a shareholder agreement.

Usually, there will be different classes of stock issued. When a portfolio company is sold, first the debt is paid off, then the capital plus any agreed preferred return is distributed to the limited partners—and to you if you've rolled over equity or written a check to invest in the company—via the first class of shares. Any further profit is distributed through the other share classes, some percentage of which is often issued to senior management as an incentive.

As an entrepreneur selling to a private equity firm, this sale process may be your first, and you will be at the center of the process. It may be daunting, but you should be well advised by lawyers, consultants or other intermediaries you trust. It is also a good opportunity to really get to know your future private equity partners, as there are invariably hiccups and challenging issues that occur in any deal cycle. It's how the parties ultimately handle them that is the most telling sign for what your relationship will be once the ink is dry on the contract.

The other thing to keep in mind is that three to five years down the line, you will be on the same side of the table as your current PE partners selling to another buyer, making the case for the increase in value that has (hopefully) been created during your hold period together.

10 QUESTIONS TO ASK PE FIRMS DURING THE TRANSACTION PROCESS

1. What is your investment thesis—i.e., what do you believe is the opportunity for the company to increase its value over the next three to five years?

2. In what specific ways is your firm going to add value and improve the company? What can I count on you to deliver or take off my plate?

3. What people and resources do you think need to be added to this business? What additional investments are you willing to make or not make?

4. How will you support my existing team and create opportunities and incentives for them?

5. What's your approach to governance and how much discretion will I have to manage the business going forward?

6. Who else have you invested with in a similar situation? And can I speak with them to discuss their experience with you?

7. When have things not worked out with a founder post-acquisition, and what have you learned from that?

8. Can I make a rollover investment or other equity investment?

9. What's your historical IRR and return on invested capital at the fund level and with individual portfolio companies that resemble this one?

10. How much debt will you use and how will it impact our ability to invest in growth?

CHAPTER 4
CONSIDERATIONS FOR ENTREPRENEURS + BUSINESS OWNERS

For most small to medium-sized businesses, private equity offers the best opportunity to maximize value and create long-term opportunities for your team. A sale to a strategic buyer in your industry or an employee stock ownership plan are alternative options, though less common, and with their own advantages and disadvantages.

So you're an owner or partner in a business—a private company with revenue of at least $20 million—and the business is profitable. Your company is rather small for an IPO to make sense, but you've decided it's time to realize some of the value you created. Is a sale to private equity the right option? What are the other possibilities?

If your company supplies a product or service that fills a strategic need for a competitor in your industry, you may have a potential strategic buyer. Such a buyer expects to realize long-term value through synergies, value that may exceed the intrinsic value of the company, and so may be willing to pay a premium. This may make sense for you, especially if your goal is to retire and leave the business. The potential downside? How it may affect your employees. The strategic buyer will likely realize value partly from eliminating redundant facilities and laying off staff.

Another approach is to create an employee stock ownership plan (ESOP). If you want to transfer ownership of the company gradually rather than all at once, reward your employees and bolster their 401(k)s, this could make sense. It also creates certain tax advantages, assuming your company is profitable.

But there are significant potential downsides. For one thing, you probably won't make as much money. An ESOP is allowed to pay only fair market value for the company's stock, and that is determined by an independent valuation expert. And the ESOP must offer to buy back an employee's shares when they leave the company, which could entail a large expense if many employees quit or retire in a short span. And there's substantial cost involved in setting up an ESOP.

So private equity remains the most likely option for most midmarket companies looking for a buyer. And if you intend to stick around and keep running the business, this could well be the most profitable option for you, thanks to the ability to roll forward a portion of your equity.

SKIN IN THE GAME

A business owner selling to private equity for the first time will likely retain a significant amount of equity in the deal. This equity "rollover" aligns the owner's incentives with the PE firm that has just invested and expects the owner to continue to deliver growth post-acquisition. By staying through additional PE ownership cycles and continuing to roll equity into the next transaction, owners can get multiple bites at the apple, as each subsequent exit could offer a larger gain than the initial one.

PE firms are looking to increase both profitability and the valuation multiple, and to do it quickly. One major factor here is simply aligning everyone's incentives. As an entrepreneur, you'd generally roll over between a quarter and a third of your equity into the deal, essentially becoming a minority partner with the PE fund in the business you just sold. Other members of the management team will likely also receive some incentive stock, and possibly the chance to simply write a check to invest further in the company. As long as the company hits its targets, everyone should do well.

It is also worth mentioning that many transactions will have an "earnout" component. That means that part of the purchase price (it could be up to 20% or more depending on price paid and key risks identified) is payable only if the company meets its forecast revenue or profit projections over the relevant time period. This means that, as the owner, you may not be able to bank the entire purchase until you achieve what you said the business will achieve.

"I've had three roles as CEO and Board Director with PE-backed companies. I'm consistently impressed with the level and quality of support I've received from my PE partners when I've needed it. I think as an executive it's critical to be aligned with your sponsor around the investment metrics that drive their returns—is cash flow most important or investing for long-term value, etc.? If you're not on the same page, you won't have as successful a relationship."

Bonnie Kintzer, CEO, Trusted Media Brands (which includes iconic media brands such as Reader's Digest and Taste of Home)

HOW TO PICK THE PE FIRM THAT'S BEST FOR YOU

The price offered for your business is clearly an essential consideration for selecting a PE partner. However, if you are remaining with the business and intend to roll over part of your equity, you will need to also be aligned with its management style, culture and ability to add value through its hold period.

So you, as the entrepreneur or partner in the business, and your investment banker or advisor have narrowed down the number of interested PE firms to just a few. How do you decide on your top pick?

Many have the mindset of an auctioneer and sell their business to the bidder who values it at the highest price. It's natural to want to extract the most monetary value from an asset you've built up.

But if you intend to stay with the business and retain a piece of your equity, you should take a harder look and evaluate the ability of your prospective PE partner to help you increase the value of the business during its ownership period, so that the equity you retain in the company is worth at least as much as what you sold off. In which case, your relationship with the private equity firm and how you will work together to achieve the next phase of growth can be at least as important a factor as the price you'll get on this first transaction.

Of course, there will be new governance in place. You will be dealing with a board of directors. Typically, the PE fund's managing partner who is most involved with your company becomes chairman of the board and is accountable to the other managing partners in the fund as well as to the investors who make up the limited partnership. The question that arises is what type of oversight will be in place. Will every minor decision be micromanaged, or will you have reasonable discretion to operate the business?

IT'S CRUCIAL TO WORK WITH A FIRM THAT REALLY UNDERSTANDS YOUR BUSINESS AND WILL ACTUALLY COLLABORATE WITH YOU. IDEALLY, THE PE FIRM'S GENERAL PARTNERS WILL WORK WITH YOU FROM THE VERY BEGINNING—POSSIBLY EVEN BEFORE THEY CLOSE THE DEAL—TO CO-CREATE A STRATEGIC PLAN.

Another key factor to assess is whether the PE firm takes a more hands-on or hands-off approach. Firms run the full gamut here, and what will suit you is more a matter of your own temperament than anything else. A common pattern, especially with firms where the general partners tend to be financial engineers rather than operators, is to be hands-off as long as you're making your numbers and executing your growth strategy. This type of firm will pretty much leave you alone to run the business day to day. Your dealings with the firm may consist of monthly phone calls and quarterly board meetings in person. If your business is having trouble, however, this same firm may well become very hands-on.

But if you're open to collaboration, advice and encouragement, you may do well with a hands-on firm. Firms that tend to be hands-on with all their companies, even when they're doing well, often have general partners who are business operators, having already run several companies in the course of their careers. They may be incapable of remaining uninvolved in the business, but if you develop a good relationship with them, this can be useful.

Remember, the best way to maximize your own financial gain is to get as much, or more, out of the second sale of the business—when the PE firm that bought your business resells the optimized company to another investor. If this is your goal, this sort of mentorship model should work for you: You'll be continuing to expand your leadership skills and thus the potential of the business, and the general partners will push you to take this as far as you can, as fast as you can.

It's also crucial to work with a firm that really understands your business and will actually collaborate with you. Ideally, the PE firm's general partners will work with you from the very beginning—possibly even before they close the deal—to co-create a strategic plan. They can help you quickly and accurately identify the levers that will enable you to accelerate organic growth as well as M&A. You need the PE firm's help for both those things, but if it doesn't understand your business, it will make mistakes.

"Entrepreneurs should spend some time thinking through how they describe their company, what makes it unique, why it's unique in the ecosystem in which it plays," says Jim Brennan, managing director and senior partner at Boston Consulting Group. "Also, think through the next phase of growth for your company, and the next phase beyond that. Many haven't thought much about that next phase beyond, but it will be critical to future investors. And understand the different types of PE firms. If you need international growth as a key driver, how do you pick a firm with international presence? You might be better off with a very specialized firm than a generalist firm. Try to figure out which firms could buy your strategy in advance."

If you're selling to a PE firm—of whatever style—and staying to run the business, you're signing up for an intense several years. The pace will accelerate, as speed matters. If you select a hands-on firm, the general partners will push you out of your comfort zone and encourage you to achieve big things, but they will also provide guidance, their expertise, valuable contacts and financial resources.

CHAPTER 5
CONSIDERATIONS FOR EXECUTIVES WORKING IN PRIVATE EQUITY PORTFOLIO COMPANIES

You may be a senior executive at a company that's being acquired by private equity. Or a PE firm may be recruiting you from a Fortune 500 company to step in as part of senior management at a newly acquired portfolio company. How do you set about working in this new environment and succeeding? What are the opportunities for you?

WHAT PRIVATE EQUITY FIRMS LOOK FOR IN EXECUTIVES

Private equity funds want to align themselves with executives that help achieve the goals of the fund. That means being data driven, speed oriented and highly collaborative. Most executives find their association with private equity to be highly rewarding, but it requires a willingness to be challenged beyond your comfort zone.

Crucially, from private equity's point of view, the ideal candidate is personally candid and intellectually honest. A company that has been bought by a PE firm will have a board of directors installed. One of the best moves you can make as an executive is to truly engage with the board. Give them a heads-up as soon as you detect a problem brewing and feed them as much data as you can. PE firms have an insatiable thirst for data on their portfolio companies.

Of course, private equity firms like executives who execute on growth strategies and meet their numbers. The ideal candidate performs well under pressure and is decisive, adaptable, open to learning and capable of stepping back from day-to-day considerations to think strategically. The candidate will assess the performance of other key personnel and seek a talent upgrade if they can't perform as required.

ONE OF THE BEST MOVES YOU CAN MAKE AS AN EXECUTIVE IS TO TRULY ENGAGE WITH THE BOARD.

"I have now worked for three different private equity–backed businesses as a senior executive. Each of these roles has offered a higher steppingstone to a bigger role at the next company. I think the key to success working with a 'hands on' private equity investor is to embrace the partnership. Our investors have been instrumental in helping establish the right culture, breaking down the silos and instilling the organization with a spirit of entrepreneurship that's helped me and my team grow the business in ways we could not have envisioned."

Jeff Litvack, CEO Adweek
(portfolio company of Beringer Capital)

Like most anyone, PE firms also prefer executives who are responsive and easy to work with. Inevitably, personal chemistry plays a role, so try to work with a PE firm that has general partners you get along with.

If you've been working in management at a Fortune 500 company and a PE firm wants to recruit you to work at one of their portfolio companies, this is a smart entrepreneurial step. You may well have the opportunity to invest in the company, and be granted some equity as an incentive. You will probably need to step away from a company that's a household name to be a bigger fish in a smaller pond, but if you have always had entrepreneurial inclinations, this is a trade-off worth making.

Of course, this will mean taking yourself to a different level. You want to partner with someone who can help you stretch as a leader. You know how a large company works—you have the skills that can take this smaller company to the next level. Can your PE partner help you take yourself to the next level?

There is also a larger opportunity.

FROM EXECUTIVE TO ENTREPRENEUR

A successful stint as an executive at a private equity portfolio company can provide a highly lucrative professional opportunity. Building a track record as an executive that knows how to win for a PE fund can generate serial opportunities to do so, building wealth with each successful transaction, beyond what can be expected working in middle management at a Fortune 500 company.

The private equity world is relatively small and difficult to break into. You have an opportunity to make a reputation. After a successful sale of the company, if the same PE firm doesn't ask you to run yet another company, it's likely that another PE firm will look upon you favorably. You now have a track record in this small world, where word gets around.

It's possible to make a career as a serial CEO, for example, invigorating one PE-owned company after another, with a significant financial event every few years—payouts that will tend to become more lucrative over time and dwarf the salary plus bonus you'd have earned as an executive in a highly respected company in which you have no equity stake or upside from a liquidity event.

Admittedly, this is an intense, fast-paced existence. But the opportunities—and the satisfaction at extending yourself—are very real. A few years of pushing yourself hard could transform the rest of your life.

THE PRIVATE EQUITY WORLD IS RELATIVELY SMALL AND DIFFICULT TO BREAK INTO. YOU HAVE AN OPPORTUNITY TO MAKE A REPUTATION.

CONCLUSION «

Private equity is an asset class that is not well understood by the vast majority of entrepreneurs, management teams and corporate executives. But it offers the best opportunity to exit a successful business that has been created by an entrepreneur or management team. It also offers a unique chance for salaried executives to finally take an entrepreneurial plunge while working at a stable business.

There are many important considerations for both owners and executives when evaluating the opportunity to partner with a PE fund.

Obviously, if you're an owner, the valuation needs to make sense. But that's only the tip of the iceberg. If you intend to continue to work with the firm post-acquisition, you'll need to buy into the PE fund's approach and culture if you're to maximize your financial outcome through successive transactions with the business. The same goes for executives being recruited to work with a PE-backed portfolio company—you should take on the challenge only if you believe in the strategy of this ownership group and their ability to help drive it to a successful conclusion.

But making your relationship with a PE firm work is like making a marriage work: It's about picking the right partner, being clear about your needs, being open to compromise, delivering on expectations and keeping the channels of communication open.

In the end, only you can decide which firm is the best fit for you. But if you're open to professional and personal growth, to stretching yourself and building your skills, consider a firm that will supply mentorship and help you reach the next level as a leader. That achievement is what can set you on a path towards success measured in financial terms, but also the gratification of knowing you've become all you can and are in a position to help others do the same.

›› NOTES

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ABOUT BERINGER CAPITAL

Beringer Capital is a private equity fund specializing in the marketing services, technology and media sectors. Since 2002, Beringer has operated four successive funds and is led by a team of operators, strategists and finance practitioners. Beringer is an investor in Adweek/Brandweek.