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Private Equity and Family Businesses



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Making the Partnership Work

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For further information on the INSEAD Global Private Equity Initiative, please visit www.insead.edu/gpei

1- The need for capital

When John, the 55-year-old owner of a fast growing medical devices company, was looking to finance his expansion, the banks balked at his company's risk profile and lack of collateral. Despite a unique portfolio of products, he lacked the experience and resources that were necessary to compete with the multinationals or the network to expand overseas. He also thought it might be time to search for a successor. So when a friend introduced him to a Growth Equity firm specializing in minority investments for fast-growing enterprises, he thought it an avenue worth exploring. A subset of the private equity (PE) industry, these firms are known to provide more than just capital.

2- What a Growth Equity partner offers

Most family businesses like John's are managed by the founder or family members through a fairly informal structure, which makes it hard to attract quality external professionals. Whilst such a lean set-up is advantageous in the early stages of a company's development, many family businesses reach a point where they require different skills and resources to fully capitalise on growth opportunities.

The right Growth Equity partner can very well add substantial value beyond the provision of capital for the considered expansion:

- **Support for Growth and Expansion**

The experience of the PE partner can provide the owners with the confidence to structure deals outside their comfort zone.

- **Transformation of structures & processes**

PE partners often act as an external catalyst to develop a strong corporate governance structure and formalize the management of human capital, financials and internal processes.

- **Succession Planning**

By backing first- and second-generation owners of family businesses in their search for a successor, the Growth Equity firm can help identify the best possible candidate by establishing a strong corporate governance framework and mentoring internal (often family) candidates or by tapping its wide network for external candidates. On a practical level, succession planning raises questions around financial, tax, legal, and equity issues, which an experienced partner can help to resolve.

- **Performance improvement**

Given their fiduciary duty towards their investors, PE firms focus single-mindedly on performance improvement and profit maximisation of their investments by leveraging their know-how and relationships. Aside from top line expansion, be it through new product development, a new sales framework or entry into new markets, cost measures can be equally important to improve the long-term viability of the business.

- **Balance Sheet Optimisation**

On the debt side, improving the structure of the balance sheet through the restructuring of credit lines can not only optimize the cash flow of the firm but also enhance the credit standing of the company and provide ample headroom for future business expansion. In terms of equity, the investor's capital can be used to consolidate family ownership in the hands of members active in the business and provide an exit for passive family members to pursue other interests or diversify their assets.

"What we've seen time and again in these businesses ... if that's 100 percent of my family's net worth, the natural instinct is to get cautious with that business ... So our job is to provide the capital ... to get to that next stage of growth."

*- Walter Florence, MD
at Frontenac*

3- The challenges of working with PE

With those benefits in mind, let's consider the potential pitfalls before entering such a partnership.

For one, PE *is an expensive source of capital*. PE firms' high return expectations derive from information asymmetry (the PE firm has only a fraction of the information the owner possesses) and the specific risk of entering a business at the transformational stage. Yet returns also need to cater for the management and performance fees PE firms charge to their investors. The PE industry has further developed a whole universe of fees (although mostly in buy-out transaction) which they attempt to extract from their investees (e.g. transaction, monitoring or exit fees). These are often introduced late in the process.

"The plan was to expand rapidly with private equity.... But after raising the money there were so many changes that my company was no longer the way I wanted it and many of my old employees, the ones who help me build it, left."
- Family business owner

At times, the hands-on engagement of PE firms can be perceived by the family owner as if he is gradually *losing control* over his company. While PE firms need to have some influence in order to deliver the expected results, an owner should look for a partner with a proven ability to add value without micromanaging day-to-day business decisions. A clear partnership agreement can also help to allay fears and preemptively abort misunderstandings.

Yet, written agreements cannot fully anticipate and resolve the frequently arising *culture clash* between a family business and new partners. Family members strongly vested in the culture, and/or "character" of the business might resist required changes, preventing the very transformations they are trying to achieve.

Family business owners should also be aware of the *difference in transaction experience* between their management and the PE partner. The latter are repeat sophisticated players at the transaction game, so family business owners, who are usually not transaction experts, are strongly recommended to look for an independent experienced advisor to guide them, lest they trade away a substantial portion of their potential returns.

Finally, *exit plans may differ* greatly between family owners and their PE partners. PE firms' holding periods (4-7years) are generally much shorter than the often inter-generational timeline family business owners operate on. This might create conflicts at the time of exit when the PE firm will naturally prioritise the most attractive exit route (e.g. strategic trade buyer), possibly against the owner's wishes. The parties therefore need a clear understanding about the exit from the outset, considering both the wishes of the owner and providing a fair exit for the PE partner.

4- Conclusion: An Uneasy Marriage or a Perfect Union?

The search for the right partner is therefore crucial and is often compared to a dating or courtship ritual, where the "marriage" should only be finalized if each party is able to respect the other's values and priorities.

In John's case, after carefully looking at several Growth Equity firms, he finally settled on one with the right industry experience, rooted in trust that was built during the negotiation process. This necessary trust helped him overcome several hiccups throughout the investment period, such as when the CEO brought in by the Growth Equity partner did not work out. Ultimately the business was sold for an attractive return to a strategic buyer. With cash in hand, and realizing he was not, after all, ready to retire, John spun-out a unit from his former business that had an exciting beta product, and began a new journey.

Due diligence on PE partner:

- *Talk to other portfolio companies of the firm*
- *Find out more about a PE firm's investment style from advisors and former portfolio managers*
- *Look at other PE investments in your industry and where the value add came from*



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