Accountants the key to a successful private equity relationship

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Businesses are looking to private equity to fill the debt gaps banks have created as their lending policies have tightened. But any business considering this option must fully understand the consequences of jumping into bed with private investors. And, although the revival of the equities market makes an IPO exit for businesses coming out of private equity ownership viable once more, the poor macro economic conditions following the financial crisis means there's a backlog of investments waiting to be listed.

In the Black spoke to investors, advisers and owners about what it's really like to enter into a private equity marriage. Although the end of the era of cheap debt has metamorphosised the private equity model, it's still a viable conduit to an IPO, trade sale or, intriguingly, to a series of relationships with private investors.

What private equity wants

Greg Robertson, a director of private equity firm Investec, says when selecting investments "private equity funds look for businesses that are well organised and have clear objectives for why they are looking for equity. It may be that the founder wants to retire and sell their stake in the business or it could be that the business has lots of growth opportunities and is looking for a partner to fund or corporatise the business."

Laura Raymer from CFO Strategic, who has advised 50 clients that have attracted private equity, as well as worked as a CFO with two private equity firms, says there's lots of work to do before a business can even think about working with private equity.

"You need to prepare a detailed business plan including audited accounts, cash flow forecasts, detailed information about the organisation's structure and management team, products the business sells and markets it operates in. You also have to show a track record of meeting budgets and sales and profit targets. The easier it is for the investor to understand the business the better it is for the owner because they use this information to work out how much they are prepared to pay," says Raymer.

Although preparing business information to share with potential investors sounds straightforward, it can often be confronting for a private business to lay its cards on the table. David Hooton, managing director of telco Platform Networks, which is looking to attract an initial private equity injection of $5 million, says "it's easy to get your back up when someone wants to probe your baby. But it becomes easier once you understand the better investors can understand your business the easier it is for them to work with you. I've had to be candid about why we've funded the business's growth out of debt rather than profit and have learnt how important it is to be clear about the way the business grows and functions."

It's also essential to be upfront about how much money the business needs and whether future capital injections will be required. Macquarie University lecturer Philip Wing, whose area of research is private equity and who has worked in private equity firms and in businesses that have had private equity ownership, says anyone looking for private equity has to consider whether "private equity will support further capital raisings. Don't underestimate how much capital you will require when talking to investors – it's important to ask for as much as you need. Think about your capital requirements up until exit, not just for the first engagement."

Given this, the accountant should be central to the process of readying the business to work with private investors. Raymer says "private equity firms won't write a cheque for their cold, hard readies without a good finance person in the business." She says it's critical to remember that "private equity invests in businesses not products and it's up to the accountant to package the right information to demonstrate the business's value. The accountant has to be capable of understanding what the investor is there for. They must be part of the management team and not the back office, old-style bean counter. The accountant should be able to align the objectives of the management team with the investors' objectives, which is why the rewards are high for management teams that can help create value in a private equity arrangement."

Anthony Harris, who is currently working as a consultant CFO to Platform Networks as it reviews its private equity and other capital-raising options, says for a business to be investment-ready "especially now you have to have a proven business model. It's not always necessary for the business to be profitable, especially with start-ups and early expansion businesses, but investors want to know the capital and management expertise will contribute to a dynamically growing business."

Key to forging a successful deal, says Greg Robertson, is the ability of the private equity firm to get its head around the business's reliance on the existing owners and succession planning. "Anyone coming into the business will mark it down if it's only the founder that knows anything about it."

Indeed, ideally succession planning will have been dealt with before going to talk to private equity firms. "If relationships with clients are tied to key people, if you want to maximise the value of these relationships they should be transferred," says Jeffrey Luckins, a director of William Buck Audit.

Talent in the choice

Once the business is in a position to start talking to private equity firms it's important to select the right type of firm. "Each firm has a different area of interest and it's about finding the right fit. Some firms will only invest in large businesses and will have a short investment horizon, say two or three years.

Others are prepared to take on more risk and have a longer-term view," says Luckins.

If you're an accountant working with a firm that is looking to attract private equity Ian Knight, KPMG's head of private equity says it's your role to "understand the different funds, their portfolio of investments and how far into the lifecycle they have travelled – do your research before talking to a fund because the fund could be out of dollars."

"It's up to the accountant or CFO to understand what the investors want. They are looking for an above average return on capital and before they will make an investment it must meet certain criteria – some are looking for a 15 per cent return and others look for more than a 30 per cent return. Some are happy to take a risk with an investment if the business is looking at a huge growth trajectory, others might make an acquisition to bolt on to another business. Some might look for turnover of $10 million or more than $100 million, others want EBITDA in excess of 15 per cent, or a business that generates free cash flow above a certain level – each one has slightly different reasons for investing," Raymer says.

As to whether private investors prefer to have majority or minority control, again Raymer says it depends on the individual fund. "Some want more than 50 per cent to be able to get things done in the business. Others are happy for management to maintain a reasonable share of equity so they have some skin in the game."

David Hooton is open-minded as to how much of his business he's prepared to sell. "It depends what the investor brings to the business – if they add to the management team as well as contribute funds I'd consider selling a greater share; I'm still trying to work out what I feel comfortable with."

According to Greg Robertson, before doing a deal it's essential there's a shared understanding of the business's future direction and what needs to be done to take the business forward. "You need to have an agreement about the plan for the business three to five years out – and there must be the right chemistry between the investors and the managers."

Done deal

Once shareholder agreements have been executed between the business and its new investors the business will almost certainly go through a rapid period of extensive change so the equity investors can generate good returns. High on the to-do list will be ensuring the business has the right people in place to take it forward.

Jeffrey Luckins says the investor will "conduct reviews to look for opportunities to change systems and extract efficiencies. Often, there's also a change in culture that people don't like." He says often the complete exit of the previous owners suits the private equity firm because they can take real control of the business and bring in new people to fit in with the new firm culture.

This has been the experience of David Egan, general manager of one of Investec's current investments, mining services business Atom Supply. Investec appointed Egan to increase the sophistication of the company's financial reporting framework. Since being appointed five years ago he has reorganised the business's creditor policy and introduced accrual accounting.

"It used to be a week-to-week business. It had a tendency to pay invoices quickly so we've pushed out credit terms, which gave us immediate funds. When I started we had 33 employees and the books were done once a year. Now, we've got a full-time financial controller and 150 staff," says Egan.

As the business is now carrying debt Egan also manages relationships with banks, ensures the firm adheres to covenants, has appointed Deloitte as the external auditor and has developed controls for the business.

"When you're accountable to outside investors you have to show you have reasonable controls in place – for example that the person responsible for purchasing isn't also responsible for writing off stock," he says.

The investors will want to keep a close eye on the financial performance of the business, but they don't want to be involved in the day-to-day running of it. Anthony Harris says "investors don't want an executive management role, but they will appoint someone to the board with the appropriate financial experience to monitor performance on a month-to-month basis."

Sell out

The key reason investors don't want to be involved in daily operational issues is so they can spent their time assessing exit strategies for their investments. When it comes to the right exit strategy, Jeffrey Luckins says "keep an open mind to what's possible because if you're only focused on one track you might loose opportunities."

"It's important to understand what's driving any exit transaction," says Greg Robertson. "Is it because the firm wants to close the fund? Or is it because there's an opportunity for the business to grow but there's no capital available? You have to understand the objectives of all parties."

Robertson uses Investec's investment in shipping business Avcal, which was a family-owned business for 50 years until Investec bought in in 2007, as an example. "We invested and restructured the business and two years into, in the middle of the financial crisis, we got an offer from a trade buyer that was too good to refuse. We'd already improved profitability, reorganised the fleet and refinanced the company and we didn't really contemplate any other exit because that party was the natural owner and that was the right exit strategy for that business."

“To do an IPO you need the right equity market and a mature business. If earnings are less than $30 million a year being listed will only add to the costs of the business because it’s not going to get analyst coverage. IPOs are only attractive if the business has a specific growth story; exit IPOs for smaller firms are not achievable unless the market is in a feeding frenzy. But if the business has size and is a dominant player in a differentiated niche market you could look at an IPO exit – although a trade buyer or sale to another fund is more likely,” he says.

For anyone thinking of talking to private equity firms Ian Knight has this advice. “It’s an idea to speak directly to a fund’s existing investments. It’s a red flag if the fund won’t let you speak to previous owners or CEOs. You need to find out what the working relationship is like after the investment has been made because it’s never all roses and you shouldn’t expect it to be. Get an understanding about how the investors react to good and bad performance and whether the fund has lived up to its promises.”

BREAKOUT BOX

Paul Toussaint-Jackson is the previous CEO of Perkins Shipping, a former Investec investment that was sold to toll road operators Toll Holdings in 2009. He tells the story of the business’s fruitful relationship with private equity.

Like many other private companies we had reached a point at which it was right to look at additional investors. When we started talking to Investec they were very focused on understanding the business and its bottom line. A marine freight and logistics business is a complex operation, servicing overseas and domestic markets, with lots of different parts to the business and I was impressed by how quickly they were able to get across it.

They brought in a high level of analysis, which enabled us to take a step back. We were also faced with structural change in one area we hadn’t addressed. Their analysis helped us to effectively restructure this division. They also invested in IT, when we would have made do with what we had.

Corporatising the business also helped us to acknowledge individuals that deserved recognition. They also helped to remove the social elements of decision-making and challenge ‘we’ve always done it that way’ thinking. But what they did was very well considered – it wasn’t about making short-term gains that might have allowed competitors to gain competitive advantage.

It was a positive that Investec had a majority stake. It allowed them to do things like establish an audit committee. They also broke deadlocks, for example they supported capitalisation of the purchase of vessels in our international business. Previously we’d just chartered vessels, which wasn’t very efficient because charter rates were squeezing margins. This decision allowed us to weather the financial crisis.

Investec was also able to market the business and package it up to make it attractive to potential investors. They also brought prestige – the fact Investec were prepared to invest was a sign of confidence in the business.