

How Private Equity Really Works (Part 2 of 2)

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Private equity firms make money in two ways: first, by managing capital (management fees), and second, by increasing the value of the capital they invest (carried interest). Management fees support overhead costs such as travel, infrastructure, office space, salaries, service providers (lawyers, accountants, and bankers) and other costs that arise in between transactions. Management fees are also charged back to a company after a transaction is completed. Management fees range between 1 percent and 3 percent (similar to mutual fund fees or fees for private client services), and the market has tended to settle around 2 percent.

Carried interest is based on the amount of capital returned to investors after an investment period. Carried interest ranges between 10 percent and 30 percent, although it can vary widely depending on the specific terms of the capital invested. The private equity market has tended to settle around 20 percent. Private equity groups frequently bandy about these two figures—2 and 20. Highly successful firms can charge higher fees; few firms charge less.

Private equity firms pay careful attention to the price they pay for a deal. Most businesses perform consistently with however they have performed historically, although there are certainly opportunities to improve performance. However, businesses that have had a 3 percent growth rate over the past five years will most likely have a 3 percent growth rate in the next five years. Unless something changes, businesses that have lost \$500,000 per year for the past 10 years will most likely lose \$500,000 per year in the future.

The “Sample Private Equity Returns” chart provides some basic scenarios of multiples paid for businesses along with the amount of leverage required for the transaction to produce an established internal rate of return (return on investment) for the transaction. The numbers use the following assumptions:

- **Purchase multiples and exit multiples are the same**—the model assumes the same exit multiple as the original purchase multiple (e.g., if a company was acquired at 3X, the model assumes it sells at 3X; if purchased at 7X, the model assumes 7X). This is a conservative assumption for low purchase price transactions (below 5X) and an aggressive assumption for high purchase price transactions (above 5X).

Sample Private Equity Returns

EBITDA Growth Rate **-10%**

Equity Contribution	EBITDA Multiple				
	3X	4X	5X	6X	7X
20%	19%	9%	1%	-7%	-15%
40%	11%	5%	0%	-3%	-6%
60%	8%	3%	0%	-2%	-4%
80%	6%	2%	0%	-2%	-3%
100%	5%	2%	-1%	-1%	-3%

EBITDA Growth Rate **0%**

Equity Contribution	EBITDA Multiple				
	3X	4X	5X	6X	7X
20%	41%	35%	31%	27%	25%
40%	27%	22%	19%	17%	15%
60%	20%	17%	14%	12%	11%
80%	17%	13%	11%	10%	8%
100%	14%	11%	9%	8%	7%

EBITDA Growth Rate **10%**

Equity Contribution	EBITDA Multiple				
	3X	4X	5X	6X	7X
20%	59%	54%	51%	48%	46%
40%	41%	37%	34%	33%	31%
60%	32%	29%	27%	25%	24%
80%	27%	24%	22%	20%	19%
100%	23%	20%	19%	17%	16%

■ Unacceptable base case returns for a PEG. ■ Questionable base case returns for a PEG. ■ Acceptable base case returns for a PEG.

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- **Depreciation and Amortization is High**—the model assumes that goodwill accounts for 80 percent of the purchase price, which is a relatively aggressive assumption for low purchase price transactions, but a reasonable assumption in the compatible imaging supplies industry for higher-priced transactions. The depreciation and amortization affects the available cash flow before and after taxes.
- **Taxes**—the model assumes taxes to be 45 percent, which may be high for much of the country but it is consistent with California and New York tax rates.
- **Excess Cash Flow**—the model assumes that excess cash flow is added back to the returns and, more importantly, that negative cash flow simply reduces the equity position. In fact, negative cash flow (which results when the company cannot afford to pay its debt) would most likely cause the company to be sold in a distressed situation or require equity investors to contribute more capital to the transaction. It is relatively rare that a bank would allow its debt to go unpaid for a period of several years. Most of the scenarios with negative or flat growth with any type of leverage result in negative cash flow scenarios.

So, given the above assumptions, while the actual figures may not represent the exact accurate returns for the equity, they do provide directional guidance as to the rationale behind purchase price for transactions. Three tables appear, all with different growth rates assumed for the business.

The first table assumes that the earnings of the business decline by 10 percent every year, not an uncommon scenario for certain businesses. The second table assumes a growth rate of 0 percent. And the third table assumes a growth rate of 10 percent. Each table then displays different purchase price multiples across the x-axis and equity contribution percentages across the y-axis. Generally, most acquirers assume the business will grow (the 10 percent table); the business is purchased for between 4X and 6X; and the equity contributed is between 30 percent and 50 percent. The resulting returns range between 33 percent and 54 percent.

As can be observed from the tables, the lower the acquisition multiple, the higher the return. Additionally, the lower the equity contribution (20 percent versus 80 percent), the higher the return. Low purchase prices and low equity contributions result in higher returns for the business. High purchase prices and high equity contributions result in lower returns. Many sellers struggle to believe that a private equity firm should be able to receive 30 percent-plus returns on their business, and it is often this tension that results in

The Top 10 Misperceptions of Sellers

"Sellers always value the future, and buyers always value the past."

1. **Buyers should pay for value that they will be creating**—Some strategic or financial buyers are able to increase the value of an acquisition through new sourcing arrangements, integration activities, revenue enhancements (more effective marketing), new management or other means. Sellers often assume that a buyer has an obligation to pay for the opportunity to create that value. Buyers believe this is the value they bring to the transaction, and that they should not be forced to pay a seller for what they bring to the equation. Ultimately, if the gap is too large, a deal will not be made. To expedite the process, sellers can offer to share the rewards (and the risk) if the value is created.
2. **Strategic buyers will find my business more valuable than a private equity buyer**—Strategic buyers often are classified as everyone that is not a private equity firm or a financial buyer. They ask the

same question that financial buyers ask—how much value will this acquisition bring to my organization and me? Just like financial buyers, strategic buyers have financial targets that they are required to hit and may have multiple options when pursuing acquisition targets. Strategic buyers pay more only when the acquisition target offers something unique that is of particular benefit to the buyer—something that they otherwise could not procure. More importantly, strategic buyers will only pay more when they are required to pay more because the company is in demand.

3. **My business is a reflection of me**—Business owners, particularly of small enterprises, often correlate their own personal worth with the worth of the business. A business, particularly when it's your own, is personal. A successful transaction will require separating your own feelings of self-worth from the value of a business. Wonderful people have owned low value businesses, and terrible people have owned high value businesses—there is little to no correlation with the moral character of a shareholder and the ultimate equity value of the business. Confounding these two concepts can make for a very long (and traumatic) transaction process.

4. **My business is worth more than the average business/I deserve a higher multiple on my earnings**—Entrepreneurs and founders often point to another transaction they recently learned about and say, "If Mr. Smith got five times for his business, I should get 10 times because I am twice the man he is." Alternatively, if the market average multiple is four times, the business owner may think that he should receive six times for some select set of reasons. Businesses in highly fragmented industries with limited differentiation between models are, alas, commodity business models with no generated premium value. Businesses with no or limited historic earnings (even large businesses) will struggle to be of high value, unless the business model has some highly unique features.
5. **My business will perform differently after the transaction than it did before the transaction**—Sellers that target rosy (or hockey stick) projections risk jeopardizing their credibility with buyers. If a business has grown at an average of 10 percent a year for five years in an industry that is growing 8 percent a year, the business will probably

the lack of a sale. However, sellers must keep in mind the following concepts when evaluating the internal rate of return for private equity groups:

- **Risk-adjusted returns**—Leveraged buyouts (like venture capital) are generally risky ventures, particularly if management transitions out of the business, the industry has challenges or lower growth rates, or the business does not have a strong history of success. As a result, very few private equity firms actually consistently receive returns above 30 percent. The industry, as a whole, has averaged 13 percent—15 percent returns for the past 20 years and closer to 10 percent returns for the past 10 years. Furthermore, the numbers presented are the benchmarks for private equity firms in the lower middle market, where acquisitions of businesses with less than \$100 million are substantially more risky; larger transactions can command higher purchase multiples and, due to the lower risk, have lower returns.
- **Location within the capital structure**—Senior banks that provide financing for LBOs will receive between 8 percent and 12 percent returns on the capital contributed. Mezzanine funds or second-lien lenders receive between 20 percent and 25 percent returns on their capital contributed. So, equity funds, which are the riskiest part of the capital structure, will, obviously, be higher than mezzanine capital.



- **Ability to do it themselves**—Shareholders are able to maximize their own returns by leveraging the businesses themselves; shareholders who choose to take out debt on the business and then pay the debt back can achieve the same returns on their equity that private equity firms receive (provided the business grows and can pay back its debt).

not grow at 25 percent a year for the next three years. Similarly, if a business has had an EBITDA percentage of 3 percent for the past seven years, the business will probably not increase to 15 percent without some substantial changes. Moreover, if a business is going to go through a significant change in revenues or profits within a year, sellers will achieve their maximum return if they sell after they have implemented the change rather than before. So, selling early suggests that the likelihood of achieving the results is low and that the seller does not necessarily believe in the targeted performance results.

6. **Buyers are not held accountable for achieving specific returns**—Sellers frequently assume that buyers, given that they have a lot of capital, can spend the capital freely without consideration as to the amount of capital allocated toward any one acquisition. While private equity firms that have completed many acquisitions typically have a few bad deals (deals that do not perform consistently with expectations), those that repeatedly overpay will jeopardize both their ability to raise future funds and their existing relationship with their limited partners. As such, private equity firms as well as strategic buy-

ers have relatively strict rules governing the amount of capital they can use to purchase a business.

7. **Sellers should not bear any risk after the transaction**—Sellers who propose aggressive results post transaction (results that are substantially different than the results prior to the transaction) and yet refuse to bear the risk of those results through the form of equity, an earn-out, or a note will struggle to convince buyers to pay a high multiple on the business. In fact, unless sellers assist in financing the transaction for companies less than \$50 million value, it will be challenging to get multiples more than four times.
8. **Employees, customers and vendors will flee after a transaction is made public**—Deals happen all the time in the U.S. In most instances, businesses will not see a significant change in the customer and vendor base.
9. **The business is perfect. Flaws should not have a price**—Sellers, consistent with some of the concepts above, often believe their business has many more strengths than it has weaknesses. Additionally,

sellers may espouse that whatever weaknesses a business may have should not be translated into a reduction in value (e.g., customer concentration, poor management, limited financial and informational systems, litigation, etc.) Acknowledging the limitations of a business is the first step in moving forward with a transaction. Indeed, sellers who believe their businesses are too perfect are probably not really sellers.

10. **Buyers are untrustworthy**—Buyers, in particular, private equity groups (PEGs), make their living by acquiring companies. PEGs that have completed multiple past transactions have a record of getting along with other individuals. PEGs that have been successful in past transactions clearly have created trust with prior sellers, management teams, banks, customers, limited partners, and a host of other stakeholders. PEGs, like any business, have reputations to maintain in order to complete future transactions. ❏

- **Becoming a limited partner of a private equity fund**—One of the best ways for entrepreneurs to become a limited partner of a private equity fund is to sell the business and reinvest a portion of the funds received back into the private equity fund. Then the entrepreneur can achieve the same returns the private equity firm receives.

The Arguments Against Private Equity

Given its success over the past decade, private equity as an industry has drawn criticism (much of it aimed at its executives). Private equity clearly is experiencing a boom, and, whenever there is success, there will always be critics. Some of the most popular arguments against private equity are:

- PEGs flip companies for a fast buck.
- PEGs load up companies with dangerous amounts of debt and strip them of their assets.
- PEGs do not care about customers, employees or suppliers.
- PEG partners take home excessive salaries.

Critics must keep in mind that a good portion of the recent rise of private equity, particularly in the mega-deals, can be attributed to fundamental changes within the public markets. Sarbanes-Oxley and other regulations of public entities have driven managers to question the value of being public in today's capital markets. With-

out these increased regulations, which were a response to the boom in the public markets and the dramatic increase in the stock markets, the private markets might look much less attractive.

Additionally, managers appreciate the concept of five-year targets instead of quarterly targets. Furthermore, managers like to answer to a single board as opposed to thousands or millions of shareholders. And, while private equity firms use their own fair share of law firms and experience legal challenges, typically, senior executives are not subject to frivolous lawsuits from legal firms formed exclusively to agitate and sue public companies. Finally, for the largest companies, private equity firms may value the companies more than existing shareholders. Typically, private equity firms buy out the existing shareholders at a premium.

Private equity also owes a portion of its recent rise to the low-interest rate environment. As interest rates increase (as they surely will), purchase multiples will come down (because buyouts cannot afford as much debt). And, private equity owes a portion of its success to the low capital gains tax rate, which makes it attractive for business owners to sell. For the past 65 years, the capital gains tax rates have moved between 20 percent and 35 percent. Today's rate of 15 percent is the lowest in two generations. A change in the administration or legislation could easily return the capital gains tax rate to its historic levels, if not higher. The Maximum Individual Capital Gains Tax Rate chart shows the capital gains tax rate for the past 65 years.

The Top 10 Misperceptions of Buyers

"All deals are guilty until proven innocent."

1. Buyers are smarter than sellers—Buyers, particularly those in private equity groups (PEGs), are often armed with stellar pedigrees including Ivy League MBAs, stints at top-tier consulting shops, investment banks or law firms and impressive backgrounds in accounting, finance and business development. With such backgrounds, buyers are prepared to believe (and sellers often concede) that they are smarter than sellers. However, many buyers have rarely, if ever, actually managed a business or been responsible for a profit and loss. Furthermore, most buyers are looking at an industry on a part-time basis with substantially less historical experience than a seller. Sellers know a tremendous amount about their business and will often have many years of more management expertise than buyers.

2. Sellers do not care about the legacy of their business—Sellers, particularly the founders, managers and owners of a business, will care deeply about the future of their business. A buyer who appears to not wish the company well or will potentially harm the employees or customers of a business after the transaction will be perceived much less favorably than buyers who will treat the employees and customers well. Most sellers care intimately about what happens to the business after they depart.

3. Sellers care more about the legacy of their business than anything else—Although sellers care about the future of the business, they do not care so much that they will dramatically reduce the price for a "nice" or "well-intentioned" buyer. First-time buyers (usually individuals) mistakenly believe that a seller who likes a buyer will accept a discounted price. There are few sellers that would not accept a high multiple for the business (greater than five times) even if that purchase price meant the business

would face financial hardships, even bankruptcy, in the future.

4. The business can easily operate without the key managers—Small businesses, and even large businesses without strong operating systems, are highly dependent upon the key managers within the organization. The desire of a seller who also serves as a manager or the president/CEO represents an enormous risk for the business going forward.

5. Good management is easy to find—While there are tens of thousands of managers in the U.S., managers with experience within a given industry, who've worked in a business of the same size and in the same geographic area, and who would be a good cultural fit, among other criteria, are challenging to find. Finding the right talent can take three to 12 months—the wrong decision can take 18 to 36 months to correct. Indeed, the wrong manager in a transaction can ruin the entire investment.

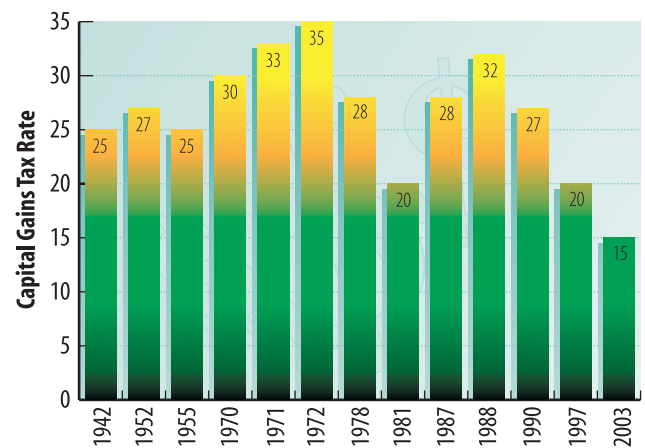
In response to the criticism from the business press and the general public, some of the claims (strip companies of assets, load up companies with too much debt, do not care about other stakeholders) are simply a reaction to the primary mission of private equity firms, which is to return capital to their investors. Private equity firms focus on maximizing value of businesses primarily through operating performance as well as through financial engineering, the discipline of debt, fewer shareholders, and strong incentives to management teams. While it is true that select PEGs have overemphasized value creation relative to other components of a company, organizations that do not emphasize value enough risk providing poorer than necessary returns to their shareholders. Clearly, businesses need to be evaluated comprehensively and, one hopes, that what is in the best long-term interest for the shareholders is the same as for the employees, vendors and customers.

Also, don't forget that PEGs typically only enter into mutually agreeable buyouts. Most PEGs do not conduct hostile takeovers or "greenmail" like corporate raiders of the past. PEGs offer an alternative to an existing capital structure with an emphasis on value creation and, most often, a track record of having created value for past investors.

Why Private Equity Works

Private equity, in its simplest form, is simply the allocation of a new capital structure to existing entities with a primary focus on value creation. Private equity returns, when adjusted for the risk associated with the transaction, are not inconsistent with general market returns for investments not easily converted into cash.

Maximum Individual Capital Gains Tax Rate



Source: American Council for Capital Formation, 1998; Deloitte & Touche, 2003

Private equity is working today because it affords managers and executives an opportunity to focus on value creation with the support of a talented and experienced board, without the distractions of a public company or the often insular focus of a private company. Private equity also disciplines an organization through debt, which forces earnings, strong incentives and monthly results reporting. Operating in a leveraged buyout environment is not for everyone, but for those focused on maximizing the value of their organization, it sure seems to work well. 🌟

6. The industry/business model is simple—Every industry has its particular features and every business will have its own peculiarities. Buyers (see #1 above) often believe that they can fully understand the industry and the business after a limited due diligence period.

7. There is limited cultural change that occurs after an acquisition—Businesses that undergo an acquisition or an investment by a private equity firm will be held accountable for achieving targeted financial results. Businesses that have not established budgets, sales goals for account executives, productivity requirements for factory employees or other operating results requirements will be in for a substantial cultural change post acquisition. Typically, managers and employees that thrive in or prefer that type of environment will not appreciate or be effective in a performance-based environment. Buyers often overlook the toll this cultural change can take on a company.

8. Financial performance provides a complete picture of the business—Buyers are predisposed to spending a lot of time with the numbers of a business and less time evaluating the actual operating systems or meeting with employees. (Sellers can frequently prevent this from happening as well.) While the financials certainly provide a good overview of the cost structure of a business, they only present a partial view of the organization.

9. The business is unique—Buyers who fall in love with a particular business may find themselves willing to pay too much for a given company. Frequently, there are at least five or six companies with a similar business model in the industry. Larger industries that are fragmented have even more similar business models. So, patient buyers that identify an attractive industry will investigate multiple companies within an industry, locate the most well-run, highest-performing businesses, and invest in or acquire those that are at the top of the game. Far too often, buyers will identify the first company with a particular busi-

ness model and fall in love with that company. This is an advantage for sellers.

10. Sellers are untrustworthy—Buyers often struggle to interact effectively with sellers due to education and experience gaps. As a result, buyers can become distrustful of sellers. Buyers perception of sellers as untrustworthy can become even further exacerbated by slight variations that result from findings during due diligence. Most sellers have never examined their own business as rigorously as it is examined during due diligence. As a result, it is not surprising to find minor differences between what was presented early in the process and what is uncovered during due diligence. These gaps, if addressed properly by the seller, should not result in significant distrust by the buyers 🌟