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Private Enterprise

Behind the curtain:

What mid-sized private companies need to know about what drives Private-Equity investments

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Executive Summary

While CEOs and senior management of mid-sized private companies attracting Private-Equity investment have the potential to be richly rewarded for successful performance, their tenure can be brief unless they continue to grow the business and meet their targets. CEOs of mid-sized private companies considering this financing option need to pursue Private-Equity investment with a clear-eyed, honest appraisal of both the risks and rewards it entails.

These are among the key findings of a survey of 269 senior Private-Equity executives conducted by Deloitte and Touche USA LLP. The purpose of the survey was to provide a snapshot of current Private-Equity practices and their impact on the owners of mid-sized private companies contemplating Private-Equity investments.

Key Findings

- **High pricing puts a premium on growth prospects.** With the competition for investment in attractive mid-sized companies driving prices higher, a company's growth outlook was considered the most important factor in the investment decision, rated much higher than current profitability.

- **Quality of senior management team, not just the CEO, is critical.** The quality of the senior management team was one of the most important factors Private-Equity firms consider before making an investment in mid-sized private companies. In contrast, the ability of the individual CEO or President was one of the least important factors.

- **Substantial incentives offered for success.** Private-Equity executives said their firms set aside a significant portion of equity of a mid-sized company as an incentive for the management team to achieve business goals—with 47% of Private-Equity executives saying they set aside 5% to 10% of equity, 34% setting aside 10% to 15% of equity, and 12% setting aside 15% of equity or more. Only 7% of executives said that they provide less than 5% in equity or provide no equity incentives at all.

- **Hit targets or management changes will be made.** Senior management of mid-sized private companies seeking Private-Equity investment should realize that their tenure may be short if they fail to meet business objectives. Roughly one-third of Private-Equity executives said they had changed management at more than 40% of their mid-sized portfolio companies, usually due to targets not being met. Furthermore, when their investments in mid-sized companies have failed to meet the target internal rate of return, most Private-Equity executives have blamed the poor management performance.

- **Exit transactions can come quickly.** CEOs of mid-sized companies should not plan on an extended holding period. Private-Equity executives said the mid-sized companies in their portfolios were held on average for just four years, with one-third citing even shorter holding periods. When it comes to exit transactions, Private-Equity executives said that a sale to a strategic buyer was the most common type of transaction for the mid-sized companies in their portfolios. While sales of Private-Equity portfolio companies to strategic buyers will continue to be important, our experience in the marketplace indicates that sales to other Private-Equity firms will continue to increase.

Introduction

What do owners and executives at mid-sized private companies need to know to successfully attract Private-Equity investment in their business and share in the rewards of such a transaction in today's market?

To answer this question, Deloitte and Touche USA LLP conducted a survey of 269 senior executives of Private-Equity firms regarding the key factors they consider when investing in mid-sized private companies. The survey provides insight into the private-equity decision-making process and offers a snapshot of current practices and issues affecting Private-Equity investment in mid-sized private companies.

Private-Equity investment has become increasingly attractive to mid-sized companies—those with annual revenues less than $1 billion—both as a source of capital and for the strategic advice the fund managers provide to the companies they finance.

Industry experts estimate there are roughly 2,700 private-equity firms around the globe, and the pool of capital allocated to this asset class continues to grow. Fundraising in 2005 broke all previous records, with $170 billion raised by 400 Private-Equity groups alone, far higher than the $42 billion raised in 2004.[1] Private-Equity funds could raise up to $300 billion in 2006, if a healthy economy and low borrowing costs continue.[2] Despite the well-spring of both the number funds and their total assets, securing Private-Equity investment is challenging. Leaders of mid-sized private companies need to understand the key factors driving Private-Equity investment in their segment and what such investment can entail for their companies…

Our findings revealed several key areas that leaders of private mid-sized companies need to consider when seeking Private-Equity investment:

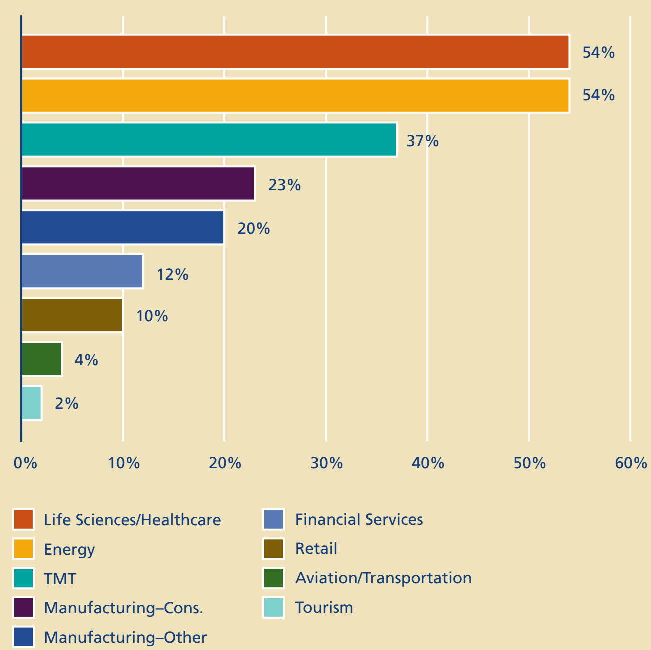
- What Private-Equity firms look for when considering and finalizing an investment;
- The role that the Private-Equity firm will play in the company after the investment;
- The targeted returns expected by Private-Equity investors and the implications on management;
- Exit scenarios: life after the investment.

Life Sciences/health care and Energy Industries Expected to Lead the Pack

In which industries are mid-sized private companies likely to see the most Private-Equity investment over the next 12 months?

Private-Equity executives surveyed put the life sciences/ health care and the energy industries at the top of the list, with 54% predicting that each of those industries would be either first or second in Private-Equity activity. (See Exhibit 1.) The technology/media/ telecommunications (TMT) industry came in third with 37% of executives rating it number one or number two as a target for Private-Equity investment in mid-sized private companies. A likely explanation for the high ranking of these industries is the emphasis placed by Private-Equity firms on a strong growth outlook when they are considering an investment.

Exhibit 1. Industries Expected to have Most Private Equity Investments over Next 12 Months
Percent of Executives Ranking Industry Number 1 or 2



What are Private-Equity Firms Looking for?

Strong growth prospects top the list. This should not be surprising, given the high prices that the most attractive deals command today.

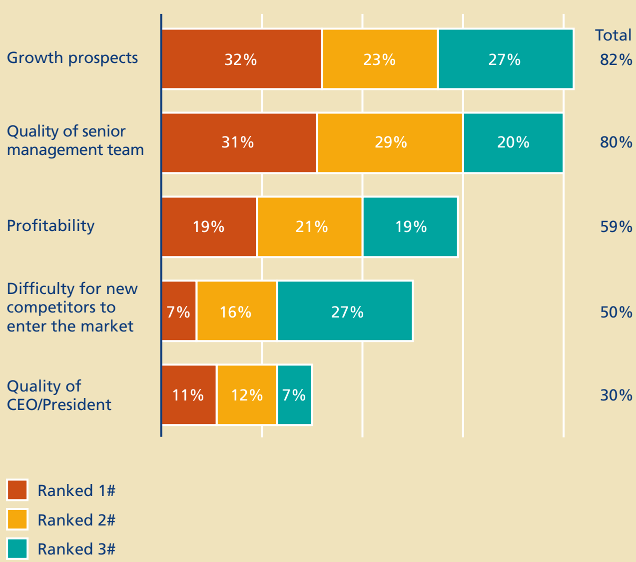
But the Private-Equity executives surveyed said they are also focusing intensely on the quality of the senior management team as a whole when they consider and finalize an investment. Perhaps the most surprising result was that the quality of the CEO/President was the *least* important factor. Private-Equity executives are looking for deep management talent, rather than simply betting on the vision of a single person. Other factors, such as profitability and barriers to entry are important, but clearly are secondary.

Strong Growth Outlook Key

When Private-Equity firms decide whether to explore an investment, strong growth prospects are the most important factors. Eighty-two percent of the Private-Equity executives surveyed said it was one of their top three factors, with 32% rating it the most important consideration. (See Exhibit 2.)

Compare this statistic with the much lower emphasis placed on profitability or competition when initially considering an investment. Only 19% of the Private-Equity executives surveyed cited profitability as the most important factor when considering an investment, while 7% rated the likelihood of new competitors as their top consideration.

Exhibit 2. Most Important Attributes When Considering an Investment in a Mid-Sized Private Company



Note: Total percentages may differ from ranking percentages due to rounding.

The emphasis on growth outlook is a reflection of the paradigm shift that has taken place in Private-Equity. In the past, Private-Equity firms investing in mid-sized companies were most interested in identifying businesses with strong, stable earnings that were under-leveraged. In recent years, however, intensified competition among Private-Equity firms for the best companies has driven prices higher. While in the past, Private-Equity firms would rarely pay more than seven times EBITDA to acquire a mid-sized private company, pricing now can be higher. Private-Equity firms must target mid-sized companies with the growth potential to support today's higher prices.

When it came to their decisions not to submit an indication of interest in a mid-sized private company, however, an overwhelming 90% percent of executives said it was almost always or frequently due to a poor outlook for growth and profitability. (See Exhibit 3.) In addition, roughly three-quarters of Private-Equity executives indicated said that a lack of growth and profitability were often the reason they did not complete a deal. (See Exhibit 4.)

Management Team Overall More Important than CEO

A skilled and deep senior management team emerged as a second critical factor in attracting Private-Equity investment—far more important than the quality of the individual CEO/President. More than 80% of the Private-Equity executives considered the quality of the senior management team among their top three factors when considering an investment, roughly equal to the importance attached to growth prospects.

The relatively low importance placed on the quality of the CEO/President, which was ranked last in importance, may be related to the emphasis on growth. Companies that rely on the ability, vision, or relationships of one individual often cannot achieve significant growth. Private-Equity firms want to invest in a *business*, not a solo act.

The quality of the mid-sized private company's senior management team remains an important factor throughout the deal-making process. More than half the executives surveyed stated that doubts about the quality of the senior management team almost always or frequently resulted in their decision not to submit an indication of interest or complete an investment.

Pricing and Ability to Achieve Business Plan, Lead List of Other Hurdles

Competition for good deals is ferocious, and is resulting in higher pricing. Seventy-three percent of executives said they will pass on an investment opportunity in the initial evaluation process early if they expected the company to command a high transaction value and in turn lower their chances of successfully achieving their targeted returns.

The achievability of the business plan also ranked high. Roughly two-thirds of survey respondents said concerns about whether the business plan was realistic had frequently led them not to submit an indication of interest for mid-sized private companies. A similar percentage said that this issue had often prevented them from closing a planned investment.

Reasons when not Submitting an Indication of Interest in a Mid-sized Private Company

Exhibit 3. Reasons when not Submitting an Indication of Interest in a Mid-Sized Private Company

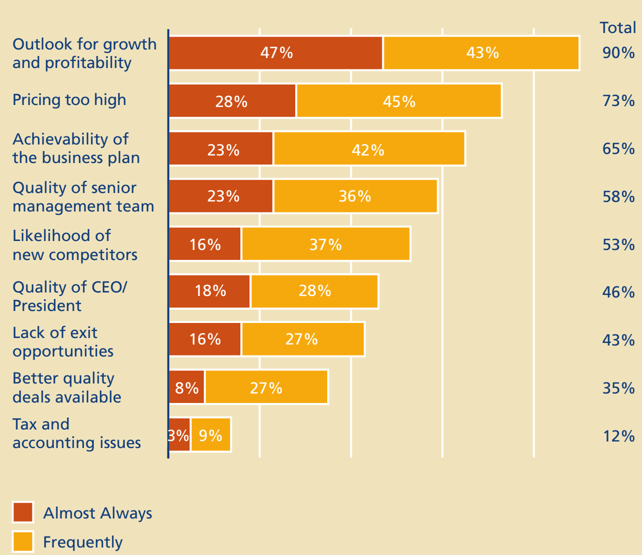
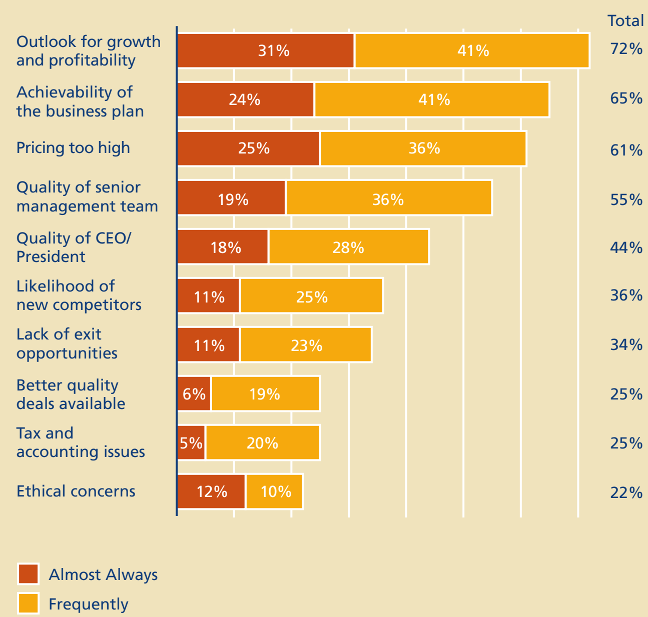


Exhibit 4. Reasons When not Completing an investment in a Mid-Sized Private Company



Transferring Control

What role should mid-sized private companies expect their Private-Equity partner to take in their business in addition to providing capital?

Companies often relinquish a controlling interest to a Private-Equity firm as part of the transaction. In return, the targeted company will be able to leverage the industry knowledge and strategic advice from their investor as well as strong governance from a board of directors that has a vested interest in the company's success.

Size of Equity Ownership Position Varies Widely

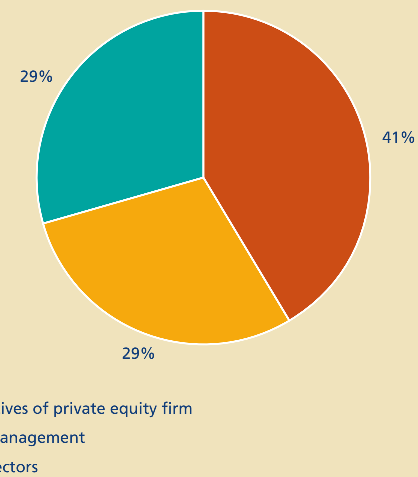
Although mid-sized private companies can expect to transfer a considerable degree of control to the Private-Equity firm as part of the deal, the percentage of ownership can vary widely. The Private-Equity executives surveyed reported typical equity ownership percentages in mid-sized companies ranging from less than 25% to greater than 75%.

Surprisingly, while slightly more than half the executives reported that they typically require a controlling interest of 50% or more, a full 47% of Private-Equity executives indicated that they usually acquire a minority interest in their mid-sized private company targets. In other words, there can be more flexibility in the structure of a Private-Equity investment than owners of mid-sized companies may realize; not every Private-Equity investment involves the purchase of more than half the equity.

Executives at Private-Equity firms with large funds said they were more likely to take a substantial ownership position than those associated with smaller funds. One-third of the executives at firms whose most recent fund was greater than $100 million said they typically took equity positions of 75% or more. In contrast, only 18% of executives from firms that had most recently raised smaller funds said they typically took equity positions that large.

Management of mid-sized private companies can also expect the Private-Equity investor to assume majority representation on the company's board of directors. On an average, Private-Equity executives reported that post-transaction, representatives of the investing firm held 41% of the board seats. The company's management and outside directors each typically accounted for 29% of board membership. (See Exhibit 5.)

Exhibit 5. Percentage of Members of Boards of Directors for Typical Mid-Sized Company in Portfolio
Average Percentage of Board Members



Meeting Expectations

Competing for investment in their funds with other asset classes, Private-Equity firms face continued pressure to outperform less risky alternatives on a risk-adjusted basis. As a result, Private-Equity firms set aggressive targets for their internal rates of return. They are willing to offer significant rewards to senior company executives when targets are met and to change management when targets are not met.

More than half of the Private-Equity executives surveyed said they targeted an internal rate of return in excess of 25% when investing in mid-sized private companies, with 28% of those firms looking for returns greater than 30%. (See Exhibit 6) Firms with smaller funds were more likely to set higher targets. Thirty-eight percent of surveyed executives from firms whose most recent fund was less than $100 million said they targeted returns of 30% or more, compared with 25% of surveyed executives from firms whose most recent fund was $100 million or more.

Operational Improvements Key to Increased Value

Private-Equity deals used to be primarily about financial engineering. But now Private-Equity firms have to earn their returns the old fashioned way—by improving the operations of the companies in which they invest.

Sixty-five percent of Private-Equity executives reported that when they invested in a mid-sized private company, most of the increased value typically came from operational improvements rather than financial engineering.

A variety of Private-Equity models are currently being pursued. While firms used to rely simply on financial engineering to generate value, now there needs to be more. Private-Equity firms typically add industry experts to the management team in a variety of roles. Private-Equity groups seek to add horsepower to the business they invest in, for example, by supplying consultants or a new CFO, CEO, and board members. In each situation, the Private-Equity group is seeking to add expertise to refine the company's strategy, pursue growth opportunities more effectively, or improve profitability by reducing costs and increasing efficiency.

High-Performing Managers Amply Rewarded

Private-Equity executives highlighted the importance of a high-quality management team during the investment deal process, and the internal rates of return they set help explain why. Most importantly, they are willing to provide healthy incentives to achieve their objectives.

Almost half of the executives (47%) reported that their firms set aside 5% to 10% of equity as incentive for the management team to achieve their business objectives, with another 34% setting aside 10% to 15% of the equity. A few executives (12%) said their firms set aside 15% or more. Only 7% of executives said that they provide less than 5% in equity or provide no equity incentives at all.

If the targeted returns are *not* met, however, Private-Equity executives often point to poor management performance as the cause. Fifty-nine percent of the Private-Equity executives surveyed said that over the past three years, when the targeted internal rate of return was not achieved, the reason was almost always or frequently due to poor management performance. However, more than half the executives also acknowledged that the overall industry environment was also a common reason for failing to achieve targets.

While Private-Equity investors often "nurture" companies to more healthy and productive market positions, management changes are not uncommon when targets are not met. Thirty-five percent of executives said management had changed in more than 40% of their mid-sized portfolio companies.

But changes in management can result from subjective as well as objective measures. Private-Equity investors said they will change company management if they have concerns about the quality and ability of the company's management and leadership, even more often than a failure to meet targets.

Concerns about management's abilities was the factor cited most frequently, with 72% of executives saying it was almost always or frequently the reason for a change in management. (See Exhibit 7.) Concerns about the quality of the company's leadership followed closely, cited by 69% of executives as a reason for a management change.

More objective measures were also important, with a failure to meet targets cited by 61% of executives as a frequent reason for changing management after an investment.

Exhibit 6. Typical Internal Rate of Return when Investing in a Mid-Sized Private Company

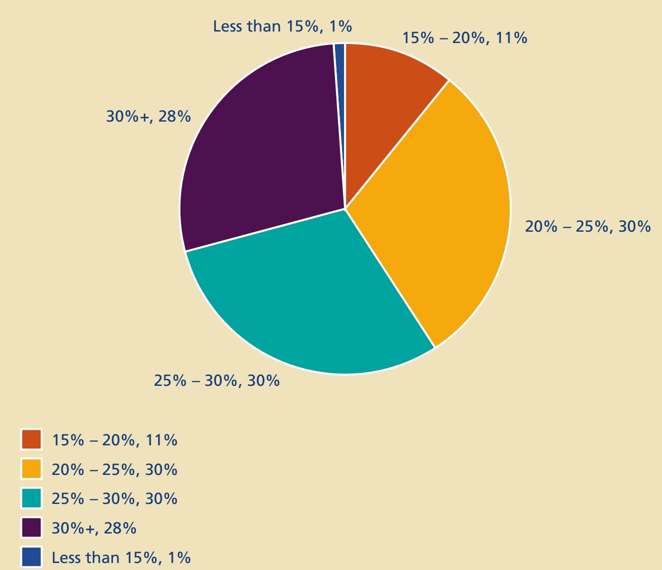
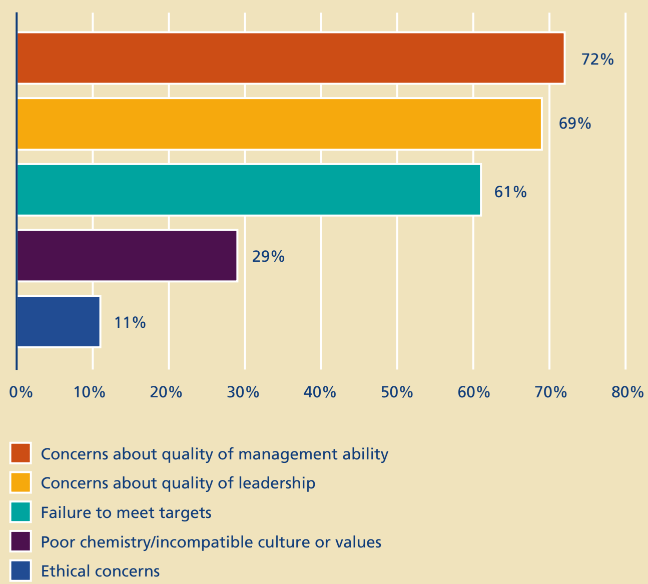


Exhibit 7. Factors when Changing Management in a Mid-Sized Portfolio Company
Percent of Executives Saying Factor is Almost Always or Frequently a Reason



Exit Scenarios

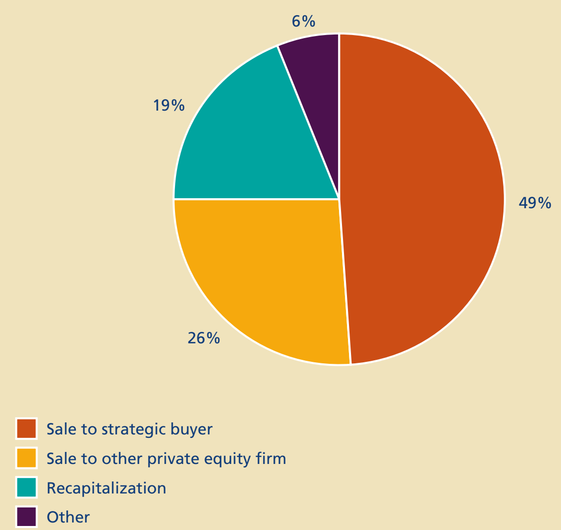
How long will a Private-Equity firm hold a middle market company in its portfolio? What type of transaction will they use to exit their investments?

Private-Equity executives said that mid-sized private companies were typically held in their portfolios for 4.3 years on average, while roughly one-third said companies were held for less than four years. In our experience, many Private-Equity investments appear to be exited more quickly than in the past. Private-Equity investors are simply weighing the potential benefits from continuing to hold a company in their portfolios—growing it, improving the cost structure, and paying down debt—versus capitalizing on other investments. When the bulk of the heavy lifting in adding value has been accomplished, which can often be accomplished within 18 to 36 months, many Private-Equity firms are pursuing sale alternatives. Private company owners and management teams should consider the implications of a sale that may come sooner than expected after a Private-Equity investment.

When asked what types of exit transactions their firm had used over the past three years for the mid-sized private companies in their portfolios, executives said that, on average, 49% of exit transactions had been sales to strategic buyers, while one-quarter had been to another Private-Equity firm. (See Exhibit 8.) Recapitalization accounted for only 19% of the exit transactions.

Private-Equity groups consistently assess the likely exit paths prior to making an investment. In today's market, the number of secondary buyouts (i.e., selling a company to another Private-Equity group) is on the rise. We expect this trend to continue as the combined demand from both strategic and Private-Equity buyers outstrips the supply of attractive middle-market companies available for investment.

Exhibit 8. Types of Exit Transactions for Mid-Sized Private Companies in Portfolio over Last Three Years
Average Percentage of Exit Transactions



End Notes

1 ThomsonFinancial, *Buyouts*, Volume 19, Issue 1.

2 Sender, Isabelle, "More Banks Turn to Private-Equity Funds", *BusinessWeek*, August 23, 2006