Private Equity - A Pathway to Exit a Privately Held Business

The leveraged buyout ("LBO") has become well-practiced among private equity professionals, and is now standard industry practice as a means by which to acquire private companies. Private Equity Firm began in the mid-1980. Today over 2,800 private equity firms exist in the U.S. alone, buying tens of thousands of companies each year. As its name implies, the use of financial leverage, or debt, is one of the primary elements that distinguish an LBO from a traditional acquisition executed with cash or stock. Leverage can enhance equity returns to the investors, who have discretionary control over all cash flows that exceed the debt payments incurred. Because interest payments on debt are tax-free, leverage improves equity returns by reducing the amount of equity required to acquire a company, and then further magnifies those returns through the favorable tax treatment that interest payments receive under US tax code.

Business Owners Seeking an Exit Plan from their business.

Private Equity Firms recapitalizing is a popular option, especially for privately held business as baby boomers retire in the United States and leave healthy businesses lacking heirs. Private equity firms typically favor this type of business as recognize the opportunity to acquire a high-quality business that needs minimal help, but comes with an owner that simply wishes take equity yet retains operating control of the business and as important, the owner gains a strategic and financial partner. Not every company is a viable candidate for Private Equity Firms. One or more of the following characteristics that Private Equity deal professionals typically seek when assessing a target company's viability as a candidate.

Hard Assets

Banks lend more cheaply against hard assets as collateral. If your assets consist predominantly of your employees, it can be very challenging to gain bank financing. Bank debt is usually collateralized by the physical assets of the company, so the more plentiful, sizable, valuable, and stable the assets – machinery, inventory, receivables, real estate – the more available and cheap the leverage for your deal becomes. While these hard assets certainly help the credit structure, intangibles like brand names, goodwill, and human capital have nonetheless become increasingly important considerations in an LBO.

Steady Cash Flows

Free cash flow is king in an LBO, and it's generally defined as the amount of cash that a business generates in excess of what's required to maintain its current operations. The reason this is so critical is because the free cash flow of a company's operations determines how much leverage that company is capable of supporting without imperiling its ability to stay solvent in a downturn.

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Maturity of Market

Companies selling into an established, well-defined market (e.g., automotive valves, soft drinks, etc.) are more conducive to an LBO than those selling into a fledgling market (e.g., social networks, nanotech, etc.). Indeed, while an entity's growth prospects are important, they are secondary to stability. A mature market with predictable demand, steady revenue, and no eminent game-changing, competitor-crushing disruptions is ideal for a buyout because the cash flows of the company are likely to be substantively more predictable. Low Capital Expenditure

Requirements

The lower the annual investment required to operate a business, the better. Consistently high levels of capital expenditure are unwelcome, as they consume cash that could otherwise go toward paying interest payments, principal debt payments, or dividends to the equity holders.

Non-Core Assets

There are few ways to boost cash flow more painlessly than to liquidate non-vital assets that carry an attractive value to the right bidder. If a publisher derives the majority of its topline from digital media, but maintains a costly and unprofitable printing press, it can sell the latter for cash. An experienced financial sponsor keen on leaning out of a business often spots this kind of low-hanging fruit quickly, and might move to sell anything of value that's not functionally synergistic with the core business.

Businesses Impaired by Underlying Industry Sectors

Sometimes businesses with attractive long-term earnings capacity are held hostage by a poor underlying industry or economy, causing deflated trading prices and valuations. Such opportunities are attractive, offering a chance to buy companies for cheap before an expected rebound in the market price.

[1]Source: Scoopbooks' "The Practioner's Guide to Investment Banking"