Minority Equity: Structural Considerations

To succeed at fund raising when banks won’t help, you need to understand private equity investors.

by Mark D. Working

A burgeoning economic climate has created an attractive opportunity to expand your business, but your banker can’t fill the funding gap. Ideally, a “silent partner” who will provide the needed capital would be just the ticket. This would allow you to continue to drive the business forward unfettered.

We’ve seen this scenario arise regularly. Unfortunately, this is not a set of conditions that attracts professional investors, a group that represents the greatest source of equity capital available to business owners. For those owners facing a funding need, it is important to understand the motives and practices of private equity investors so that fundraising can be successful.

WHAT IS “INSTITUTIONAL PRIVATE EQUITY”?

An enormous amount of institutional private equity capital is raised every year by professional managers and is targeted toward investments in private companies. Local examples include Vulcan Capital (Paul Allen’s investment vehicle), Endeavour Capital (a

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The greatest concern facing a private equity investor is that individuals and/or family owners might sacrifice economic return for other benefits, such as status, employment, continuity, or lifestyle considerations. A private equity investor making the same choices would violate its fiduciary responsibility to maximize the return on its investors’ money. Aligning the potentially conflicting interests of institutional and family owners, and providing protection for both, is the most challenging aspect to structuring an investment in a privately held company.

STRUCTURAL STRATEGIES

Institutional private equity investors have a few tools to help control the factors influencing risk and investment return. The table above summarizes the potential range of actions institutional investors typically demand to protect their investment.

The tradeoff between the current owners’ desire to retain independence and the investor’s need to protect its investment leaves two possible options for the company desiring external private equity. Either the existing owners can cede control over certain issues, or the investor can be offered economic priority. Often, in exchange for receiving a less-risky position than the existing owners, the investor can be more lenient with regard to “control” issues. Generally, as the two parties’ relative ownership approaches equality and there is a common purpose and investment horizon, negotiation of control provisions is emphasized.

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When the ownership position of the outside investor becomes disproportionately small and investment horizons diverge, economic priority is a more customary avenue to align the parties’ interests. Economic priority is typically achieved by tiering the equity structure. The new capital can be structured as convertible preferred stock, with a “put” option. This assures that the investor’s capital
and a portion of its return will have priority over the other owner(s) and that the investor will have a measure of control over the timing of its exit.

The point of all of this is that when there is economic opportunity that requires external capital, a financial partner can provide the fuel to grow the business. The challenge is to customize an investment structure to meet the objectives and fit the constraints of all parties. With a full understanding of the variables and alternatives, a structure can be developed that allows all parties to achieve their goals, and frees the business to realize the opportunities presented. ✤