Selling Your Business to Private Equity: Traps for the Unwary

By DAVID KRAMER

Selling to Private Equity (PE) is an attractive option for anyone looking to exit their business. In recent years, PE has been active in virtually all verticals, from white collar enterprises like accounting firms and medical practices to more blue collar businesses like car washes and HVAC companies.

Unlike traditional M&A activity of the past, however, selling to a PE firm often presents additional complexities—and traps for the unwary. This is equally true for experienced sellers who have sold prior businesses to more traditional buyers, and for first-time sellers exiting the businesses they formed decades ago (including the estimated 10,000 baby boomers who retire each day in the U.S.). Here are a few tips sellers should keep in mind when considering a sale to a PE firm:

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PE SPONSORS MAY NEED TO RAISE DEAL CAPITAL.

Despite the common perception of the deep-pocketed and well-funded PE firm, this is not always the case. While many PE firms are flush with cash prior to negotiating the terms of a particular acquisition, some PE sponsors raise deal-specific capital only after a target has been identified. Therefore, just as PE firms will diligence a target, sellers must diligence their PE sponsor to ensure that it has – or can quickly raise – sufficient funds to close the transaction. If not, the exit can be delayed.

THE SELLER WILL NOT RECEIVE ALL OF ITS CONSIDERATION AT CLOSE.

Because PE deals hinge on the target's post-closing success, these transactions are often designed to incentivize the target and its owners post-close. One way to accomplish this goal is via earnouts, or conditioning a portion of the purchase price on the target achieving certain performance milestones post-close. These metrics can include revenue or margin targets, cost-saving measures, operational objectives, or any combination thereof. For sellers, it is critical that the purchase agreement includes provisions requiring the PE buyer to maintain the business's historical business practices. Otherwise, it may be difficult to satisfy the milestone and achieve the earnout.

THE SELLER IS NOW IN THE MINORITY.

Another way PE firms may incentivize a seller post-close is to

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allow the seller to retain equity as part of its deal consideration. And while such a structure enables a seller to benefit from its business's future success, the seller must be prepared for – and structure around – the fact that it will now be a minority owner of the business that it once owned all or most of. In an ideal world, the seller will receive voting shares of the buyer entity, retain a board seat, and hold certain veto rights over major transactions like future sales or financings. Practically, however, PE firms are often reluctant to grant some of these controls. At the very least, it is imperative for sellers to understand what rights they will and will not retain in the business going forward.

Unlike traditional M&A activity of the past, selling to a PE firm often presents additional complexities.

PE activity is a driving force in today's M&A landscape. And while a PE deal can be a viable option for exiting a business, it requires careful attention to the above considerations and is certainly not a one-size-fits-all solution. To that end, the guidance of experienced counsel is a must when determining whether selling to PE is the right choice for your specific business.

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