

# The Impact of Private Equity: A Seller's Perspective

Investors who, a decade ago, experienced spectacular returns in the publicly traded securities markets are now seeking similar results in the same market despite an extended period of comparatively tepid performance since the corrections that occurred during the dot-com bust. Dissatisfaction with the publicly traded market has led to an increase in the amount of funds flowing into the private equity sector and ultimately deployed in M&A transactions. According to a survey by ACG and Thomson Financial, \$1.6 trillion of total combined M&A deal value occurred in 2006 in the United States alone, close to the record of \$1.7 trillion in 2000. Twenty-five percent of this deal value came from private equity funds. Further, the liquidity in the private equity market, the demand for attractive targets, and investors' desire for higher returns have resulted in transactions featuring higher-than-historical-average multiples.

Shareholders of publicly traded companies headquartered in Western New York have sold non-core businesses, or in some cases their entire holdings, to private equity concerns. Private companies struggling with second or third generations' disinterest in sustaining the family business are also looking to the private equity markets for an exit strategy. This trend in Upstate New York is creating unique opportunities and risks both before and after the deal closes.

Many private equity funds are managed by financial professionals who either desire or require local management of newly acquired companies to stay intact, preserving valuable jobs. Vesting control with existing management tends to also benefit area vendors and service providers who have worked with local managers in creating value over the years. Leaving the management and operating structure generally intact also avoids complicated integration plans that may otherwise disrupt a company's supply chain. Furthermore, having a private equity fund as a partner can allow for greater access to funds for future growth and acquisitions.

While these and other benefits can and are realized by the seller in private equity



## PROFESSIONAL OPINION

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transactions, issues can also surface that may or may not be anticipated or acknowledged before the transaction closes. The financial reporting demands placed on a newly acquired business by its new owner can put a strain on internal resources. Managers who typically ran the business based on "gut feel" and with little oversight are now subjected to more rigor and scrutiny in making strategic decisions. The leveraged buy-out nature of a typical private equity

transaction can also put financial stress on an organization, making it more difficult to make long-term strategic decisions if current cash flow must support debt service payments. Hidden management fees and other costs, as well as preferential dividends and required payments to private equity investors, can be detrimental to legacy minority shareholders that are required to maintain a stake in the newly acquired business. With the appropriate attention during the transaction negotiation process, most of these issues can be managed to the reasonable benefit of all stakeholders.

Sellers can manage their risks by following a structured approach and involving the right resources dictated by the circumstances. A carefully managed process can also ensure that the deal closes in an orderly fashion, while at the same time providing a fair value for the sellers. Salient things to think about in preparing for a successful deal include, but are not limited to, the following:

- Management should consider performing pre-emptive due diligence on their company to identify areas of interest to a potential buyer or transaction roadblocks. This will allow the management team to take appropriate corrective actions, where possible, to make the company more attractive to a buyer. Some believe an audit of a company's financial statements would address this issue. However, due to the fact that an audit of financial statements often does not cover the same types of issues that will arise during a due diligence process, a pre-emptive due diligence may still be beneficial.

- Consider the potential structure and tax impact on the selling shareholders and potential buyers. This will help man-

age the sellers' expectations in terms of after-tax proceeds, and assist with understanding the buyer's need to maximize deal negotiation strategies. This may also help to identify less obvious potential issues such as the bulk sales tax on the transfer of tangible personal property levied in New York State on asset deals. With proper planning and structuring techniques, the seller can mitigate the tax exposure for a potential buyer, making the company more attractive with a neutral impact to the seller.

- The seller should consider performing due diligence on the buyer on an as-needed basis. This becomes more crucial in cases where, for example, the sellers are required to exchange some or all of

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their shares in the company for shares issued by the buyer, or where the seller is required to hold a note for a big portion of the purchase price.

- Develop expectations with respect to continuing employment and related employment contracts. This will be particularly important in order for the organization to retain the appropriate talent. Private equity buyers will also be interested in developing a suitable compensation structure for key employees to assist them with maintaining and growing the value of the company.

These are just some of the key items a seller should contemplate. With a reasonably structured approach, a successful deal can become reality for all parties involved.

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