The Private Company Market Report: Minority Investments for Your Business

K. Perry Campbell, Ph.D., CM&AA
ACT Capital Advisors

Is a Non-Control Investment Right for Your Business?

As the need to invest continues unabated for private equity firms, more and more of them are reaching out to me to explain that they are now considering taking minority equity positions in small and mid-sized businesses. They often refer to themselves as "BDCs" or Business Development Companies since their goal is to grow and develop the smaller firms they invest in. Some BDCs are publicly traded. We've always maintained contacts with those few firms that were willing to take a non-control position in a company's equity. Now, however, there are many more options to choose from as many more of these BDCs have excess capital that they need to deploy so they are considering deals where they will end up owning less than 50% of the equity in a business.

What this means to an owner or an ownership group that would like to stay in control, is that they can have an experienced financial investor with access to abundant capital that has oodles of capability to help when needed but that will leave management and owners in control of business operations. It also means that the current owners can reduce their risk while still maintaining a very significant equity stake in the business, allowing them to profit from future business growth.

Many of the firms who offer this type of deal structuring are Small Business Investment Companies ("SBICs") who are not government entities, but have a mandate through the Small Business Administration to make investments directed toward job growth. Many of their investments take the form of loans to small and mid-sized businesses; however, they can also acquire equity in these businesses. In the past many of them limited their equity investments to control positions greater than 50 percent, but now more and more have begun to look at non-control equity positions. These groups will typically have a lending arm and an equity investment arm, so I consider them one-stop-shops. The same group brings all the money needed to make a deal. They'll say "We just write a check", and that's pretty much right. It works out to two checks in practice – one for their equity position (control or non-control) and one for an acquisition loan to bring leverage into the transaction. The sellers stay on board and continue to run the company, after having pocketed the money necessary to buy a minority share of the business.

So what's the catch? Not really a catch but a reality. Since many of the SBIC buyers of a minority share also become a lender to the business, they become like your new banker. Loans have covenants and restrictions, and loans from an SBIC are no exception. These become the new rules of the road for the controlling shareholders. I call them negative controls, since they effectively say "No, you can't do that unless you ask permission and get your lender's agreement." So you can't just decide to pay yourself a big dividend, or buy another company, or start a new line of business, or make a major investment in new equipment using the lender's money without first going back to them for a discussion and concurrence. It's a back door way to get some amount of control over a business, but other lenders have such restrictions and covenants too so it's not like this is a foreign concept. They want some say over how you decide to use their money when they lend it to your business. It's how minority equity investors get comfortable taking a non-control equity position. Having a lender who is also an owner of the business can be a good thing since they may be more understanding and cooperative with their partners if the business runs into a rough patch.

Most of these one-stop shop investors in both the equity and the debt of the company would like to be the company's only lender, except perhaps for an operating line of credit. As a cash flow lender, rather than an asset based lender these entities can usually loan more to a business than a bank can. Sometimes their loans to the company are in the form of mezzanine debt, i.e., loans with warrants attached. Warrants are like stock options and these options attached to the loan function to keep the interest rate of the cash flow loan lower than it otherwise would be. Sellers need to understand that cash flow loans are not cheap debt like fully collateralized loans might be. The amount of a loan over and above collateral is known in the trade as the "air ball". Lenders who finance the air ball have only the company's performance to fall back on. You'd have to pay me quite a bit to walk on a tight rope even with a net. Without a net? I'm not that much of a risk taker, but when dealing with those lenders who operate without a safety net you can expect to pay up. Occasionally loans from such firms are denominated as 1) a senior loan that is fully collateralized at interest rates that will look familiar to most owners, and 2) a junior loan with nothing much to back it up besides an expectation of future profits that will necessarily carry higher interest. The one stop shop investor can make money from all of these: 1) their equity investment (control or non-control), 2) interest on their senior loan, 3) interest on their junior "mezzanine" loan, 4) exercising warrants to increase their equity position at a future date specified in the terms of the warrant.

If you'd like to take some chips off the table while maintaining operational control and still own a majority of the company's equity an investment from a group like this might be your ideal solution. For this type of investment to make sense your firm will typically need to have a minimum EBITDA (Earnings Before Interest, Income Tax, Depreciation and Amortization) of $2 million. Some groups will have higher minimum investment criteria. You'll also need a good story about why your company makes sense to an investor – why will your business be worth more in the future than it is today?

ACT CAPITAL ADVISORS

K. Perry Campbell, Ph.D., CM&AA
Managing Director
WA: 360-696-9450 | OR: 503-520-5050 | Cell: 360-904-9048 | Free: 800-240-4609
www.actcapitaladvisors.com
Seattle | Portland | Phoenix | New York