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Why Sponsors Matter (Third of a Series)

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In our continuing special series on the value of private equity sponsors, we turn our attention to what motivates a family-run, privately-held, or even public company to sell to a private equity firm.

On the face of it, it would seem challenging to convince businesses owned by families for decades to give up control to an outside group. And private equity as an industry has not always had the best public relations. Yet the reality is quite different. For many reasons, sellers have looked increasingly to private equity to solve a variety of issues.

The most obvious is generational wealth transfer. There's a huge wave of baby boomer founders of small to medium-size companies who are heading to retirement. One study reported almost one-quarter of all entrepreneurs are over age 55. These patriarchs/matriarchs don't always have younger relatives interested in taking the reins of the family business.

There's also the problem of multiple generations with varied interests. We've seen many situations where one family member wants to keep the company, while the rest want to take monetize their share and pursue other interests. The remaining relative may not have the liquidity to buy out the rest of the family.

That's where sponsors come in. By investing significant capital, PE can give exiting families the liquidity they seek, yet still retain the interested member with a minority share of the equity, a board seat, and a C-level position on the management team.

As we noted last week, sponsors are able to provide both financing and expertise to take the company to the next level of growth. In those cases, the business can become exponentially more valuable to the family than if it had been held or sold outright. A smaller slice of a much bigger pie can be worth more than the original pie.

Another benefit to selling founders is the sales process itself. Large corporate buyers may be able to offer a higher purchase price at auction. But their integration plans often involve cost cutting and layoffs, rather than growth-oriented strategies. Sponsors have more flexibility integrating founders into future organizational plans.

Indeed, retaining key family personnel is a top PE priority with new buyouts. This is particularly true where continuity is critical, such as maintaining client relationships. In those cases family retention is viewed favorably by both the sponsor and lenders to the company.

Finally, sponsors understand that the auction process itself presents challenges. While it is designed to achieve the optimal price for the selling family, sometimes entrepreneurs recognize certain firms may be a better fit, despite a lower offer. Built-in incentives can help sweeten the overall pot.

Next week we examine the world of non-sponsored lending – the risks and rewards.